Market Perspective

Ten years after

Issue 105 | September 2018

Rothschild
Private Wealth

Foreword

The everlasting summer is fading fast, and we're back to school against a rather sobering backdrop: the 10th anniversary of Lehman's collapse, ongoing US–China tariff worries, an emerging market (EM) sell-off, geopolitical concerns – and with the longest-ever bull run in US stocks just behind us.

My personal take on the Global Financial Crisis perhaps differs from the conventional one. Shocking and shameful as the GFC was, I did not see it as a watershed for the global economy or capitalism.

If the financial plumbing was fixed, there was no reason why the world – though not the financial sector itself – couldn't move back towards business as usual. With the conspicuous exceptions of European and Japanese monetary policy, it largely has.

The economic climate remains relatively benign: a mix of ongoing growth with mostly subdued inflation, which is delivering healthy profitability alongside only modest interest rate risk (even in the fully employed US).

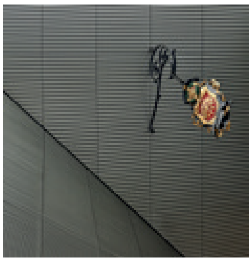
Stocks have travelled a long way, but strong profits growth means that the US market's forward price–earnings (p/e) ratio is little different to what it was three years ago.

A full-blown trade war can still be avoided, and the sell-off in EMs looks containable to us. The strong US growth that is helping normalise US interest rates and supporting the dollar should also boost many emerging economy exports – higher tariffs notwithstanding.

Those wider geopolitical concerns may also be more manageable than feared. Fashionable talk of democracy's demise seems premature.

Overall, then, historical echoes and more contemporary risks aside, we still see growth-related assets as the most likely source of long-term inflation-beating returns.

Kevin Gardiner
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: September 2018.
Values: all data as at 31st August 2018.
Sources of charts and tables: Rothschild & Co or Bloomberg unless otherwise stated.

Ten years after

GFC revisited; cyclical update; emerging difficulties

Economic watershed – or financial farce?
A year ago we saw the 10-year anniversary of the run on Northern Rock, which signaled the start of the Global Financial Crisis (GFC). This September (15th) sees the anniversary of the GFC's apogee – the collapse of Lehman Brothers.

We look back more in bemusement than anger. The GFC fostered lots of soul-searching and big picture painting, but – absurdity aside – it may have been a less existential event than commonly supposed. The subsequent decade has certainly been eventful (figure 1) but we have collectively "muddled through" successfully.

At the time I saw the GFC as the most dramatic in a "richness of embarrassments" for newly deregulated capital markets – after the stock market crash of 1987, the Asian crisis of 1997, the LTCM fiasco in 1998, and the "new economy" mania of 1999–2000.

