Market Perspective

We get there when we get there

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Rothschild
Private Wealth

Foreword

The media – and much of our industry – sees economics and finance as drama. Urgency, imperatives and sensation abound.

We anxiously await imminent recessions, market crashes and renewed emergency cuts in interest rates. We hear Italy's debt is unsustainable, and that the euro is doomed. We are told the Trump presidency and Brexit must end in economic disaster.

Amid the drama, wealth management is presented as an urgent, relentless hunt for returns, encapsulated in a unique, 'optimal' portfolio.

The reality is less exciting. Most of the time workers and businesses are steadily getting better at what they do by producing more stuff, more productively. In practice, investing is more of a marathon than a sprint, and there are many perfectly acceptable portfolios. A little patience can help.

Thus it still seems to us as if the next US recession and/or financial crisis may be some way off – higher interest rates, bond yields and oil prices notwithstanding.

Italy's renewed profligacy looks underwhelming. The trade tussle is becoming more focused along the US–China axis, but we can imagine positive as well as negative outcomes. A UK–EU deal is still feasible – as is a longer transition.

Sensation-hungry pundits will be right again one day (and by then we may even agree with them). Volatility has stayed remarkably low this year, and a rebound to more 'normal' levels remains overdue (as we have said many times). We can see more testing times ahead as US profit growth slows sharply in 2019 while the Federal Reserve (Fed) continues to normalise interest rates.

But economies and markets do not always collide and crash. If we invest as if they do, our portfolios may well be more resilient when the bad stuff eventually arrives – but they may be smaller too.

Kevin Gardiner

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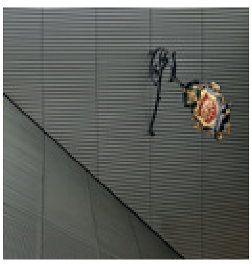
Global Investment Strategist
Rothschild Wealth Management



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.

Publication date: October 2018.
Values: all data as at 30th September 2018.
Sources of charts and tables: Rothschild & Co or Bloomberg unless otherwise stated.

We get there when we get there

Patience is an investment virtue

Dash: "Are we there yet?"
Mr Incredible: "We get there when we get there."

US rates and the next downturn

As we write, global bond yields have been rising, led by strong US data and Fed policy. This is hardly a surprise, and it need not be telling us anything other than that bonds have been more expensive (and yields lower) than the economic climate warrants.

It would have been big news in September if the Fed had *not* raised interest rates for an eighth time in this cycle: a hike was almost unanimously anticipated.

The first move was in December 2015. We then waited a year for the next, with the tempo picking up since.

At 2.25%, the top of the Fed funds band is now 200 basis points higher than at the all-time low reached after the Global Financial Crisis (figure 1). As of October 2017, the Fed's balance sheet has been slowly shrinking too as quantitative tightening (QT) replaces quantitative easing (QE) (figure 2).

It feels as if we've travelled a long way in terms of monetary policy. The Fed dropped a long-standing reference to monetary policy remaining accommodative. Meanwhile, trade war remains a risk – the US–Mexico–Canada Agreement (USMCA) notwithstanding – and the US expansion is firmly into its tenth year, the second-longest ever.

So, are we nearly there yet? Is the Fed's normalisation job done?

We think not. The independent Fed will continue to do what it thinks is right – whether Mr Trump agrees or not, and irrespective of the result in November's mid-term elections – and its own projections for interest rates, the 'dot plot', continue to point to a further four rate hikes between now and the end of 2019.

