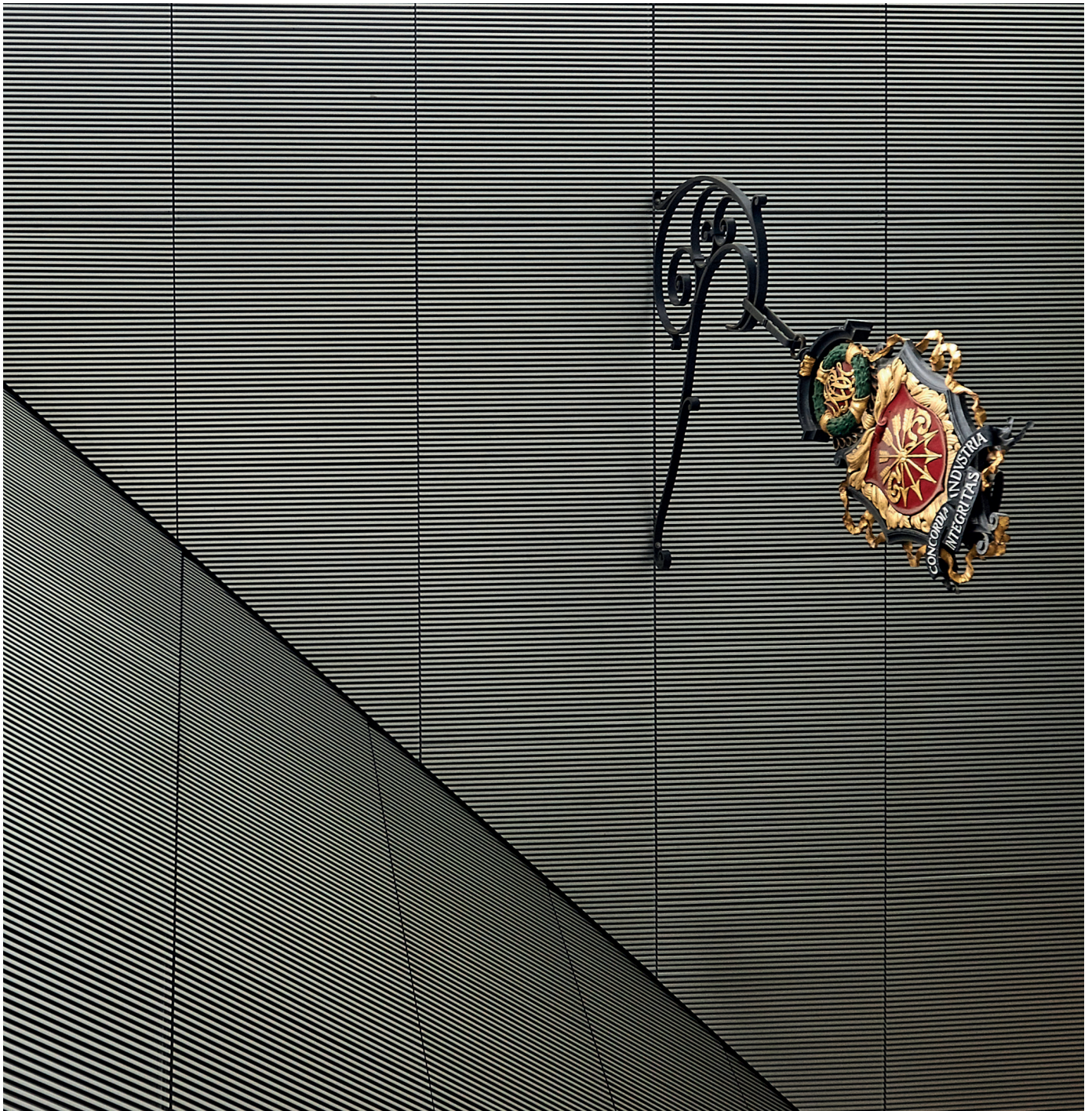


Market Perspective



The big chill? | It's about time

Issue 100 | March 2018



Foreword

The stock market is not a person. It doesn't panic, celebrate or pause for breath, though we often talk as if it does. Nor is it an animal. Bull and bear markets are no easier to analyse than the common garden variety.