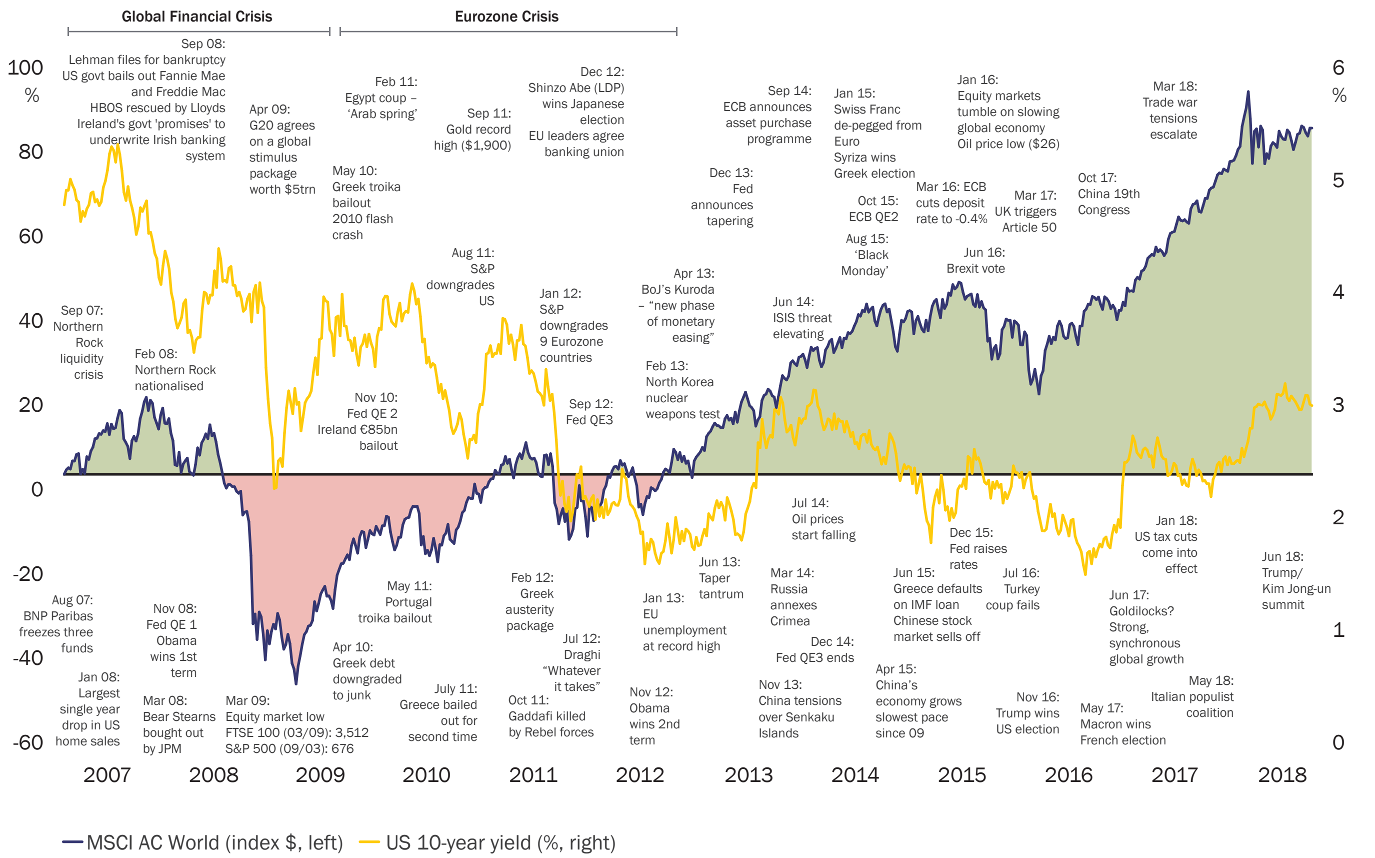
It was shocking and scary. Banks had behaved recklessly and stupidly. Regulators were missing in action. The fallout was unfair. But its significance may not have been as profound as many conventional accounts suggested.

It certainly had a big economic impact, but in my view it did not reflect a flawed global economy. Nor did it herald the collapse of capitalism. The "system" was not insolvent, but suddenly illiquid.

Short-sighted lending (and borrowing), some complex financial engineering, and a failure to join up the dots ("you're doing *what* with those credit default swaps?") eventually led to a seizure in the global money supply – the "Minsky Moment".

Figure 1: An investment timeline

Selected events since the start of the Global Financial Crisis



Source: Bloomberg, Rothschild & Co

The specific failure was not widely predicted – hence the Queen's question to economists: "Why didn't anyone see it coming?" But such an event had always been possible (and still is).

Some analysts think that replacing today's "paper" (or increasingly digital) money with gold would eliminate the risk of such a crisis. In 2008 they seemed to have their "we told you so" moment.

But fiat money, and/or fractional reserve banking – banks lending more than they take in as deposits – was not the ultimate cause.

The ultimate driver of crisis and volatility is human nature. We are emotional, and we extrapolate. We expect good times to last forever, and bad times never to end. Our collective and infectious mood swings are what produce business and financial cycles.

Stability and predictability can really only be secured by removing spontaneity and subjectivity from the economy. Unfortunately, planned economies function even worse.

Since the economy was not fundamentally flawed, the day could be saved by policymakers pumping liquidity back into the system. And after such a deep setback, there seemed a good chance that the recovery would last.

The global economy is now a third bigger in real terms (an eighth, on a per capita basis) than before the GFC. The average human has never been better fed, clothed and housed. Admittedly, all that debt has not gone away – but it didn't need to.

The US expansion has entered a 10th year, the second-longest on record (with the all-time record now just nine months away), and the US stock market has seen its longest-ever run without a 20% ("bear market") setback.

The financial sector, however, never seemed likely to recover as fully, and it hasn't. If banks can't be allowed to fail, they can't be allowed to be so profitable either. Meanwhile, the link between banks and money creation has been loosened by quantitative easing (QE) and a lack of loan demand. This could reverse, of course – but perhaps not before a new payments technology has disintermediated away much of banks' systemic function.

What's the investment lesson?

First, volatility and risk are inevitable in market-oriented economies. That does not make them unfit for function, though we can debate whether rewards and risk are distributed fairly.

Second, most of the time, growth should be given the benefit of the doubt. Not because of what central banks and governments do, but because more often than not, workers and managements are steadily getting better at what they do.

