Market Perspective

Keeping an open mind | Modern monetary theory | US elections and portfolios

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Foreword

A year that looked set to be a washout for investors may be declared a vintage. As we write, most assets have beaten inflation, and comfortably. The surge in stocks in particular was not just a rebound from the big falls at the end of 2018 – returns since the end of 2017 are firmly positive too. Volatility has been low across stocks, bonds and currencies.

We're trying to keep an open mind about what comes next.

Monetary policy remains remarkably generous, which is one of the things boosting both bonds and stocks. It may remain so for a while yet, given the growing interest in (even more) unconventional measures such as Modern Monetary Theory (MMT), which is popular with some of the candidates chasing the 2020 Democratic nomination. In this issue we take a quick look at what both MMT and the presidential campaign might mean for portfolios.

We doubt policy needs to be so generous. The global slowdown may have almost run its course. Even if it hasn't, we've seen little macroeconomic need for the sort of downturn that might make more sense of today's interest rates and bond prices. As a result, we continue to see many bonds as prohibitively expensive: most yields remain below current inflation rates.

A rethink by the Fed in particular would hit stocks too. But it will probably only happen if a significant economic setback is indeed less likely than feared. With stock valuations still largely unremarkable, such a setback might prove short-lived. We continue to think stocks offer the most likely source of long-term inflation-beating returns. Here in the UK, the election result has reduced one potential risk for business owners.

Market Perspective will be published next in February 2020. We wish readers everywhere a peaceful and prosperous New Year.

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

Keeping an open mind

Still no sell-by date on this cycle

There have been further signs that the slowdown in the global economy, which is now two years old, may be starting to bottom out.

The highly cyclical manufacturing sector seems to be stabilising on both sides of the Atlantic and in China. The most likely cause of a renewed downward impetus – escalation of the US–China trade spat – seems a bit less likely.

We can hardly relax just yet: the presidential Twitter account is still active. As impeachment progresses (if only towards eventual collapse in the Senate) a defensive but electioneering President may be even less predictable.

But at least a “phase 1” agreement seems close – and we can still see a potentially more positive outcome, which helps balance the risk of a bad one. For all his idiosyncracies, Mr Trump is the only Western politician willing to remind us that China remains the most protected big economy. China knows this – and the fact that liberalisation, not central dictat, has done most to deliver its stunning economic success.

Meanwhile, manufacturing’s slide has not (yet) been very contagious. The US has just posted the lowest unemployment rate, and the most building permits, in the cycle to date.

Whether we are close to the low point or not, as we see things, there is no need for a more dramatic punctuation mark in this lengthy business cycle. The two-year-old slowdown may just be the mirror image of the acceleration, fuelled by one-off tax cuts, that preceded it.

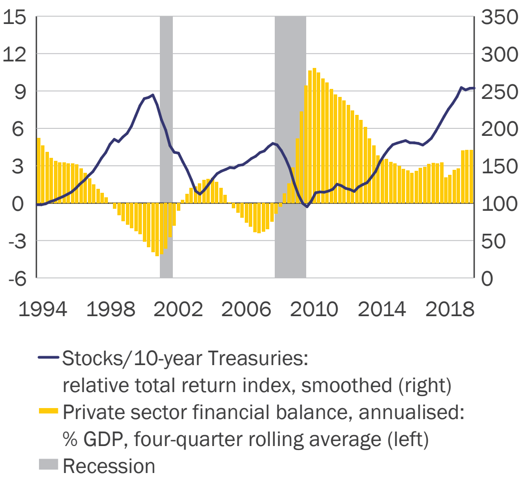
Why should a more dramatic denouement loom? We’ve noted often that this little-loved cycle has been one of the best behaved. In particular, the financial excesses that marked the two previous cycles have been largely absent.

Figure 1 reminds us that 10 years into an economic expansion, the US private sector still has a cashflow surplus. Instead of borrowing, it is supplying liquidity to the wider economy. This is no guarantee that a big recession is not at hand: maybe US consumers just want to save more, period? But it has been a good reason so far for giving this elderly cycle the benefit of the doubt – and for wondering, perhaps, whether a more frothy phase may yet still lie ahead of us.