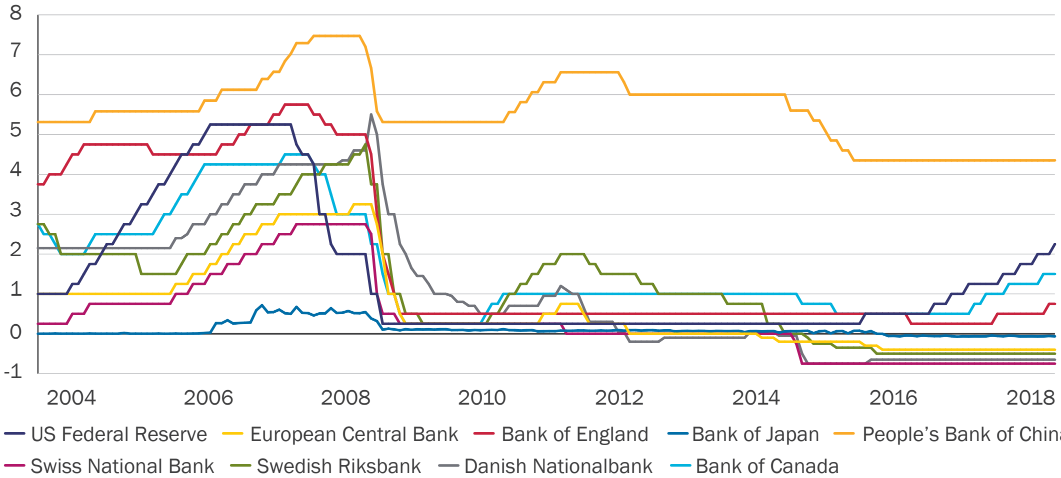
Chairman Jerome Powell made it clear that the committee still sees the US economy as strong. We agree. The upturn is getting on a bit, but it shows few signs of dying from natural causes.

GDP growth has been tracking firmly above trend; unemployment claims have been at record lows as a proportion of the workforce; and consumer and business confidence are elevated. Households' cashflow is robust and their collective net worth is dauntingly high. Inflation is modest, but drifting higher.

Moreover, the Fed has in reality been running fast almost to stand still. The US interest rates that matter most – real long-term rates – have not risen much, even after the early October sell-off, and remain low (figure 3).

Figure 1: Conventional monetary policy

Selected policy rates (%)



Source: Bloomberg, Rothschild & Co

A wider view of monetary conditions, which takes the exchange rate into account, doesn't materially change the picture. Recent moves notwithstanding, the dollar's real, trade-weighted value has barely risen since 2015. It is up against many emerging currencies and the pound, but down against the euro and yen.

Meanwhile, the Fed's balance sheet – which affects the real economy much less directly than interest rates and the exchange rate – has shrunk by less than 10%.

Talk of a sudden economic slowdown triggered by Fed rate hikes thus seems premature – so too does talk of a Fed pause. This suggests further bad news is in store for bonds, but not necessarily for stocks.

The third-quarter results season is at hand. We could see a third consecutive 20%-plus outcome for earnings growth, and a forward price–earnings ratio anchored at 17 – less remarkable than a 10-year Treasury yield still at just 3.2%.

Will oil do the Fed's job for it?

Commodities have been having a difficult time of it in 2018 – with the notable exception of oil. Internationally traded Brent crude prices have hit a post-2014 high at $85 per barrel, up 26% year to date, while US WTI is also up 24%. Dearer petrol pushes headline inflation up, but the overall impact is deflationary – it damps growth and core inflation by cutting consumer spending power.

Moreover, this surge probably reflects supply disruptions – reimposed US sanctions on Iran.

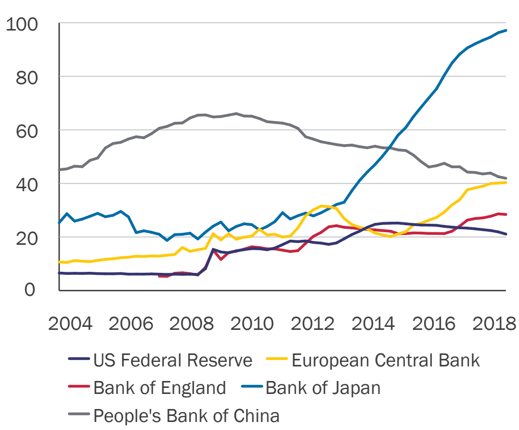
Will oil prices do the Fed's job for it?

Again, we doubt that the likely impact is yet big enough to dent the momentum currently behind consumer spending.

But there could be a material impact on corporate earnings – positively. Most big quoted companies

Figure 2: Unconventional monetary policy

Selected central bank balance sheets (% local GDP)



Source: Datastream, Rothschild & Co

– financials, tech, consumer and pharma sectors for example – buy little oil. Airlines buy oil, but they are small. The oil sector itself is big, and of course gains from higher prices.

Rome won't be dismantled in a day

Perhaps the recessionary threat lies in Europe, in the shape of a financial crisis driven by surging borrowing by Italy's populist coalition, in blatant disregard of EU guidelines?