Despite our anthropomorphic and zoomorphic tendencies, nobody really knows exactly why markets do what they do. We guess and infer, but without knowing exactly who the participants are, and why they're acting, we can't know for sure.

Prices can change without any trades taking place, and vice versa. Short-term moves can be random and meaningless. So we shouldn't over-analyse them.

We think February's sudden (yet unsurprising) setback was partly driven by a rethink on inflation and interest rates (see first essay).

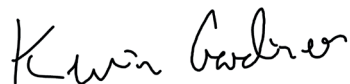
We suspect automated and volatility-related trading played a role. We knew that there were profits to be taken (how many times have we written here of an "overdue setback"?).

But we can't be sure. Which means we also can't be sure it is over – and that there aren't deeper fault lines out there waiting to be unearthed.

We think the investment climate is still constructive. Corporate earnings are growing, and interest rate risk – even after that rethink – remains relatively modest.

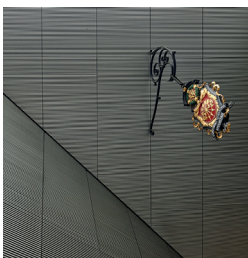
Valuations are full but not crazy. The protectionist threat is not new. But some of the reassurances we've seen are a little too glib. Some people out there seem to think a "risk premium" really exists.

Risky assets often do well, but that's despite their risk, not because of it. We think stocks can still beat inflation on a long-term view from here, but we're a little nervous. We always are.



Kevin Gardiner

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Cover:
A very public symbol of the heritage and values of the family business is the Rothschild shield positioned on the exterior wall of our New Court office in St Swithin's Lane, London. The five arrows combined with the family motto is the only advertisement for the business within.

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Publication date: March 2018.
Values: all data as at 28th February 2018.
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The big chill?

Growth cools – politics warms?

Growth may be peaking, but is unlikely to collapse. The political diary has just got friendlier.

Few cyclical excesses

Some indicators have been historically elevated, and couldn't plausibly be expected to go much higher. "Soft" survey data in particular had outpaced "harder" data such as GDP.

The picture on page 6 is not alarming. And at least it suggests inflation risk is not escalating out of control.

With labour markets in the US, UK, Germany and Japan looking tight, the odds have been tilting towards inflation. Overly loose monetary policy has been our biggest worry.

But it is one thing to think there is not enough inflation and real interest rate risk priced into bonds, and another to fret about hyperinflationary disaster. The latest US pay data has simply restored a gently rising trend (figure 1).

Meanwhile, US households continue to act remarkably responsibly for the ninth year of economic expansion. They are not borrowing recklessly: indeed, they continue to supply liquidity to the economy.

Nor do we worry about the "twin deficits" – the US (and UK) balance of payments and budget deficits. They are facts of modern economic life, and combined have been a lot larger in the past (figure 2).

Private, government and external balances are linked arithmetically. The US household surplus

(companies are roughly in balance) is reflected in the balance of payments deficit being smaller than the government's deficit.

The US' private surplus is more reassuring than its twin deficits are troubling. We do expect bond yields to drift higher, but not primarily because of the US need for funds. (Private sector cashflow is weaker in the UK, but not alarmingly so – and its twin deficits have been falling of late.)

It's all gone quiet over there

Meanwhile, as Italian elections move into the rear-view mirror (at least for the time being), and the German SPD opts for coalition with Chancellor Merkel, the electoral calendar suddenly looks empty compared with the last two years.

No offence to our Russian, Mexican, Swedish and Brazilian readers, but there are now no obviously market-moving elections scheduled until the US mid-terms in November.

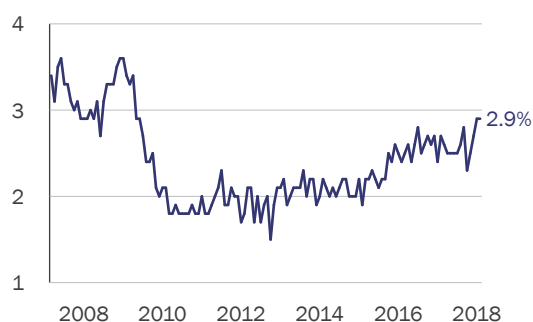
Geopolitics retains the capacity to surprise. Flashpoints include Korea, ongoing – and widening – trauma in the Middle East, and the protectionist instincts of an impulsive POTUS.

