Market Perspective

Slowing, not collapsing | Protest or pendulum?

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Rothschild & Co
Wealth Management

Foreword

The slowdown continues. It's still not clear whether it's a cyclical comma or a full stop. Our money remains on the former, but if we're wrong – US recessions can be difficult to spot in advance – we still don't see the need for a more dramatic punctuation.

This unloved cycle has been a relatively polite one. There are few macro excesses to be corrected: consumers, and consumer price indices, have not been misbehaving.

Moreover, some of the slowdown can be traced to some very specific and non-macro drags. The auto sector globally has been battling its own perfect storm, with GM's US strike (now ended) the latest headwind; Boeing's woes are also making themselves felt; and Brexit uncertainties continue to restrain the UK and (to a lesser extent) the wider EU.

Some of the slowdown too is simply the mirror image of the unexpectedly synchronised upswing which preceded it, and of the US tax cuts. Meanwhile, monetary policy remains friendly (arguably, overly so).

There are deeper-seated concerns – notably, ongoing trade tensions. Risks have faded as US–China talks have resumed, and we have always felt that a more positive outcome is possible if not yet probable. We are not out of the woods yet, but the tactical risks for stock markets feel a little more balanced than they did (most bonds, however, still seem unlikely to help investors beat even subdued inflation from here).

These tactical uncertainties remain manageable, and we suspect the longer-term investment outlook remains brighter than many fear. One of the things that could yet change that would be an altered political regime – the topic of our second essay, and the reason why UK-based investors might not celebrate just yet the reduced risk of a no-deal exit from the EU.

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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Values: all data as at 30th September 2019.
Sources of charts and tables: Rothschild & Co or Bloomberg unless otherwise stated.

Slowing, not collapsing

Could stability break out soon?

The global economy has been slowing now for almost two years, since early 2018. Investors' – and central bankers' – nerves never really recovered from the trauma of the Global Financial Crisis (GFC), and the slowdown has understandably fuelled concerns that history is about to rhyme again.

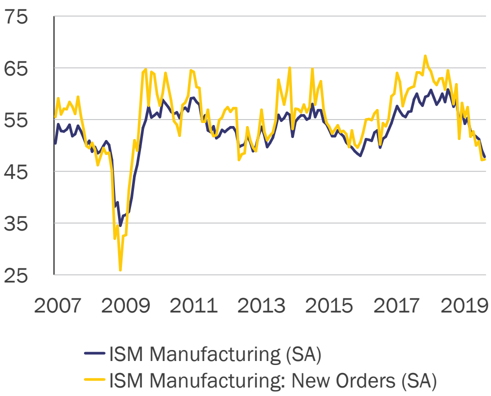
Indeed, one of our 'desert island stats', the manufacturing ISM survey for the US, fell sharply in the last two months. It has not yet hit levels that would usually be thought to signal US recession, but it is closer to them than at any time since the GFC, having moved beneath the previous post-GFC trough (figure 1 – October reading imminent).

Unfortunately, the macro picture is blurred by some one-off micro developments. A dramatic downturn in the auto and aviation sectors may be having a bigger impact on global manufacturing than we'd realised.

From China to Europe and the US, auto emissions controls and sensibilities, and a switch to electric power and (more tentatively) automated driving capabilities, have hit production – and demand. How many of us are not buying new motors because we're waiting to see what comes next? The strike at GM in the US (now ended) added to the sector's woes – and it is also centre-stage in US–EU trade negotiations. Boeing's problems with its 737 may also be having a bigger impact than we'd realised, and airframes too are in play in US–EU trade talks.

Figure 1: US manufacturing ISM

Headline and new orders indices



Source: Bloomberg, Rothschild & Co
Past performance should not be taken as a guide to future performance.

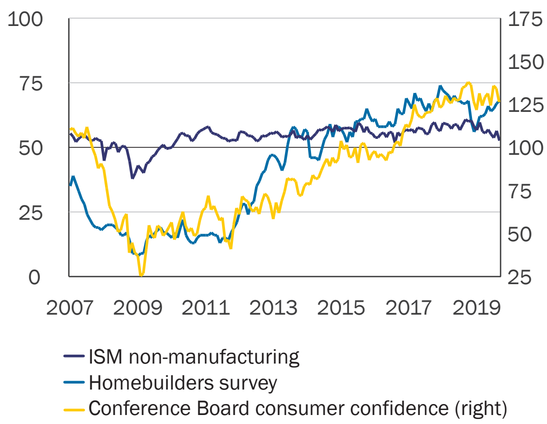
This is all still bad news for business, and part of the cyclical slowdown. But it may not be telling us much about (for example) the underlying state of consumer confidence, the availability of finance or businesses' capital spending plans. Whether such weakness warrants a monetary policy response must be debatable. And the stage may be set for a vigorous catch-up as a potentially more consolidated auto sector gets its act back together.