It could, but we doubt it – not least, because Italian government borrowing is probably not about to surge.

The clue is in the headlines citing the proposed deficit of 2.4% of GDP. Crises are not usually made of decimal points. The big figure is much lower than feared at the time of the election, and the deficit would be one of the lowest since 2007, after 2018's likely 1.6%.

This is in no way a justification of the coalition's fiscal stance, let alone its wider character. But despite the predictable response from European Commission President Jean-Claude Juncker, its proposed profligacy is underwhelming.

Italy's government is borrowing to pay its interest bill – it has a primary budget surplus (unlike France). It spends less than half of GDP (unlike France). It needs to reduce that debt, but its new plans are not necessarily inconsistent with doing so, albeit more slowly than the EU would like.

Italy's (gross) government debt is 131% of GDP. Another 2.4% would be a proportionate increase of 1.8% (2.4% divided by 131%). If nominal GDP grows faster than this, the debt ratio will fall.

Nominal growth of 1.8% is hardly unattainable: it would be in line with the five-year average. Growth in the second quarter was 2.6% (compared to 2.4% in France). Of course, the deficit may overshoot the planned 2.4%. But it may not.

Italy's debt ratio has been high and rising for many years, peaking (so far) in 2017 at 132%. Much of it is held by consenting Italian adults – less than a third is owed abroad. Italy has a balance of payments surplus, and its private sector borrowing is unremarkable.

That balance of payments surplus partly reflects Italy's weak domestic spending – but it also suggests that Italy's competitive position is not as grim as many suggest. Italy is not Greece.

In neither country, by the way, is a cheap new currency the obvious road to economic success. 'Piling 'em high and selling 'em cheap' is not a sustainable business plan for a developed economy. If a weak currency was all it took, the UK would have carried all before it after 1949.

To repeat: this does not make us fans of the Italian coalition or its budget plans. We're just questioning the urgency of the debate (and this has not prevented us holding some portfolio insurance on this account).

Developments in France are likely more important for the euro than those in Italy (which is usually in some political disarray). If President Emmanuel Macron's liberal agenda were to fail, it might pose a bigger threat to the 'muddle-through' scenario than events in Rome. So too might a eurosceptic chancellor in Germany.

Developments in France are likely more important for the euro than those in Italy.

A captive curve

The US and Swiss economies don't often have much in common, but both have been beating expectations in recent months. Is the Swiss National Bank (SNB) likely to join the Fed in normalising interest rates soon?

We think not. Despite the local economy's clear ability to diverge from the embrace of the surrounding eurozone – fully employed Switzerland has been growing faster than the eurozone for almost a year now – its monetary policy has few degrees of freedom. (Fewer, for example, than Norway – which has already raised rates – and Sweden).

The most important drivers of Swiss rates and bond yields are euro rates and German Bund yields, not the local economy. Swiss rates mostly stay close to their neighbour's.

This is because the SNB doesn't want to draw attention to the franc, which is a small but perceived 'safe' currency with the potential to move sharply. In an attempt to avoid destabilising capital flows, SNB rate moves tend to echo those at the European Central Bank (ECB). If this doesn't succeed, and the franc comes under sustained upward pressure, the SNB often intervenes directly, 'leaning against the wind' by selling francs.

Sometimes the flows are just too big – as in late January 2015, when the SNB abruptly stopped selling the franc and it surged briefly to parity and beyond. Continuing to sell (effectively, to create) francs would have committed the SNB to even larger holdings of overseas assets, and to making available even greater domestic liquidity when local real estate markets were already overheating (even as the economy was then languishing).

The franc has since been slowly returning to earth, only to be boosted anew this spring by global risk aversion. The Swiss economy is better placed to withstand another surge in the franc than many would have guessed – you don't buy Swiss products because they are cheap. But even so, we think Swiss rates are on hold until the ECB moves, which it has suggested may not be until the second half of 2019 (though a governing board member recently noted that this timeline could be reviewed).

When or if risk appetite settles down, we think the franc – which to us still looks expensive on a long-term Big Mac index-type view – will eventually resume its gradual descent.

What about Asia?

The trade tussle between the US and China is hitting emerging Asian markets hard, but we doubt that it heralds the end of the current business cycle or alters the long-term outlook.

