# Market Perspective

## Bondstock | UK consumers: ready for Brexit?

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Rothschild & Co
Wealth Management

# Foreword

Fifty years after Woodstock, global bond markets have been staging their own summer of love. Traditional inhibitions – such as positive yields – have been cast to the wind as more conservative onlookers have struggled to make sense of it all and wondered who'll clean up the mess.

As in 1969, organisation has been lacking, more people have showed up than planned, and all they've had in common is the expectation of a good time.

Then, of course, what came next was Altamont – and the seventies…

In this back-to-school *Market Perspective*, we offer our thoughts on the likely significance of Bondstock. Falling yields and inverted curves are credited with near-mystical forecasting powers, but while economies are cooling and trade and geopolitical tensions have risen, we don't yet see a major economic accident looming. Nor do we yet see a material revival in inflation, monetary irresponsibility notwithstanding. And we do still think that an uncertain future needs to be – and one day will again be – discounted.

It's probably just kids having a good time.

We also take a quick look at UK consumers as Brexit risks loom. They have not been as well-behaved as their US peers in this cycle, and their excesses can be seen in a current account deficit that is (even) bigger than usual. That said, we doubt confidence and spending power are about to suddenly collapse – and UK-oriented stocks have already underperformed markedly since 2016, suggesting some risk is in the price.

Just when you think it is not possible to exaggerate the dysfunctionality of British politics, our pundits rise to the task. But remember that a noisy public debate does not always translate into noisy portfolios.

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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 31st August 2019.
Sources of charts and tables: Rothschild & Co or Bloomberg unless otherwise stated.

# Bondstock

## Bond markets' summer of love

Bonds were already performing strongly, but gathered momentum from May. Many European government yields have recently hit new all-time lows – below even those seen in 2016. Negative yields have spread across more countries and maturities (figure 1), to almost one-third of high-quality global bonds, compared with one-quarter in 2016. Germany has raised 30-year funds at a negative yield. Greece's government faces almost the same terms as Uncle Sam.

The short-term interest rates priced into money markets have also been falling as the big central banks have followed the lead from bonds. After encouraging markets to expect lower policy rates, the Federal Reserve (Fed) duly delivered a cut – the first in a decade – at the end of July. At least one more cut seems likely soon. Rather than "taking the punch bowl away", then, Powell's Fed has offered Bondstock another round of drinks. The European Central Bank also seems poised to loosen, and the Bank of England might have signalled similarly – particularly with that Brexit risk – if the pound had not been doing some of its work for it.

Policy rates have nonetheless lagged the bond markets, and the yield curve – the gap between long-term and shorter-term yields – has inverted along more of its length, a traditional sign of looming recession (figure 2).

### Why have bonds been partying?

We wrote about bonds in early July, but the summer surge warrants a revisit. Why the festival mood?

The possible explanations we focused on then were (1), a looming economic accident, and (2), more contentiously, a fall in inflation independently of economic growth. For completeness, we might add (3), altered time preference and/or (4), a technical squeeze.

### 1. Looming downturn

The idea that bonds can see a big economic downturn, which will reduce inflation and policy rates, is the popular prime suspect. The market is credited with near-mystical forecasting ability. Our fixed income specialist Rob Stewart notes that media use of the word "recession" has surged to levels not seen since 2009.

But data point to slowdown, not dramatic recession. Risks are focused on manufacturing, hit by tariffs and a perfect storm in the auto sector (especially in Germany and China), and the UK, with a Brexit-related inventory cycle. Service sectors and labour markets are stronger, and the key US economy seems to be slowing least.

Nor do we buy the idea that recessions these days are necessarily more dangerous, and/or that the authorities have no levers left to pull.