Despite its precarious parliamentary position, the UK government continues to negotiate with itself rather than its EU partners. So does the main opposition party – the least business-friendly to get this close to government.

But callous capital markets are not always moved by humanitarian concerns, remember. Even now, the US protectionist bark may be worse than its bite. China is the most protected big economy,

Figure 1: US wages are inflating slowly

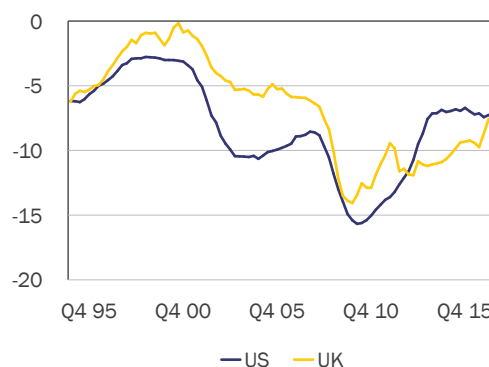
Average hourly earnings, % y-o-y



Source: Datastream, Rothschild & Co

Figure 2: Twin deficits

The sum of current account and budget deficits, % GDP, 4q mav



Source: Datastream, Rothschild & Co

and perhaps more willing to compromise – or to help in North Korea – than imagined.

We still think the costs of even a hard Brexit could prove manageable. Luckily, embarrassment

doesn't affect portfolio returns. And an early, unscheduled UK election seems unlikely.

So as growth cools, perhaps the political temperature is getting more comfortable.

Investment conclusions

Stocks remain moderately expensive (a plausible end-2018 P/E ratio for the S&P 500 of 18x is not outlandish). Some protection is warranted. But the investment climate still seems benign, and a more substantial portfolio restructuring might leave us stranded if stock markets rally. Tax cuts and growth have restored headroom in the US; globally, profits are growing, interest rate risk remains modest and some political risks have faded. Stocks can still deliver inflation-beating long-term returns.

- Government bonds have weakened further but remain expensive (more so than stocks), flattered by central bank buying. Most yields are still below likely inflation rates. We still prefer high-quality corporate bonds (credit), but they are also unlikely to deliver positive real returns. We view bonds and cash currently as portfolio insurance.
- In the eurozone and UK, we continue to favour relatively short duration bonds. In the US we have been more neutral, and see some attraction in inflation-indexed bonds. Speculative grade credit has cyclical and policy support for now, but we think it has run out of longer-term headroom: net of likely

default and loss, returns may struggle to match inflation.

- We prefer stocks to bonds in most places, even the UK (where the big indices are in any case driven by global trends). We continue to favour a mix of cyclical and secular growth over more defensive bond-like sectors.
- Trading currencies does not systematically add value, and we have even fewer convictions than usual. The pound rallied from its oversold levels as we'd thought it could, and we are now more neutral: the Bank of England may raise rates faster than markets expect, but domestic politics feel more precarious. The dollar's weakness has not yet made it cheap, and higher interest rates are largely baked in. The euro is no longer cheap, and economic surprises have peaked. The yuan is dear relative to trend, but the softest of landings for the Chinese economy – and slower liberalisation – has boosted it. The yen remains inexpensive, but its monetary policy remains the loosest. Of the big currencies, we single out only the still-expensive Swiss franc, whose safe-haven appeal has fallen: we expect it to lag the others.

It's about time

Bond yields and stocks

A reminder of why rising bond yields might matter for stocks.

Inflation and interest rates

Moderate inflation is broadly neutral for business overall, though some companies have more pricing power than others. But central banks and investors push up short-term rates and bond yields (long-term rates) in response to – or anticipation of – it.

Policy rates may rise by more or less than the immediate inflation threat, depending on how central banks see things playing out. If their response is credible, there may be little or no effect on bond yields. If it is not, they may be

“behind the curve”, and bond yields rise further than short-term rates.