Brexit uncertainties seem also to have been playing a role, though we suspect that the UK inventory cycle(s) that they have fostered have been more potent than the more widely discussed shortfall in business capex, which is volatile at the best of times. And guess who has some of the most vertically integrated supply chains in European manufacturing? Autos and airframe production.

As we write, the risk of a disruptive no-deal UK exit from the EU seems to have faded. We have said that before, only for it to revive. Meanwhile, a potentially game-changing UK election is at hand (see below). But we continue to suspect that leaving the EU – even without a deal – will not be as economically traumatic for the UK as many fear, and that a clear win for the main opposition party is possible but not yet probable.

Figure 2: Selected US non-manufacturing indicators

Service sector ISM, consumer confidence and homebuilders survey



Source: Bloomberg, Rothschild & Co
Past performance should not be taken as a guide to future performance.

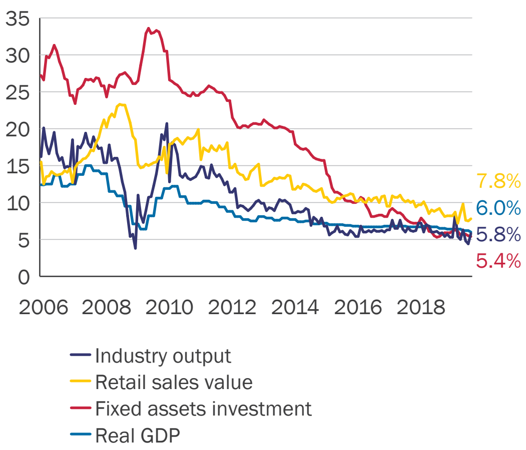
Service sector indicators in the US (figure 2) and globally have also weakened in recent months, but they generally remain further above potentially recession-indicating levels. And in the US, some cyclical indicators have been rising – housing starts and building permits, for example, helped no doubt by lowered interest rates (though market expectations of further falls are being reined-in, as we'd guessed they might be). Another of our 'desert island stats', US retail spending, looks resilient, as does consumer confidence (figure 2) – and corporate results: third-quarter earnings data released so far suggest earnings growth may have bottomed a little sooner than we'd thought.

Finally, while China's economy has once again got its share of negative headlines – the slowest growth since 1992 – the slowdown under way remains gradual (figure 3). China cannot sustain even 6% growth in the long term, but it will be some time before its trend growth rate falls to western levels.

The markets and business surveys are clearly still vulnerable to a re-escalation (should that be a re-re-escalation?) of trade tensions. Stock markets are close to their highs. But there may be a little more tactical headroom than there was. Presidential tweets aside, we suspect the manufacturing indicators may be close to bottoming out, and with US consumer cashflow still healthy, and confidence underpinned by a still-tight labour market, we continue to see this episode as a rather late 'mid-cycle' pause rather than something more sinister. To a large extent, it is a mirror image of the surge in growth that caught economists by surprise in 2017. The muddle-through cycle may yet make it into 2020.

Figure 3: China's gradual return to earth

GDP, industrial production, retail sales value and capital spending (% year-on-year)



Source: Bloomberg, Rothschild & Co
Past performance should not be taken as a guide to future performance.

Protest or pendulum?

Collectivism redux?

"All of us who prize greater economic equality would do well to remember that with the rarest of exceptions, it was only ever brought forth in sorrow. Be careful what you wish for."
Walter Scheidel

"Change? Aren't things bad enough already?"
Attributed to Lord Salisbury

For the last half-century, the focus of global politics has been gravitating towards the individual, not the group. Is the recent revived interest in collectivist ideas in the US and UK – and in some Continental economies – a passing phase or something more profound?

So far, we've resisted the temptation to go for a 'Big Picture' view: we've seen the revival as essentially another strand of populism, a potentially short-lived wish to 'stick it to the man', the establishment. But if it's more durable, our worldview may need changing.