### Figure 1: The extent of negative yields

More countries and more maturities see government yields turn negative (%)

| Country | 1 yr | 2 yr | 3 yr | 4 yr | 5 yr | 6 yr | 7 yr | 8 yr | 9 yr | 10 yr | 15 yr | 20 yr | 30 yr |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Switzerland | -1.22 | -1.21 | -1.21 | -1.17 | -1.12 | -1.08 | -1.05 | -1.03 | -1.05 | -0.99 | -0.78 | -0.70 | -0.55 |
| Denmark | -0.92 | -0.93 | | -0.93 | -0.89 | | | -0.76 | | -0.65 | | -0.40 | |
| Germany | -0.85 | -0.91 | -0.94 | -0.94 | -0.90 | -0.89 | -0.84 | -0.78 | -0.71 | -0.65 | -0.50 | -0.35 | -0.10 |
| Netherlands | | -0.89 | -0.91 | -0.88 | -0.83 | -0.75 | -0.70 | -0.62 | -0.57 | -0.50 | -0.39 | -0.16 | -0.12 |
| France | -0.76 | -0.83 | -0.87 | -0.84 | -0.76 | -0.68 | -0.60 | -0.52 | -0.44 | -0.35 | -0.04 | 0.07 | 0.51 |
| Sweden | | -0.64 | | -0.72 | -0.69 | -0.62 | | -0.52 | -0.42 | -0.30 | -0.14 | 0.11 | |
| Japan | -0.28 | -0.30 | -0.31 | -0.34 | -0.34 | -0.36 | -0.37 | -0.37 | -0.33 | -0.28 | -0.08 | 0.05 | 0.13 |
| Spain | -0.54 | -0.58 | -0.56 | -0.40 | -0.32 | -0.16 | -0.08 | 0.01 | 0.09 | 0.18 | 0.62 | 0.63 | 1.09 |
| Portugal | -0.54 | -0.70 | -0.48 | -0.35 | -0.30 | -0.14 | -0.07 | 0.00 | 0.12 | 0.19 | 0.59 | 0.76 | 1.10 |
| Italy | -0.32 | -0.35 | -0.07 | 0.07 | 0.27 | 0.29 | 0.54 | 0.62 | 0.65 | 0.84 | 1.36 | 1.52 | 1.90 |
| United Kingdom | 0.45 | 0.38 | 0.34 | 0.37 | 0.37 | 0.32 | 0.35 | 0.40 | 0.46 | 0.52 | 0.73 | 0.93 | 1.03 |
| United States | 1.69 | 1.47 | 1.39 | 1.38 | 1.36 | 1.40 | 1.43 | 1.46 | 1.48 | 1.51 | 1.63 | 1.76 | 2.01 |
| Greece | 0.08 | | 0.49 | | 0.86 | | 1.27 | | | 1.51 | 1.86 | 2.22 | |

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

This has been a well-behaved cycle, and fiscal policy has plenty of room for manoeuvre.

True, the yield curve has usually inverted before recessions – but with such varying lags as to be of little practical use. US stocks have on average risen for a year afterwards. We think bonds' fabled forecasting reputation is unwarranted. The future is profoundly unknowable – to all of us.

## 2. Secular deflation

This possibility is overlooked, but intriguing: it would be a free lunch for most assets.

A change in the way economies work – with supply driving growth, rather than demand – could see inflation not just stay subdued, but falling further and even turning negative, even alongside ongoing, profitable growth.

As noted in July, this seems to have happened before in the US and UK in the second half of the 19th century (and to some extent in Ireland since the early 1990s: the Celtic Tiger is still misunderstood).

Possible reasons for the end of the 'Phillips curve', linking growth positively to inflation, might include liberalised global labour markets and new technology. But globalisation is not exactly flavour of the month, so why seize on this now?

The inflation expectations priced into government bonds do seem to have led nominal yields lower. But core or real yields – net of that expected inflation – have also fallen, though they are not as historically low as nominal yields.

## 3. Altered time preference, storage costs

Academic writing on interest rates is not much fun – those Austrian economists are obscure for a reason. But interest rates ultimately reflect our collective view of the future (our 'time preference') and the physical terms at which we can exchange today's consumption today for tomorrow's (the 'production frontier').

Because we usually see the future as uncertain, we expect a reward for deferring spending – and because the value of what we make is usually bigger than the value of the stuff we use in making it, productive enterprise has been able to deliver that reward. Positive interest rates have discounted the uncertain future and value-adding production processes.