Figure 2 shows that it is not just the US where bank lending to the private sector has grown more slowly in this cycle than in the last: lending has been much more subdued in the eurozone and the UK too.

Figure 1: Little sign of macro excess

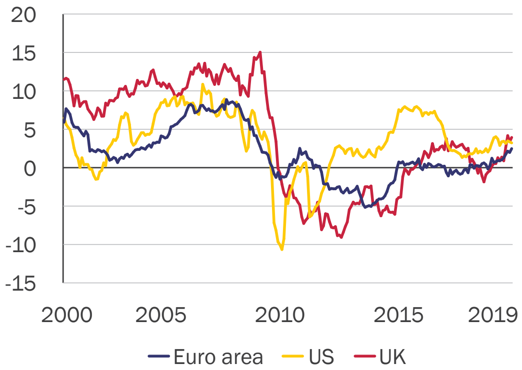
US private sector, financial balance (four-quarter moving average, % GDP)



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

Figure 2: Bank lending relatively subdued

Growth in US, eurozone and UK bank loans (% year-on-year, inflation-adjusted)



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

In some cases – corporate loans, for example – slower bank lending has reflected banks' loss of market share, as lending has shifted to bond markets. But bonds are probably 'safer' for the system – and borrowers – than bank loans. Their coupons are mostly fixed, their maturities longer, and any defaults will hit individual bondholders, not the banking system. And overall, this has never felt like an 'irrationally exuberant' cycle.

Inflation is another excess that has led to a "corrective" recession in the past. But in this cycle, subdued inflation has been one of the factors encouraging central banks to keep the already-slack monetary reins loose – and to look for even more unconventional ways of doing so, as we discuss, with misgivings, below.

(Stop press: the UK election makes a less business-friendly government unlikely. Main beneficiaries are the currency, and domestically facing stocks. Internationally oriented stocks, and gilts, face offsetting risks – higher taxes versus a lower currency for the overseas earners; higher issuance and inflation versus safe-haven status for gilts).

MMT: what can they be thinking?

Monetary cynicism could backfire

"*Practical men who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler...*" – Keynes, *The General Theory*

We've spent much of the last decade arguing that economists worry too much about many things, such as debt, demography and deflation. But there is something we think they worry too *little* about: does monetary policy need to be so generous?

We are hearing about another proposed innovation that makes us nervous on this account. Something called Modern Monetary Theory (MMT) is being taken seriously by economists and central banks – as well as a couple of would-be Democrat candidates for the White House.

MMT is not in fact a modern idea, nor – unfortunately – is it a theoretical one. It has been put into practice all too often.

MMT: a money-financed fiscal boost

If a government decides something must be done to boost the economy, what are the options?

- Try to change the level of activity in the economy with its own spending and taxation plans (fiscal policy).
- Try to manipulate interest rates, and/or the quantity of credit or money, and/or the exchange rate (monetary policy);
- Do both.

(This assumes the government has some monetary autonomy or sovereignty. The US has the luxury of being able to both print its own currency and borrow in it. But members of a currency union, for example, or small countries dependent on overseas funding, may have little control over their interest rates and exchange rates.)

If they spend more, but also raise taxes, the budget stays balanced and net demand doesn't change much (it probably rises a little: some of the taxes would have been saved).

If they spend more (or cut taxes) and pay for it by borrowing (issuing bonds) from the public, then fiscal policy is said to be expansionary, and will boost net demand as long as the funds borrowed were not already earmarked for other projects.

If they spend more and pay for it instead by creating money, or if they spend more and cut interest rates to offset any 'crowding out', they are using both fiscal and monetary policy.

MMT does both: it combines monetary and fiscal stimulus in the shape of money-backed public spending. The monetary component, however, differs from other recent 'unconventional' monetary tools like quantitative easing (QE).