Rates and/or yields can easily rise by more than inflation: that is, real interest rates can rise – maybe in order to prevent the risk growing, or perhaps they were too low to begin with. Since November, inflation expectations have risen, but so too have real yields – especially in Europe.

This is not surprising: yields had fallen to record lows. Inflation was weak, and central banks pulled yields lower via quantitative easing. But growth has gathered momentum, adding to demand for capital.

How do rates and bond yields hurt stocks?

They can affect stocks in three main ways:

- directly, by raising corporate interest charges and cutting net income;
- indirectly, via the economy and currency; and
- indirectly, via valuations.

The direct effect of interest charges is often muted. Many corporate loans are at fixed rates or coupons. Increases now are starting from relatively low levels. Financial companies can benefit from higher rates.

Turning to the indirect effects, rates affect economies and currencies in many ways. Real rates matter most to the economy – are rates rising faster than companies' selling prices, or workers' wages? Rising real rates can slow an economy by cutting spending power and making saving more attractive.

The early moves in a rate cycle may have least impact.

The gap – or spread – between countries' nominal interest rates matters most to exchange rates (each would-be buyer of a currency faces one inflation rate). An unexpected rise in interest rates usually boosts a currency.

Sadly for economic modellers, these indirect linkages are far from mechanical: they vary unpredictably, and context is important.

If interest rates are rising because growth is strong, their impact can be lost in the wash. In this context they are more effect than cause (just as we suggested currency moves can be in our February issue).

Similarly, better terms of trade for importers and consumers might more than offset the restraining effect of a stronger currency.

The early moves in a rate cycle may have least impact. Later in the cycle, after spending and borrowing have risen, and fixed rates have rolled off, behaviour can be more sensitive.

Higher rates then may be the straw that breaks the camel's back: recession – and a weaker currency – can follow. We do not think we are currently in such a sensitive phase of the cycle.

(Note that stock valuations can also affect bonds. Economic influence is rarely a one-way street).

Relative valuations: the \$64,000 question...

The possible effect of bond yields on stock valuations is a surprisingly emotive subject for strategists. Perhaps we need to get out more.

Many value investors ignore rates altogether. They focus on stocks' long-term fundamentals only, assuming that fluctuating interest rates and bond yields – like volatility in corporate earnings – will even out over the cycle.

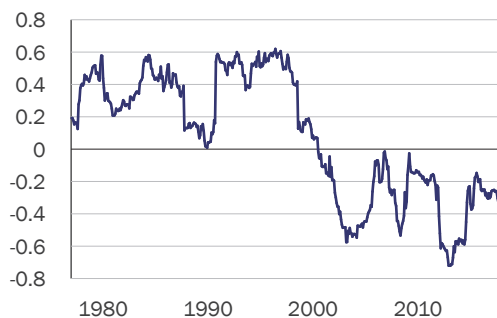
There has not been a systematic relationship between bond yields and stock valuations. Instead of a predictable link, the correlation between bonds and stocks has even changed sign (figure 3).

For a while in the 1980s and 1990s, the two assets did move together more often than not. Rules of thumb linked their valuations through the gap or ratio of their respective yields, as in the "Fed model" (1997). But they didn't last.

Despite this patchy practical history, we can imagine how the two assets might be linked. It's not just because they are competing investments, though this matters. Generally, if we're going to value an investment using

Figure 3: Stock and bond correlations are not stable

Rolling three-year correlation coefficient for US stocks and bonds



Source: Datastream, Rothschild & Co

Figure 4: The Fed model broke down in the noughties

Yield gap: US stocks' earnings and 10-year bonds (%)



Source: MSCI, Datastream, Rothschild & Co

its future cashflow, we need to translate that cashflow back into “present value”. And this requires a discount rate.

This is after all how we value bonds themselves. Equity earnings, dividends and profitability vary over time. If growth (nominal or real) or return on capital is likely to fall, or the riskiness of stocks rises, we would expect stock yields to rise relative to bond yields – which is what happened in the noughties.

Hindsight is wonderful. In practice it took a while for the penny to drop, but conservative pension accounting and the “dotcom” fiasco (making stocks riskier for trustees to hold), the impact of “the China price” on inflation and perceived profitability, the stress of the Global Financial Crisis and reduced bank leverage all helped demolish those rules of thumb.