Both could change. In volatile times, people might not need a reward for waiting, and may even value future consumption more highly than today's. And productive resources can certainly be employed so badly that they destroy value (see any planned economy, for example).

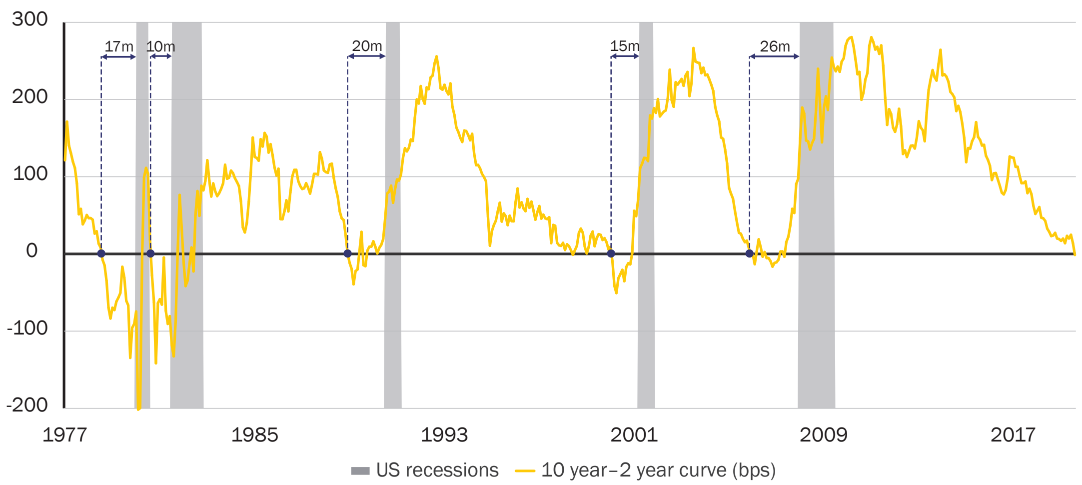
Another rethink might focus on storage costs. With tangible assets – such as property, collectibles and gold bars – we expect to pay for storage and security. So why not for digital assets? Arguably, in the post-Global Financial Crisis, cyber-threatened world, security costs have risen. Might negative interest rates partly reflect the revealed cost of the financial infrastructure?

Unlike vanishing inflation, these explanations might be bad news for future (real) returns across most investment assets, almost by definition.

In our view, however, today's many challenges do not yet justify reversed time preference. Corporate assets still suggest a value-adding production frontier (indeed, the gap between US return on equity and a risk-adjusted 10-year Treasury yield recently hit an all-time high). And storage costs are likely to remain de minimis.

### Figure 2: The US yield curve inverts

**Long-term (10-year) yields dip below shorter-term (2-year) yields (%)**




*Source: NBER, Bloomberg, Rothschild & Co*
*Note: The last five inversions have eventually led to a recession, but with an average lag of 18 months.*
*Past performance should not be taken as a guide to future performance.*

#### 4. A technical market squeeze

"More buyers than sellers" was JP Morgan's fabled reply to being asked why the stock market had risen one day. Perhaps fancy theories have been less important in boosting bonds than circumstance and coincidence?

Quantitative easing has left central banks holding a lot of bonds. Meanwhile, many pension plans and life assurers are compelled to buy bonds simply because they seem to offer a predictable way of matching future liabilities. Risk-parity and trend-following strategies may have further added to non-economic demand. At the same time, governments – the US's aside – have largely been well-behaved, keeping a lid on supply. With a small free float and many non-economic buyers, a thin market may have been squeezed higher. This is hardly profound – the 'narrative fallacy' strikes again – but that doesn't mean it must soon reverse, or affect other assets.

#### Winter of discontent?

This lengthy expansion faces clear and visible risks: explanation (1) has clearly been playing a material role. We have sympathy for (2), if only because it might shake a complacent economics establishment out of a lazy Keynesian worldview, but the timing doesn't ring true. We have less sympathy for (3). But explanation (4) for us carries most weight.