The money created by QE sits on bank balance sheets: it may or may not leak into wider circulation, and in turn may or may not support private spending. By contrast, the government's own spending is the focal point of MMT, and is backed directly by creating new circulating money – cutting out the middlemen. Arguably it might be better named 'Modern Fiscal Theory'. (Some less kind alternatives have also been suggested: Professor Ken Rogoff has referred to 'Modern Monetary Nonsense', and the phrase 'Magic Money Tree' might spring to mind had it not already been appropriated elsewhere.)

MMT could have a big impact. It doesn't have to, because if people see the money-backed spending as a substitute for projects they otherwise would have done themselves, then total spending might not rise. But generally, if the government is able to procure what it wants, and does so without causing people to take offsetting action of some sort or squeezing private finances, it could deliver directly a big increase in demand.

The man behind the curtain

Ultimately, money is a bit of a confidence trick: it has no intrinsic worth, but has value because people see it as acceptable tender, and as largely fixed in supply (or at least, as not growing dramatically and arbitrarily).

Policies which loudly proclaim a big increase in its supply might undermine that confidence, and lead to money losing some of its value (that is, to inflation). As a result, the potency of MMT could be a bit like that of the Wizard of Oz: pretty impressive, until it is revealed that the loud voice, thunderflashes and confetti come from a rather ordinary bloke behind the curtain.

Then, instead of the new money-backed demand being translated into wizard gains in output and employment, and perhaps some small increase in inflation, it might instead be transformed wholly into inflation and, if big enough, threaten monetary collapse.

We do not know where that revealing moment is. It may be some way away, particularly if there is a lot of free capacity in the economy, which can then absorb the extra government procurement without leaving less output available for other buyers. But it may not be.

Keynes talked about tackling unemployment by burying banknotes and letting people bid for the right to dig them up. But they would only do so if they felt that the notes would still be worth something. In the 1930s, with unemployment high and communication slow, their worth might not be questioned. But when there is little slack in the economy, and everyone knows what is happening, such blatant monetary cynicism might undermine faith in the currency.

Taking such a risk is not something to be entertained lightly. There are no instances of societies imploding because of low inflation, but monetary collapse is a killer. And we're saying nothing about the bigger government.

Why take this risk now?

It is not clear what question this potentially alarming policy might be trying to answer. Admittedly, global growth has been slowing for two years, and US and EU inflation rates are slightly below target. There is concern over rising inequality. There is also unease (in Europe) over negative nominal interest rates and their associated distortions (most visibly, those elevated bond prices), and some worry about what central banks might be able to do if an economic emergency were to arrive with interest rate policy already dialled up to eleven, as it were.

These arguments are unconvincing. As noted above, there are few reasons for seeing this slowdown as especially sinister. Meanwhile, unemployment in Western economies is historically low, not high.

Inequality may not be best targeted with a monetary blunderbuss. Nor is it clear that MMT would assist in normalising interest rates. Maybe MMT could help if a genuine economic emergency were to arise – a point made by the IMF's Christine Lagarde – and were to do so with interest rates still at today's levels. But why introduce it now?

Mission creep and hubris

The popularity of MMT reflects mission creep in the central banking debate. Many economists, believing growth to be disappointing, fretting that inflation is a few tenths of a percentage point below target, and emboldened by central banks' success in saving the world in 2008–09, want policymakers to try harder.

But inflation targets do not exist because we want more of it: small arbitrary targets were the only way of squeezing chronically high expectations out of the system. A bit more inflation is not a good thing in itself, and the idea it can somehow be fine-tuned is hubristic. Paul Volcker – the Fed Chairman who did so much to restore US monetary credibility in the early 1980s, and whose death sadly has been announced as we write – said in 2018:

"... even if it were desirable, the tools of monetary and fiscal policy simply don't permit that degree of precision... The real danger comes from encouraging or inadvertently tolerating rising inflation and its close cousin of extreme speculation and risk taking."

Our 'muddle-through' scenario has worked well for a decade now, but wholesale adoption of MMT (or, here in the UK, 'people's QE') might be a risk too far. It could yet snatch defeat from the jaws of victory in the fight against inflation – the investor's most determined long-term enemy.