Stock yields being relatively high – in the UK, dividend yields pushed above long-dated gilt yields in 2008 for the first time since 1959, and have mostly stayed there since – was then little comfort.

Investors sold stocks because they didn’t believe current dividends or profitability. They bought bonds not because they looked cheap, but because they looked safe.

It was another instance of how cause and effect in investing can reverse. Relative yields became an output of investors’ asset allocation decisions, not an input to them.

Here for the duration

But stocks remain the longest-lived investments in capital markets. They are like risky, perpetual bonds with growing coupons: there is no principal repayment, but their cashflow grows into the indefinite future (figures 5 and 6).

The bulk of their present value is derived from that future cashflow: in the jargon, they are long-duration assets (which helps explain their

volatility). The cashflow is uncertain. But if we use risk-adjusted bond yields to discount it, a back-of-the-envelope calculation (the only sort available!) suggests US stocks may not look expensive until the 10-year Treasury note yield pushes above 4%. It is currently at 2.9%.

Perhaps we have come full circle, and the cult of the bond will follow the “cult of the equity” into extinction. UK pension funds’ holdings of stocks have fallen from a peak of 80% in 1994 to 45% in 2016 as accounting changes and stocks’ volatility have encouraged trustees to see bonds as the best match for long-dated pension liabilities.

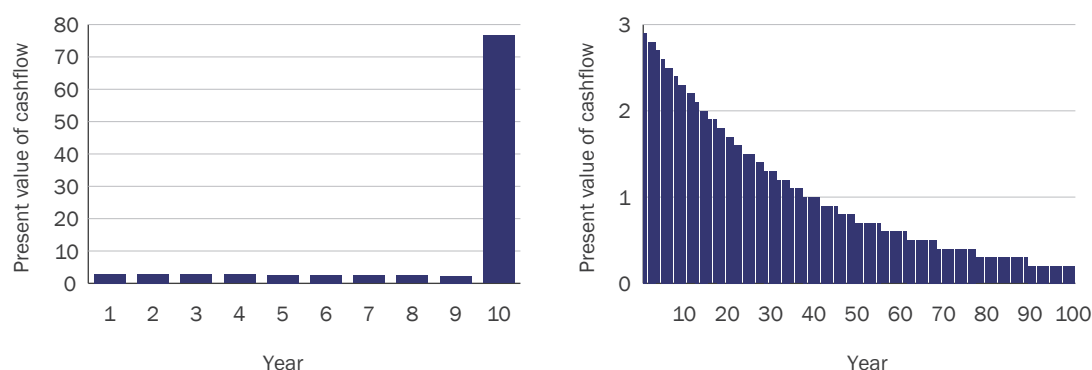
Bonds are more predictable, but they may be the shorter duration asset. However, defined benefit pension plans are unlikely to be reopened. And before a positive correlation between stocks and bonds is re-established, they may need to move in opposite directions for a bit longer first.

In the noughties the negative correlation mostly saw stocks fall and bonds rise, but in the last few years stocks have often risen while bonds have weakened. If inflation and interest rate risk is returning, it may be stocks whose prices trend higher (setbacks like February, when both fell together, notwithstanding).

When interest rates and bond yields have risen far enough, and the economy has weathered its next cyclical downturn, there may eventually be room for the two assets to move together again – positively, as part of “business as usual”.

Figure 5 and 6: Stocks are the long-duration asset

Present value of stylised bond cashflows (left) and equity cashflows (right)

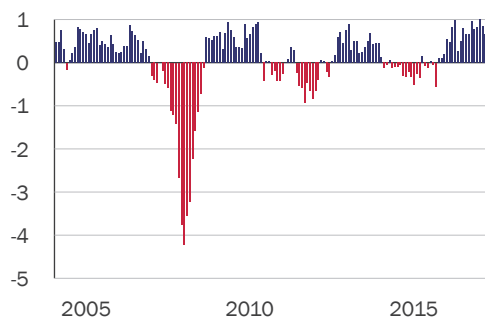


Source: Rothschild & Co

Economy and markets: background

Growth: major economies

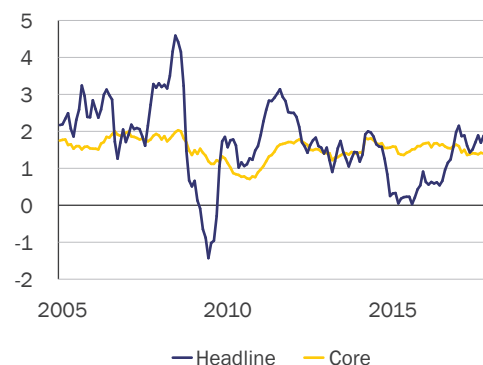
Business optimism: standard deviations from trend