On this view, we surely have to stay alert for recessionary risks, but bonds are not necessarily telling us anything new. Unless or until the data worsen more materially, we can't see an investment case for most bonds.

Meanwhile, stocks, though volatile, also had a better summer than we'd expected. Economic risk has so far been offset by those lower policy rates, perhaps. This may not last – that more serious economic downturn might arrive, or a post-festival hangover in the money markets may give stocks a headache too. But while neither of the two big markets seem to have much tactical headroom, stocks remain most likely to deliver inflation-beating returns in the longer term.

# UK consumers: ready for Brexit?

## Momentum, but less wiggle room

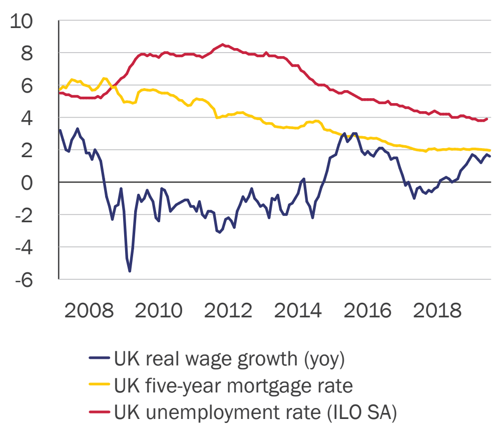
The UK is still mired in Brexit stalemate. Global investors have not needed to own many UK stocks – which have unsurprisingly underperformed for many years, not just because of Brexit. But amid the confusion and hyperbole, what can we usefully advise local investors?

There must now be a lot of bad news priced in, and anything other than a sudden no-deal outcome might result in a stronger pound and a rebound in the domestically oriented indices (such as the FTSE 250). Gilts might fall back as their safe-haven allure fades. The headline stock indices such as the FTSE 100 are not really sterling assets as most of their earnings are generated outside the UK. They have also been underperforming in common currency terms, but this has had a lot to do with their idiosyncratic sector mix (no tech but lots of oil, mining, Asia-facing banks and big pharma), which will remain intact. And most UK-based portfolios should have a healthy holding of global indices alongside the large-cap UK names.

A no-deal outcome would likely result in short-term disruption, but even the BoE is beginning to see that the risk cannot be quantified. We still hope not to find out, but think the lasting impact would be manageable. As we have noted often, the UK is one of the most competitive European economies, and not just because of that lower exchange rate. The government (we use the term loosely) also has plenty of room to boost its own spending, and plans to do just that.

#### Figure 3: Consumption tailwinds

Rising real pay, falling unemployment and mortgage rates (%)




*Source: BLS, ONS, Bank of England, Bloomberg, Rothschild & Co*
*Past performance should not be taken as a guide to future performance.*

Meanwhile, UK consumer demand looks to us to be potentially resilient. Consumer spending is determined by incomes, balance sheets and confidence (the latter determines just how much of their income or balance sheet they are willing to flex).

Household income – shaped by wages, jobs, benefits, taxes and mortgage payments – is perhaps the most significant factor, and for now at least, has some momentum. Jobs growth has been strong, and with the unemployment rate at its lowest since 1974 – which also supports confidence – inflation-adjusted pay growth is now positive again. Mortgage rates recently fell to new lows, and the BoE will not raise rates while Brexit is unclear.

Balance sheets too may be less vulnerable than feared. After the excesses of the noughties, consumers have been more restrained, and there has been a significant fall in household debt as a proportion of income (although this remains elevated by long-term historical standards – and more so than in the US, where households have made a bigger adjustment).

Meanwhile, we have seen a sharp rise in assets. House values are nearly two-fifths above their pre-crisis peak, and household net worth is at an all-time high of five times disposable income. Again though, in the US the comparable figure is an even bigger six times.

What about confidence itself? If it takes a knock, then belt tightening might follow – even if incomes and wealth are intact. As measured by what consumers say in surveys, it can look fragile. But when judged by what consumers do, it looks stronger. Since the 2016 EU referendum, surveys have weakened, even though (as noted) unemployment has fallen. But spending has continued to grow, and – significantly – so too has the proportion of disposable incomes that are spent: the aggregate saving rate has fallen. If consumers were that worried, the savings rate would rise, not fall.