Asia is the fastest growing and most dynamic part of the global economy, and likely to remain so for the rest of our working – and investing – lives. Most of the world's population lives there, and in an era of mobile capital and technology, the world's economy and capital markets will gravitate there too.

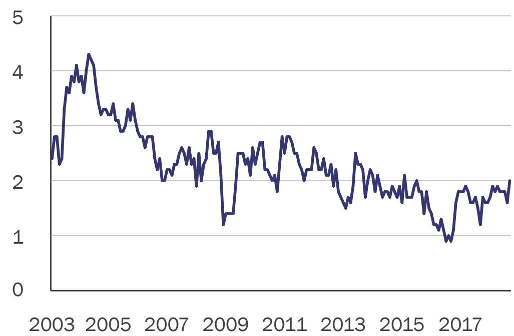
Meanwhile, in contrast to the rest of the commodity-dependent emerging bloc, emerging Asia is diversified, has little reliance on external capital, and is relatively stable – if imperfect – politically.

A bad outcome from the current trade spat is far from certain.

With the North American Free Trade Agreement (NAFTA) replaced by the USMCA, and with US–EU body language more conciliatory, the Trump administration is free to focus on China.

Figure 3: Long-term inflation-adjusted US rates remain low

US 30-yr mortgage rates less wage inflation (%)



Source: Datastream, Rothschild & Co

History shows China does not take kindly to such external bullying. But it also shows China's steady economic thaw has been delivered not at the behest of the West, but because it has been in China's long-term self-interest.

That liberalisation is far from complete – China remains the most protected big economy, and is well aware of it. The risks from a further escalation in tariffs are clear – though China will run out of additional measures before the US does, simply because it has fewer doors to close – but we continue to see the possibility of a more positive outcome.

(The region's sleeping giant, India, is also relatively closed, but – luckily – below the US radar in the current skirmish.)

US interest rates and a strong dollar are additional short-term threats, but comparisons with the financial climate and policies that triggered the 1997 Asian crisis look mistaken.

Rising US tariffs have not yet done much visible damage. Leading indicators for the wider Asian region are improving, and while US domestic spending remains vigorous, the effects of higher tariffs on Asian exports to the US may stay muted. Recent weakness in corporate earnings largely reflects currencies – profitability has risen, and is above its 10-year trend.

In the meantime, the region's sell-off in the face of trade worries and dollar interest rate risk leaves it more attractively valued than usual. We don't know when markets will stabilise, but we see current levels as a long-term opportunity.

Investment conclusions

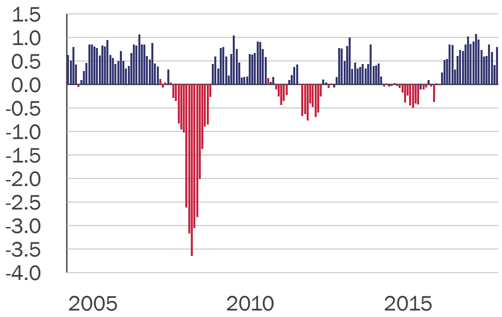
Our portfolio managers hold some specific protection in anticipation of volatile stock markets. But a more defensive portfolio might leave us stranded if markets rally. The economic climate remains constructive, and stock valuations are full but not prohibitive. US tax cuts and growth have restored some headroom; interest rate risk remains modest; and geopolitical risks may be manageable. Stocks can still deliver inflation-beating long-term returns.