US elections and portfolios

Circumstances matter more than who wins

What might the 2020 US Presidential election mean for portfolios?

The process starts in early February with the first primary, the crucial Iowa Caucus, and is likely to be noisier than usual given impeachment proceedings, unresolved trade tensions and the Democrats' collectivist lurch.

While there are many Democrat contenders – Michael Bloomberg has recently thrown his hat into the ring – the field should narrow as the primaries progress. The latest opinion polls suggest that Joe Biden will most likely prevail over Elizabeth Warren, and face President Trump in the electoral race.

POTUS may be lagging in terms of popularity, but statistically the incumbent has had the advantage. The distribution of Electoral College votes – the first candidate to receive 270 out of 538 electors wins the White House – suggests that candidates may not need to get the most votes (Hilary Clinton won the popular vote in 2016).

We might think that the Republicans' pro-business credentials might boost growth and capital markets. In fact, on average, in the post-WWII period Republican presidents oversaw over sub-par growth and equity market returns. Circumstances clearly matter as much as the president's political complexion.

Meanwhile, President Trump's first term has not been the financial calamity many anticipated. US equities have returned 12% a year (after inflation) – comparing favourably with the post-WWII average of 8% a year – while the US economy has expanded respectably despite the somewhat lengthy nature of this cycle.

But circumstances have helped. Equities have been buoyed by loose monetary policy and business tax cuts. Whoever wins the White House, it is hard to imagine that such a favourable economic backdrop will persist for another four years.

Figure 3: The post-WWII record

US presidents, investment returns and the economy

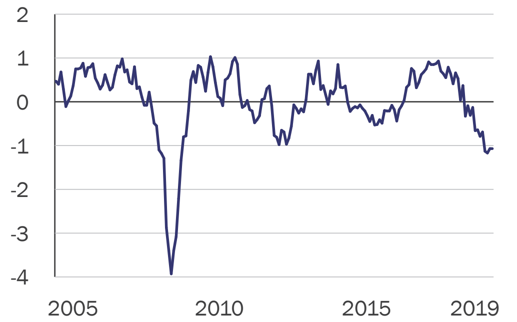
President	Inauguration	US equities (%)	US Treasuries (%)	Real GDP growth (%)	Inflation (%)	Unemployment (%)
FDR / Truman	1945	6.3	-4.3	-2.4	2.9	3.3
Truman	1949	23.0	-1.2	5.6	2.7	4.4
Eisenhower	1953	20.0	0.5	2.9	0.9	4.2
Eisenhower	1957	8.0	1.0	2.1	1.9	5.4
JFK / Johnson	1961	12.6	2.1	5.2	1.2	5.8
Johnson	1961	5.8	-1.5	5.1	3.3	4.0
Nixon	1969	2.4	1.0	3.3	4.5	4.9
Nixon / Ford	1973	-8.8	-1.9	2.2	8.3	6.6
Carter	1977	1.8	-9.5	3.2	10.3	6.6
Reagan	1981	6.5	9.2	3.3	5.1	8.5
Reagan	1985	15.4	9.4	3.9	3.4	6.5
Bush	1989	12.6	7.5	2.2	4.2	6.2
Clinton	1993	15.3	5.3	3.4	2.8	6.1
Clinton	1997	15.6	5.4	4.2	2.4	4.5
Bush	2001	-3.1	4.5	2.4	2.4	5.4
Bush	2005	-8.4	5.8	1.1	2.5	5.0
Obama	2009	13.0	2.8	1.4	2.3	8.8
Obama	2013	13.5	0.1	3.7	1.2	6.0
Trump	2017	12.4	2.1	2.6	2.0	4.1
Entire period		8.1	0.5	2.9	3.3	5.6
Democrat		11.7	-0.1	3.2	3.2	5.5
Republican		5.0	1.0	2.5	3.4	5.7

Source: Rothschild & Co
Note: Returns are adjusted for inflation and shown on an annualised basis. US Treasuries have been calculated using the benchmark 10-year bond return. The unemployment rate represents an average over the duration of the term.