Kudos to the few who saw the GFC coming when it did. (Many saw it coming every year before – and since – but that's not quite the same thing.) Even more should go to the smaller number again who bought back in at the lows.

The gains missed by subsequently being out of the market have been much bigger than losses made to early March 2009. What received wisdom said would be a "low return environment" after the GFC has, overall, been one of the best investing climates on record.

What now?

Risk is inevitable, and history rhymes. There are plenty of amber lights. EMs and commodities have slumped (see below). Are they telling us something? Credit markets look frothy. Private equity multiples are elevated. Safe-haven bonds remain in demand. US interest rates are rising. A prominent American economist just said that secular stagnation is a myth.

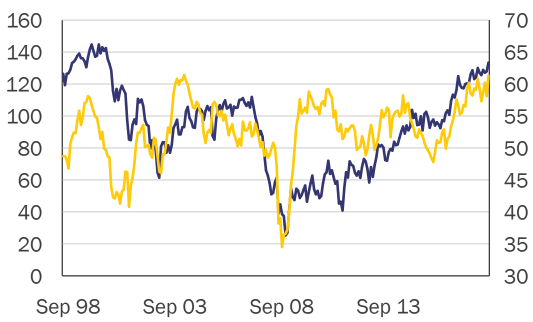
Political tensions abound: trade tussles, the Middle East, Ukraine, Brexit, Italy's budget, nationalism and a perceived crisis in (Western) democracy.

As yet, however, cyclical indicators are still in healthy territory, while stock valuations are undemanding. We think the geopolitical probability distribution still has two tails – that is, bad stuff is not the only sort that can happen (and politics does not always affect economies anyway).

We discuss those emerging market nerves below. For the developed world, the combination of ongoing growth and only modest inflation risk that has characterised this cycle to date seems to be continuing for now.

Figure 2: US economic indicators look healthy

US consumer confidence and the manufacturing ISM survey (indices)



Source: Conference Board, ISM, Datastream, Rothschild & Co

US consumer and manufacturing confidence have hit new cycle highs (figure 2). Consumers have more disposable income than we'd thought: their spending in the current cycle has been remarkably responsible, and they still have plenty of gas in the tank, as it were.

Even with recent weekly unemployment claims, as a proportion of the workforce, at record lows, US wage and price inflation – tariffs notwithstanding – are rising at a glacial pace.

Growth in the eurozone and the UK appears to have stabilised after the slowdown earlier in the year, albeit at less robust levels than in the US.

Elsewhere, growth in the eurozone and the UK appears to have stabilised after the slowdown earlier in the year, albeit at less robust levels than in the US.

China's data have been patchier, and the authorities have been loosening policy pre-emptively. But US tariffs are not yet biting significantly, and the Chinese economy's return to earth still looks like the softest of soft landings.

Remember, healthy growth alongside little inflation is not just of academic interest: in practical portfolio terms it suggests a mix of respectable profitability with only a very gradual normalisation of interest rates.

US companies' operating earnings per share grew in the first half of 2018 at 23%. It's not all down to tax cuts: revenues and margins grew too. Stock buybacks played only a small supporting role.

Earnings will not grow at this pace for long. The tax cuts are not reversible – but neither are they repeatable, and growth must slow sharply on this account alone. Wages may begin to hit margins.

A big slowdown in earnings growth may cause market turbulence and sector rotation – particularly alongside US interest rates that are rising, albeit gradually.

The Fed is currently poised to hike rates for an eighth time. We are sceptical of the view that it will then pause (and despite recent talk of executive interference, we think it will be the Fed, not Mr Trump, that decides).

For now, however, investors are still digesting the likely level at which that earnings slowdown will occur. Earnings expectations are still drifting higher, and put the S&P500 on a plausible forward p/e ratio of 17x – the same as in mid-2015, when the US stock market was almost one third lower.

The other big stock markets are not backed by such strong growth and profitability, but they are still less remarkably priced.

As noted, we continue to think that the geopolitical situation is less one-sided than many fear. In the case of trade, we have noted here often that China, not the US, is the least open big economy. Whether that is the primary cause of the US current account deficit (we strongly doubt it), Mr Trump does have a point when he says the playing field is not level.

China follows its own agenda. Since Deng Xiaoping, however, its economic agenda at least has been more liberal. If Mr Trump had just been patient... But as it is, China's response to bigger US tariffs may remain a relatively measured one.

The new Italian government is again causing waves, but we doubt the fiscal risks are as stark as many fear – the election rhetoric is already being watered down, and few Italian governments last long enough to implement election promises anyway – and we do not see "Quitaly" as a realistic prospect.