Surveys are subjective and reflect recent news. And some objective developments don't always make themselves felt immediately. For example, consumers may be concerned about the impact of Brexit on house prices, but until they are more directly impacted – perhaps when they attempt to sell their home – this may not affect spending.

## Headwinds ahead

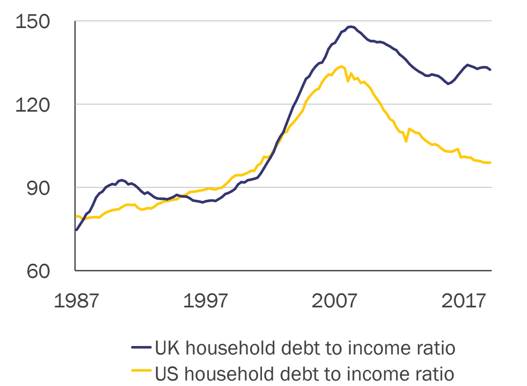
Of course, the fall in the savings ratio may have used up a potential buffer against bad news.

And if anything, the move in the saving ratio may understate UK consumers' confidence of late. If we take into account investment in housing alongside spending on consumption, UK consumer cashflow is in deficit, albeit not at the pace seen in the noughties. Again, this contrasts with the more prudent (less confident?) US consumer, who is currently a net lender and provider of liquidity, not a borrower.

For now we give the UK consumer the benefit of the doubt. The second quarter fall in GDP reflected inventories, not a weak consumer. A tight labour market, subdued inflation, low mortgage rates and an improved debt ratio are supportive of demand for the time being at least.

### Figure 4: Household deleveraging

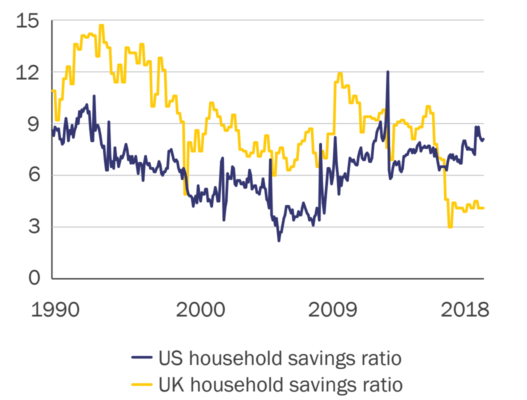
**Household debt to income ratio (%)**




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

### Figure 5: Household savings ratio

**Ratio of savings to disposable income (%)**




*Source: BEA, ONS, Rothschild & Co*
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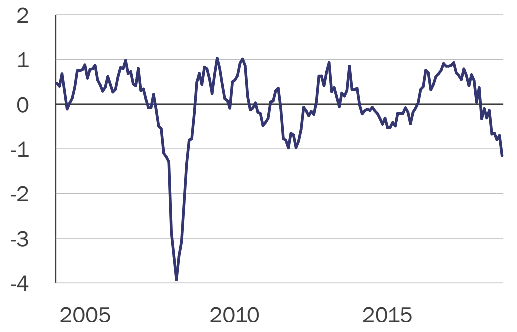
# Economy and markets: background

## Growth: major economies

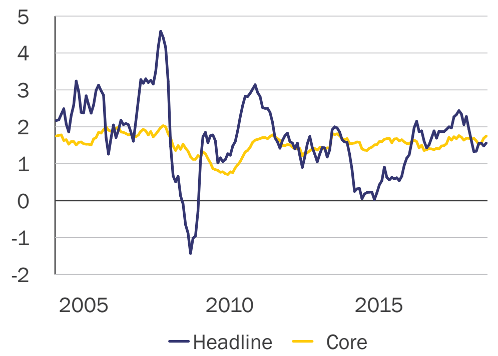
Business optimism: standard deviations from trend