Source: Bloomberg, Rothschild & Co
Composite of the forward-looking components of manufacturing surveys from China, Germany, Japan, UK and US loosely weighted by GDP

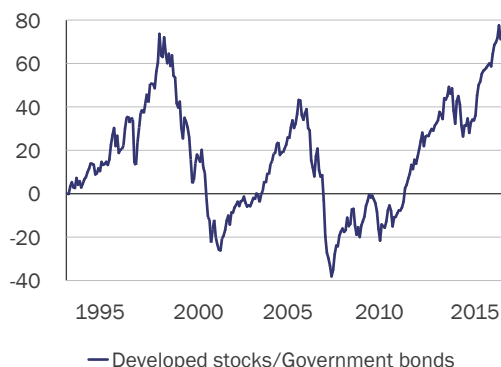
G7 inflation

%, year-on-year



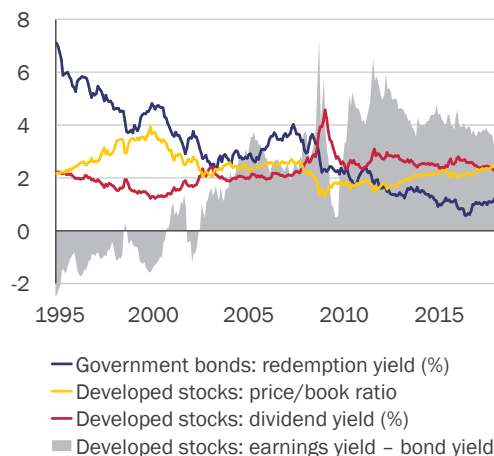
Source: OECD, Bloomberg, Rothschild & Co

Stocks/bonds – relative return index (%)



Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

Stocks/bonds – relative valuations



Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

Selected bonds

Current yields, recent local currency returns

	Yield (%)	1yr (%)	3yr (%)
10-yr US Treasury	2.9	-1.3	0.3
10-yr UK Gilt	1.5	-1.9	8.1
10-yr German bund	0.7	-3.0	1.0
10-yr Swiss Govt. bond	0.1	-1.9	1.0
10-yr Japanese Govt. bond	0.1	0.3	3.3
Global credit: investment grade (USD)	1.9	1.6	5.8
Global credit: high yield (USD)	5.6	4.8	20.5
Emerging (USD)	4.9	3.5	16.5

Source: Bloomberg, Rothschild & Co

Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

	Yield (%)	1yr (%)	3yr (%)
World: all countries	2.3	15.0	26.1
Developed	2.3	13.6	25.3
Emerging	2.3	26.7	32.2
US	1.9	16.4	34.0
Eurozone	2.9	10.1	11.2
UK	4.2	3.1	16.1
Switzerland	3.2	6.9	8.2
Japan	2.0	16.1	17.8

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (1980 = 100)

	Level	1yr (%)	3yr (%)
US dollar (USD)	102	-6.9	2.0
Euro (EUR)	125	7.6	10.4
Yen (JPY)	90	-1.3	12.4
Pound sterling (GBP)	78	1.2	-13.6
Swiss franc (CHF)	155	-3.4	-2.4
Chinese yuan (CNY)	135	2.6	-2.5

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	194	1.7	-13.4
Brent crude oil (\$/b)	65.8	18.3	5.1
Gold (\$/oz.)	1,318	5.6	8.7
Industrial metals (1991 = 100)	277	15.4	16.2
Implied stock volatility (VIX, %)	19.9	53.6	48.8
Implied bond volatility (MOVE, bp)	63.0	-11.7	-31.1

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Notes

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