Nor do we think that even a hard Brexit – reportedly looking more likely, though we wonder how anybody can know – would be a game-changer for the UK economy.

We'd prefer not to find out, of course. But the UK has a growing population, liberal markets, several globally competitive clusters and a cheap currency. Many sterling-based portfolios will be helped by their holdings in overseas and multinational businesses.

Democracy in decline?

A more general geopolitical concern has been gathering momentum of late – those perceptions of a crisis in (Western) democracy. If accurate, it would have narrow investment implications as well as the obvious profound political ones. But the analysis is superficial.

There is little discussion of what is meant by democracy, what it can realistically be expected to achieve, or of the practical – logical – constraints that any social choice mechanism must face.

A relatively illiberal economic system in which people vote only rarely might still be a legitimate one, for example. And democracy and prosperity may be linked more loosely than we'd thought – cause and effect can run in the opposite direction to the one assumed.

None of this means populism and/or nationalism is a good thing, or that freedom of speech can ever be a bad thing. But these are matters of opinion, not analytics, and the current fashion is to dress the former up as the latter.

Democracy's alleged decline may prove to be another item in the long list of things that investors are being urged to worry too much about.

Emerging difficulties

EMs are particularly prone to fads. This summer's sell-off is the third since 2010. The risk of contagion is always real, but for now we see this one, like the other two, as being likely to stabilise without doing lasting damage to diversified global portfolios.

It has both specific and general causes.

Governance is being questioned in some high-profile cases; high inflation rates and current account deficits have suddenly looked much less sustainable; and US suppliers – most obviously China – have been hit by trade war fears.

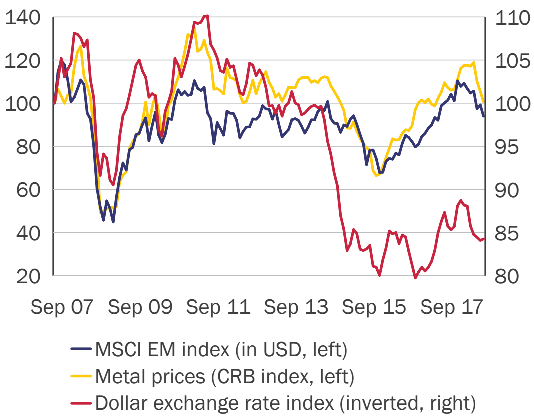
More generally, a rising US dollar and interest rates, and weak real commodity prices, have been a potent negative mix (figure 3). Debt servicing costs hurt recent dollar borrowers, while weaker commodity prices hit producers and draw attention to that ongoing slowdown in China.

To be clear: we do favour investing in EMs, and we are particularly keen on the long-term attractions of the diversified, structurally robust Asian region.

Recent dollar borrowing, the rise in dollar interest rates and the dip in some local exchange rates together seem unlikely to have been big enough to damage the region significantly (in contrast with the moves seen in the crisis of 1997/98 – figure 4). Local leading economic indicators have, if anything, picked up relative to the rest of the world of late.

Figure 3: Emerging stock markets, commodity prices and the dollar

MSCI index, spot metal prices (in dollars) and the dollar



Source: MSCI, CRB, Datastream, Rothschild & Co

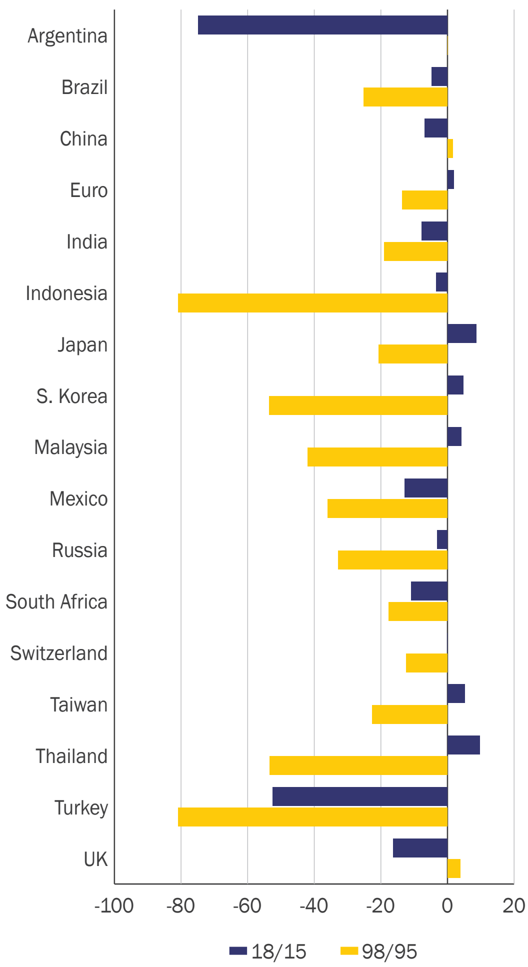
Meanwhile, the strong US growth that is pushing US rates higher is also offering more opportunities – higher tariffs notwithstanding – for many exporters there.