Regular readers will know that we are usually glass-half-full realists. We see worries about debt, deflation, demography, resource depletion, geopolitical danger and robots as overstated. We've seen 'secular stagnation' as largely an ex post rationalisation for economists' collective failure to spot the GFC in advance, and we've noted how structurally low real interest rates implicitly place a higher value on sustainability.

But one of the things that might change our constructive worldview would be a significant and lasting reversal in that political pendulum.

Having swung perhaps too far toward the libertarian, free-enterprise end of the scale in recent decades, is it poised to swing back? If it now overshoots in the collectivist direction, the longer-term investment climate – not just the short-term weather – may be more unsettled.

How big a reaction?

Many might agree, for example, that some near-monopolies belong in the public sector; that fiscal 'austerity' could have been more fairly distributed; that externalities are damaging the planet; that labour markets don't always reward potential – and more besides.

Capitalism benefits many, not just a few, which is why it has not collapsed as Marx said it would but has thrived. The average person has never been better fed, clothed and housed (and healthier, safer and longer lived). But its inequality and externalities can still be damaging, and the plight of even the smallest minority can be demoralising. (Ursula K Le Guin's *The Ones Who Walk Away From Omelas* offers a powerful, non-partisan fictional perspective.)

Value judgement alert: we think the least bad outcome for society (there is no utopia) would be for the pendulum to settle somewhere in the middle, pointing neither to unfettered markets nor to a collectivised, equal outcome economy.

Sixty years ago, Germany's Social Democratic Party (SPD) offered a description of such a mixed economy that arguably has yet to be bettered, and to which we'd happily sign up: "markets where possible, government where necessary". Some intervention is indeed needed.

But sometimes, despite the best of intentions, such intervention can become excessive, and do more damage than the market failures and shortfalls it is meant to address.

Prosperity and/or equality

Economics is not science. But perhaps the nearest thing to an empirical law that we have yet discovered is that centralised, collectively controlled economies don't work well: they make people poor and miserable. China's recent success has occurred not because it is still communist, but because since Deng Xiaoping it has been allowing markets to develop.

As wealth management strategists, perhaps "we would say that, wouldn't we". But the evidence is compelling. If anything, we are understating things: see Walter Scheidel's *The Great Leveller* for a reminder of the historical circumstances that have delivered greater equality. The collectivist experiment has been run many times: the results are always the same.

Unfettered free enterprise, as noted above, also does damage – it is arbitrary and unfair. But such extreme libertarian experiments have been fewer in number, and humanitarian damage has been smaller (particularly if you think poverty matters more than inequality).

Despite this painful history, the blogosphere and bookshops are newly full of fashionable critiques of capitalism, and urgent demands for alternatives. But they assume a historical determinism which clearly doesn't exist, or an altered human nature, one in which self-interest doesn't play an important role.

Self-interest is not a virtue, but it often works – unplanned, and paradoxically – to our collective advantage. Anyone who has worked in a group context, or read modern history, knows that individuals' incentives and appetites matter.

It is a fact of life: an economy without self-interest is no more imaginable than a physical world without gravity.

Acceptance – not veneration – of self-interest is the core of capitalism. And there is no alternative 'system' any more than there is an alternative to gravity. The point is the extent to which we try to use it to our advantage.

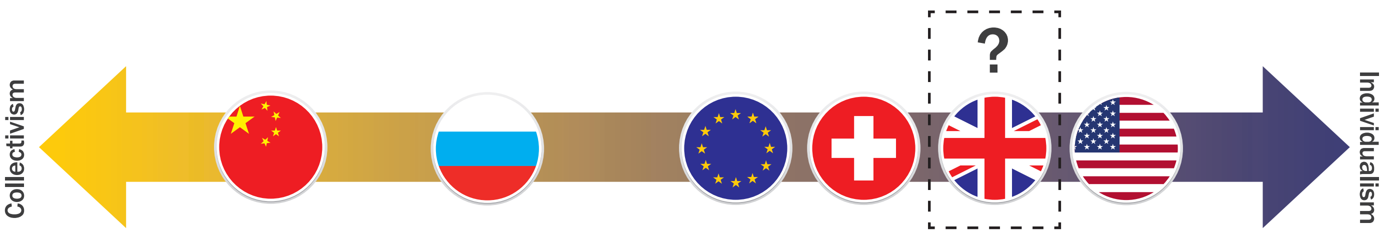
UK in the spotlight

Figure 4 judgementally places the big economies on a collectivist-individualist spectrum. Despite China's reforms, it remains by far the most centralised big economy (as events in Hong Kong perhaps remind us). Towards the other end of the scale, few of us might be able to name a Swiss politician, testimony to that country's tradition of small government.