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

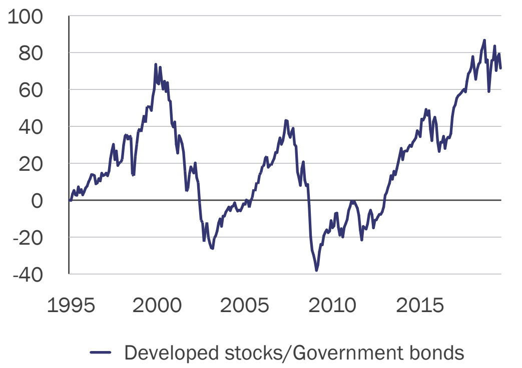
## G7 inflation

%, year-on-year



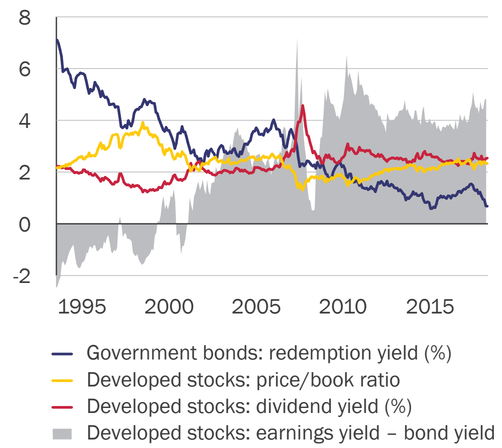

*Source: OECD, Bloomberg, Rothschild & Co*

## 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 | 1.5 | 13.8 | 8.5 |
| 10-yr UK Gilt | 0.5 | 9.4 | 6.8 |
| 10-yr German bund | -0.7 | 8.7 | 7.5 |
| 10-yr Swiss Govt. bond | -1.0 | 7.0 | 5.0 |
| 10-yr Japanese Govt. bond | -0.3 | 3.6 | 2.6 |
| Global credit: investment grade (USD) | 1.2 | 10.8 | 11.8 |
| Global credit: high yield (USD) | 6.2 | 7.3 | 17.1 |
| Emerging (USD) | 4.9 | 11.9 | 13.9 |

*Source: Bloomberg, Rothschild & Co*

## Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

| | Yield (%) | 1yr (%) | 3yr (%) |
|---|---|---|---|
| World: all countries | 2.6 | 0.5 | 31.9 |
| Developed | 2.5 | 1.0 | 33.2 |
| Emerging | 2.9 | -3.0 | 22.7 |
| US | 1.9 | 2.2 | 40.2 |
| Eurozone | 3.6 | -0.9 | 21.8 |
| UK | 4.8 | 0.1 | 18.8 |
| Switzerland | 3.0 | 13.1 | 32.3 |
| Japan | 2.3 | -9.8 | 21.6 |

*Source: Bloomberg, Rothschild & Co*

## Selected exchange rates

Trade-weighted indices, nominal (1980 = 100)

| | Level | 1yr (%) | 3yr (%) |
|---|---|---|---|
| US Dollar (USD) | 111 | 3.4 | 5.3 |
| Euro (EUR) | 125 | -2.8 | 5.3 |
| Yen (JPY) | 98 | 7.9 | 1.0 |
| Pound Sterling (GBP) | 75 | -2.9 | -3.2 |
| Swiss Franc (CHF) | 162 | 2.0 | 3.0 |
| Chinese Yuan (CNY) | 128 | -2.4 | -3.0 |

*Source: Bloomberg, Rothschild & Co*

## Commodities and volatility

| | Level | 1yr (%) | 3yr (%) |
|---|---|---|---|
| CRB spot index (1994 = 100) | 170 | -11.6 | -6.8 |
| Brent crude oil ($/b) | 60.4 | -22.3 | 24.9 |
| Gold ($/oz.) | 1,520 | 26.7 | 16.0 |
| Industrial metals (1991 = 100) | 243 | -2.0 | 23.6 |
| Implied stock volatility: VIX (%) | 19.0 | 40.3 | 44.7 |
| Implied bond volatility: MOVE (bps) | 86.9 | 72.4 | 25.7 |

*Source: Thomson Reuters, Bloomberg, Rothschild & Co*

*Data correct as of 31st August 2019.*

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## 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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