- In inflation-adjusted terms, long-term US Treasury yields still look low, even after the recent rise. Other government bond markets remain still more expensive – most nominal yields remain below likely inflation rates. High-quality corporate bonds also remain expensive, but at this stage of the business cycle we still prefer them to government bonds (though the room for renewed corporate outperformance is falling, particularly in the eurozone, where the ECB's buying will shortly cease and Italy/Turkey credit concerns pose some limited risk to banks). Generally, we still view most bonds and cash currently as portfolio insurance.
- In the eurozone and UK, we continue to favour relatively low duration bonds. In the US we have been more neutral, and see some attraction in inflation-indexed bonds. Speculative grade credit still has some cyclical and policy support, but has run out of longer-term headroom – net of likely default and loss, returns may struggle to match inflation. We are not tempted by emerging market bonds, even after their bigger sell-off.
- We continue to prefer stocks to bonds in most places, even the UK (where the big indices are in any case driven by global trends). We have few regional convictions – though we think that emerging Asia's structural appeal remains intact, recent trade tension and volatility notwithstanding – and continue to favour a mix of cyclical and secular growth over more defensive bond-like sectors.
- Trading currencies does not systematically add value, and there are currently few obvious misalignments among the majors. Cyclical momentum and interest rate carry clearly favour the dollar, but it has yet to break out of its recent trading range. The pound is still hostage to Brexit tensions, but the domestic policy mix is shifting in its favour and it is competitive. Higher ECB rates remain some way off, and there are some local credit risks (Italy and Turkey-related bank stresses), but QE at least is almost finished, the euro is inexpensive and we remain sceptical of the euro disaster scenario. China's monetary policy is loosening preemptively, and the yuan has fallen back towards trend, but on a long-term purchasing power parity (PPP) basis it was competitive to begin with. The yen is cheap, but its monetary policy remains the loosest. We have been singling out only the Swiss franc among the big currencies: we think its revived safe-haven appeal will fade, and it remains expensive on a PPP basis. But as noted, the local economy is in (even) better shape than we'd realised, and if this starts to matter (see above), the franc may yet stay stronger for longer.

Economy and markets: background

Growth: major economies

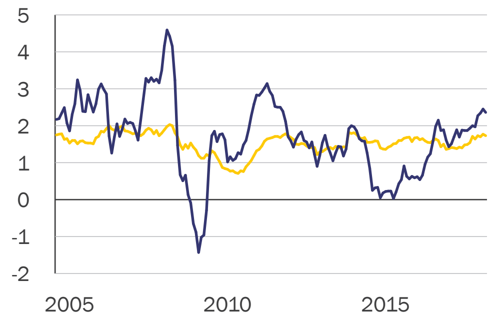
Business optimism: standard deviations from trend



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

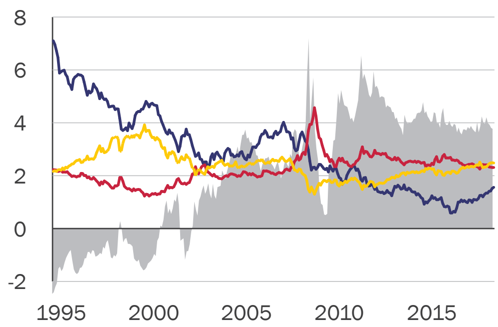


Source: OECD, Bloomberg, Rothschild & Co

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	3.1	-3.1	-0.4
10-yr UK Gilt	1.6	0.3	7.2
10-yr German bund	0.5	0.9	4.1
10-yr Swiss Govt. bond	0.0	0.2	-0.0
10-yr Japanese Govt. bond	0.1	-0.1	2.3
Global credit: investment grade (USD)	2.2	0.9	7.3
Global credit: high yield (USD)	6.3	1.2	25.2
Emerging (USD)	5.8	-1.6	17.3

Source: Bloomberg, Rothschild & Co

Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

	Yield (%)	1yr (%)	3yr (%)
World: all countries	2.4	11.6	47.8
Developed	2.3	12.7	48.4
Emerging	2.7	3.3	42.5
US	1.8	17.7	61.1
Eurozone	3.2	0.1	27.5
UK	4.2	6.6	41.6
Switzerland	3.1	3.1	20.5
Japan	2.0	11.0	31.0

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (1980 = 100)

	Level	1yr (%)	3yr (%)
US Dollar (USD)	108	3.2	2.5
Euro (EUR)	127	2.7	8.1
Yen (JPY)	89	1.4	7.1
Pound Sterling (GBP)	78	-0.1	-13.8
Swiss Franc (CHF)	158	2.0	0.3
Chinese Yuan (CNY)	130	-1.1	-8.4

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	195	6.6	1.2
Brent crude oil ($/b)	82.7	44.1	74.7
Gold ($/oz.)	1,193	-7.4	5.3
Industrial metals (1991 = 100)	249	-3.0	29.7
Implied stock volatility: VIX (%)	12.1	26.9	-56.1
Implied bond volatility: MOVE (bps)	46.2	-11.0	-40.0

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data correct as of 30th September 2018.

Notes

At Rothschild Private Wealth we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.

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Important information

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