In their different ways, the positions of the US and the UK on this spectrum are centre-stage currently. The US is by far the most important for global portfolios, but it is the UK where an election is now closest and where the opposition seems most determined to make significant changes.

Figure 4: A stylised political spectrum?

Where some big economies might sit on the collectivist–individualist spectrum



Source: Rothschild & Co

As we've argued, there is a case for public intervention in markets: we subscribe to the mixed economy. Even the entrepreneurial and buccaneering US has relied on public sector support for technology and pharmaceutical research (see Mariana Mazzucato's *The Entrepreneurial State*), and US Inc recently may be widening its narrow emphasis on shareholder value towards a wider, stakeholder approach. But the UK opposition's current proposals for bigger government, state ownership, significantly higher taxes, increased regulation and (even) looser monetary policy go further, and are designed to deliver a big reversal in that political pendulum.

Conventional mixed-economy policies have not been exhausted. There is a strong case to be made currently for more government borrowing, for example. Real long-term interest rates are low: investors are queueing for even meagre yields. This is a good time for governments to use long-term funds to rebuild crumbling infrastructures.

Some of the UK opposition's proposals seem unconvincing, however. Using controls to tackle a housing shortage, for example, can reduce supply and make things worse. Asking the Bank of England to deliver a specified rate of productivity growth without giving it any new policy levers or analytical tools seems optimistic (and a productivity target alongside an inflation target would arguably make the Bank responsible for a pay policy too). Plans to redistribute a big stake in publicly quoted companies to their workforce and to the exchequer may not have been fully thought through (what about private companies and public sector workers?).

The proposals may not make it into the published election manifesto, or into office: the opposition party has been trailing an unpopular government in the opinion polls

Moreover, it is often circumstance, not politics, that is the biggest driver of economies and markets, particularly for the larger democracies. Both red and blue governments have presided over good and bad outcomes that have had little to do with their policies, and a lot to do with global developments. (There can be exceptions – forceful personalities like Reagan, Thatcher, perhaps Macron, can be game changers – and in smaller countries the room for more dramatic measures is greater: the Venezuelan government has certainly made a difference.)

But some of the opposition's advisers reportedly favour more substantial changes, and we can't rule out the possibility that other, as yet unmentioned – or denied – policies would not materialise in government. And a big reversal of the political pendulum might swamp more circumstantial developments.

We hope we are mistaken, but domestic politics might have the potential to make a bigger economic impact than EU secession.

Figure 5: Possible UK opposition policies? (Subject to pending campaign manifesto)

The opposition wants to deliver a sea-change in British politics

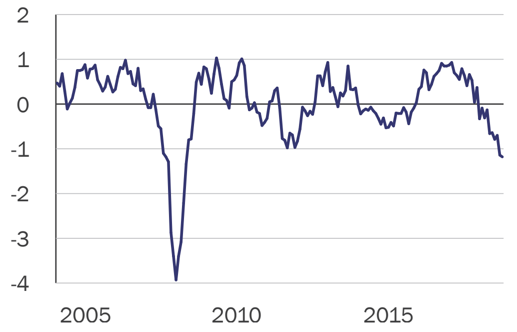
Tax	State ownership	Housing	Workers' rights	Misc
Highest rates of income tax to cover more workers Raise corporation tax from 19% to 26% £5bn pa (1/4% GDP) financial transactions tax Executive pay and bonuses to be capped	"Inclusive ownership funds": quoted companies with >250 employees to transfer 10% of shares to workers (over 10 years) Nationalisation of water companies, railways and some energy supply networks	Build over one million more homes, with at least half for social rent Private sector rent control: annual inflation cap on rent increases "Land for the Many" – right-to-buy for private tenants	Ministry for Employment Rights End zero-hours contracts Introduce four extra public holidays Enforce all workers' rights to trade union representation at work Repeal the Trade Union Act and roll out sectoral collective bargaining Target a four-day working week	Green New Deal: net zero by 2030 Boost NHS and other public spending, maintain state pensioners' triple lock/fuel allowance/ bus passes Scrap tuition fees, integrate private and state schools. Explore universal basic income. Shift Bank of England to Birmingham; give it extra task of targeting 3% productivity growth

Source: BBC, FT, Rothschild & Co
Policies reflect the 2017 election campaign manifesto and recent announcements/discussion papers.