Asian EMs mostly have diversified economies and current account surpluses (figure 5). Nonetheless, even the best-behaved Asian EMs are still much riskier investment propositions than (for example) the main North American and European stock markets. We know that markets and currencies could easily fall further first. But stepping off the train could leave us stranded if it pulls out of the station unexpectedly.

That said, we have little appetite even for long-term bargain hunting in Argentina and Venezuela (technically frontier, not emerging, markets), Brazil, Russia, South Africa, or Turkey. Idiosyncratic risk there remains high, and diversification low.

Figure 4: Selected currency moves against the dollar

Cumulative three-year declines: current and 1998 (%)



Source: Datastream, Rothschild & Co

Figure 5: Stylised emerging risk: economics

Selected economies: diversification and balance of payments positions

	Current account deficit		Current account surplus	
Commodity exporter	Brazil South Africa Ukraine Chile	Indonesia Colombia Peru Argentina	Saudi Arabia UAE Qatar Nigeria Iraq	Russia Kuwait Venezuela Iran
Manufactured goods exporter	Turkey India Egypt Romania Slovakia	Mexico Poland Pakistan Bangladesh	China South Korea Malaysia Vietnam Hungary	Taiwan Singapore Philippines Thailand Slovenia

Source: Investec, Bloomberg, Rothschild & Co

Investment conclusions

Our portfolio managers hold some specific protection in anticipation of volatile stock markets. But we still see the investment climate as constructive, and stock valuations as full but not prohibitive: a more defensive portfolio restructuring might leave us stranded if markets rally. 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.

- Most government bond yields remain firmly below likely inflation rates. High-quality corporate bonds also seem unlikely to deliver positive real returns, 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 euro zone, where the ECB's buying will shortly cease and credit concerns over Italy and Turkey pose some limited risk to banks). Generally, we view bonds and cash currently as portfolio insurance.

- In the eurozone and UK, we continue to favour relatively low-duration bonds. In the US, we are 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 continue to avoid volatile emerging market bonds.

- 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). Our regional convictions are low – though we do think that emerging Asia's structural appeal remains intact, recent trade tension and volatility notwithstanding – and 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 there are currently few obvious misalignments among the majors. Cyclical momentum has shifted back towards the US, and interest rate carry is wider than for many years, but the dollar, though firm, has remained rangebound. The pound has again been undermined by ongoing Brexit tensions, but the domestic policy mix has shifted in its favour and it is competitive. For the euro, higher interest rates remain some way off, local economic data are more sluggish and there are localised credit risks as noted. But we remain sceptical of the disaster scenario, and it is inexpensive. 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 highly competitive to begin with, and is now even more so. The yen is cheap, but its monetary policy remains the loosest. We still single out only the Swiss franc among the big currencies. We doubt its revived safe-haven appeal will be attractive for long. It remains expensive, and we expect it to eventually resume its downward drift.

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.

Brussels
Avenue Louise 166
1050 Brussels
Belgium
+32 2 627 77 30

Frankfurt
Börsenstraße 2 – 4
60313 Frankfurt am Main
Germany
+49 69 40 80 260

Geneva
Rue de la Corraterie 6
1204 Geneva
Switzerland
+41 22 818 59 00

Guernsey
St. Julian's Court
St Julian's Avenue
St. Peter Port
Guernsey GY1 3BP
Channel Islands
+44 1481 705194

Hong Kong
16/F Alexandra House
18 Chater Road
Central Hong Kong SAR
People's Republic of China
+852 2525 5333

London
New Court
St Swithin's Lane
London EC4N 8AL
United Kingdom
+44 20 7280 5000

Manchester
82 King Street
Manchester M2 4WQ
United Kingdom
+44 161 827 3800

Milan
Via Agnello 5
20121 Milan
Italy
+39 02 7244 31

Paris
29 Avenue de Messine
75008 Paris
France
+33 1 40 74 40 74

Singapore
North Tower
1 Raffles Quay #10-02
Singapore 048583
+65 6535 8311

Zurich
Zollikerstrasse 181
8034 Zurich
Switzerland
+41 44 384 7111

Important information