Economy and markets: background

Growth: major economies

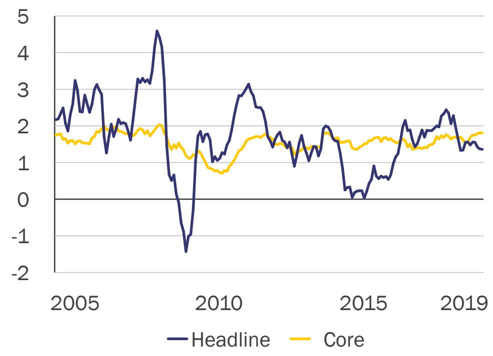
Business optimism: standard deviations from trend



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

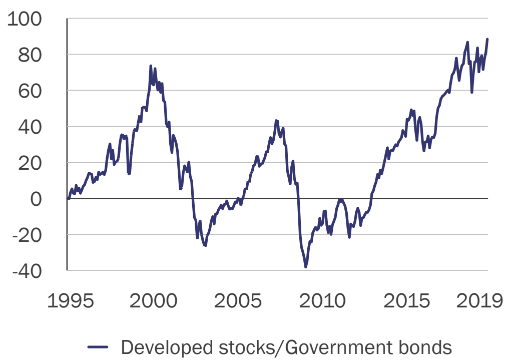
G7 inflation

%, year-on-year



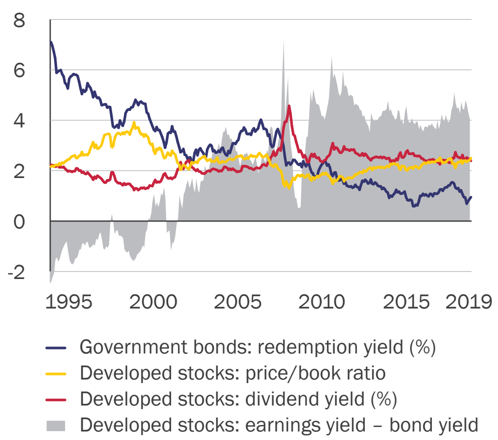
Source: OECD, Bloomberg, Rothschild & Co

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	10.5	13.2
10-yr UK Gilt	0.8	4.2	10.3
10-yr German bund	-0.3	4.1	7.3
10-yr Swiss Govt. bond	-0.6	3.0	4.5
10-yr Japanese Govt. bond	-0.0	0.5	1.5
Global credit: investment grade (USD)	1.5	9.0	14.2
Global credit: high yield (USD)	5.9	10.6	18.3
Emerging (USD)	5.0	12.5	18.6

Source: Bloomberg, Rothschild & Co

Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

	Yield (%)	1yr (%)	3yr (%)
World: all countries	2.4	18.6	35.3
Developed	2.4	19.4	36.0
Emerging	2.8	12.5	30.6
US	1.8	20.6	44.7
Eurozone	3.3	22.2	24.0
UK	4.7	11.3	16.4
Switzerland	2.9	25.0	39.3
Japan	2.4	11.4	19.2

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (1980 = 100)

	Level	1yr (%)	3yr (%)
US Dollar (USD)	110	-0.2	-0.9
Euro (EUR)	123	-2.0	5.8
Yen (JPY)	94	4.6	5.5
Pound Sterling (GBP)	81	6.5	3.0
Swiss Franc (CHF)	161	1.7	1.2
Chinese Yuan (CNY)	129	-1.7	-3.1

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	182	0.3	-5.1
Brent crude oil ($/b)	64.3	7.3	18.4
Gold ($/oz.)	1,464	17.7	26.2
Industrial metals (1991 = 100)	238	0.9	2.4
Implied stock volatility: VIX (%)	15.7	-30.7	33.4
Implied bond volatility: MOVE (bps)	67.1	11.3	-11.2

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data correct as of 30th November 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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