Economy and markets: background

Growth: major economies

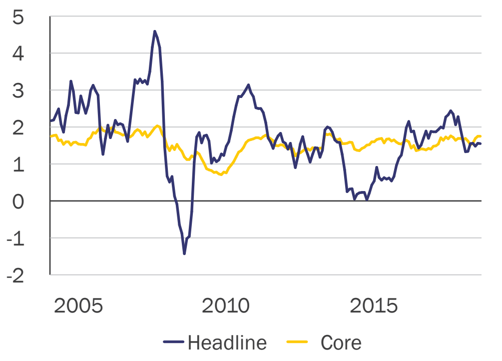
Business optimism: standard deviations from trend



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

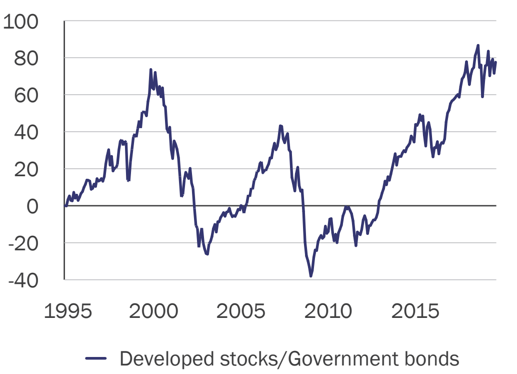
G7 inflation

%, year-on-year



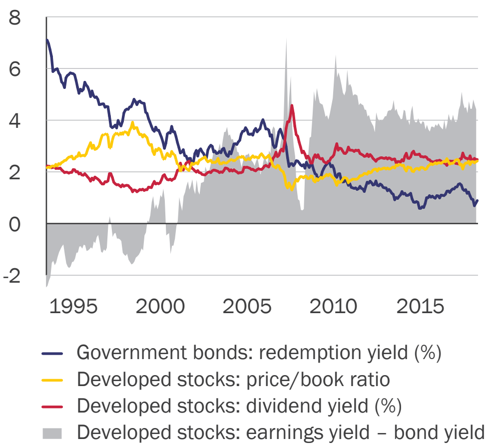
Source: OECD, Bloomberg, Rothschild & Co

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	1.8	14.1	7.7
10-yr UK Gilt	0.7	7.9	8.7
10-yr German bund	-0.4	6.5	5.5
10-yr Swiss Govt. bond	-0.6	4.5	1.5
10-yr Japanese Govt. bond	-0.1	2.8	1.7
Global credit: investment grade (USD)	1.4	10.5	11.4
Global credit: high yield (USD)	6.1	8.2	16.7
Emerging (USD)	5.0	12.1	14.2

Source: Bloomberg, Rothschild & Co

Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

	Yield (%)	1yr (%)	3yr (%)
World: all countries	2.5	11.0	36.1
Developed	2.5	11.1	37.5
Emerging	2.9	10.4	25.5
US	1.9	11.2	46.1
Eurozone	3.3	14.6	25.5
UK	4.7	8.5	16.4
Switzerland	3.0	17.7	35.4
Japan	2.3	2.7	27.9

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (1980 = 100)

	Level	1yr (%)	3yr (%)
US Dollar (USD)	110	0.7	2.3
Euro (EUR)	124	-2.2	5.7
Yen (JPY)	95	4.0	-2.8
Pound Sterling (GBP)	79	1.2	7.0
Swiss Franc (CHF)	160	2.2	1.0
Chinese Yuan (CNY)	128	-1.5	-2.7

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	177	-9.1	-6.4
Brent crude oil ($/b)	61.2	-20.0	18.1
Gold ($/oz.)	1,492	21.3	17.8
Industrial metals (1991 = 100)	248	0.8	26.8
Implied stock volatility: VIX (%)	14.0	-32.4	5.0
Implied bond volatility: MOVE (bps)	73.0	32.7	27.9

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data correct as of 30th September 2019.

Past performance should not be taken as a guide to future performance.

Notes

At Rothschild & Co Wealth Management 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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