Market Perspective

Looking across the valley | The bill

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Rothschild & Co
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Foreword

Our thoughts are with those hurt by the virus, and those who have been keeping the show on the road.

Headlines still talk of economies “facing” recession, but most are probably growing again. We don’t know exactly how deep a hole the global economy fell into, but we likely started climbing out of it in May.

It will take longer to get out than it did to fall in. Lockdowns will ease more slowly than they began; many businesses and jobs may not make it to the other side; renewed contagion is possible; some habits may change.

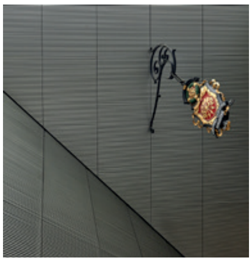
But nobody expects a symmetrical recovery anyway: the perfect V-shape is the pundits’ straw man. What is less remarked upon is the possibility that the rebound now under way may nonetheless follow a timeline that makes today’s big corporate losses look small to far-sighted capital markets.

Least discussed of all, if our inboxes and reading lists are anything to go by, is the possibility of a more positive longer-term outcome. There must be some chance that confidence steadily gathers momentum, fuelled by continuing loose policy, relief and pent-up demand, and that this virus stays contained.

Such lopsided received wisdom is one way in which this downturn – otherwise so special – resembles others. The “wall of worry” has got bigger. Meanwhile, stock markets have, as usual, rallied before the economy. We suggest here that the two are not as disconnected as they seem.

In the second essay we discuss the possible economic costs of the downturn; and we ask if there will be any fiscal and monetary hangovers. It is the latter we’ll be watching out for most closely. We’re all fans of Hamilton these days, but his key insight concerned mutual borrowing, not printing.

Kevin Gardiner
Global Investment Strategist
Rothschild & Co 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.

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Values: all data as at 31st May 2020.
Sources of charts and tables: Rothschild & Co or Bloomberg unless otherwise stated.

Looking across the valley

Stock markets are not so indifferent

The elusive Mr Market

We talk of markets panicking, or being exuberant. There is no doubt stock prices often do reflect emotions. But those emotions are ours, not Mr Market's.

When investors do collectively panic – or cheer – they focus narrowly on the things that matter most to their investments: corporate income and interest rates.

Sometimes, that investment focus may align with wider concerns. Often it doesn't, and markets seem callous, as when (for example) natural disasters, oppressive regimes, civil unrest (sadly topical on both sides of the world as we write), or the plight of refugees leave them unmoved.

Investors' current mood seems pretty impersonal. Stock markets have surged by a third since 23rd March, but virus casualties are still rising and economies are still weak. In fact, stocks and human interest may not be as divergent as they seem. The discrepancy largely reflects timing, not indifference.

The decision to suppress the virus by closing part of the global economy had big ramifications for business, as well as for people. Profits have slumped along with jobs and incomes – we are still waiting to find out exactly how far (data are lagging). In this case, what was bad for people – the virus and the cost of suppressing it – was bad for stocks too.

Expectations matter

But markets – investors – look forward, not back, and stock prices fell as soon as it became clear that profits were going to – and before they actually did. Between 19th February and 23rd March, global stock prices fell by a third. The backward-looking economic data published over that period showed little deterioration.

At those lower levels, stock prices seemed to be suggesting – particularly with interest rates so low – that profits would not just slump, but would stay at depressed levels for years.

Growth is the norm, however. You need very good reasons (other than fanciful op-ed articles) for expecting it not to resume.

As we noted in April, this is a special downturn in many ways. It is the most sudden; probably the deepest; the least contentious; the first to be led by services; it has broken financial records (the fastest bear and bull markets); it has led to the biggest and fastest policy response; and, most importantly, it has been the first *deliberate* downturn.

That latter point is important. There are few excesses needing to be corrected before recovery can begin – no speculative boom, lending binges or surging inflations to be unwound. Just as we chose to close part of the economy, we can reopen it.

Sudden, deep – and short?

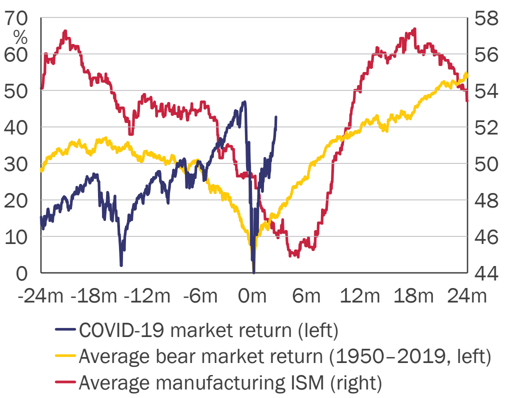
As contagion rates have slowed, roughly following China's earlier timeline, and the costs of suppression have become clearer, lockdowns have indeed begun to ease. As a result, this may yet be one of the shortest downturns. The contraction of the global economy was likely concentrated in the six weeks or so from mid-March – most economies are probably growing again now. The remarkable US jobs report for May is the most visible indication to date.

Profitability will bounce with growth. Countless columns have debated the speed and extent of the rebound, but to a stock market that fell by one-third the most important thing may be that it is there.

So, at the risk of overanalysing short-term market moves – an occupational hazard – we suspect investors initially overreacted.

Figure 1: US stocks and economic activity

Movements in US stock prices around low points in the ISM survey



Source: Datastream, Rothschild & Co
Note: Bear market is defined here as a peak-to-trough movement of greater than 20%. ISM (The Institute of Supply Management).
Past performance should not be taken as a guide to future performance.

Stocks usually "look across the valley"

On this reading, markets/investors have not been especially callous or disconnected from reality. Just as forward-looking market prices fell before economies did, they may have started to recover before them too. Stock prices usually "look across the valley" in this way (figures 1 and 2). But don't expect this to cheer the sub-editors as they headline those second-quarter GDP and earnings data in July and August.

Of course, lower interest rates are also encouraging investors to look across the valley, and they are not so closely aligned with human welfare as business conditions. One of the reasons people were sceptical about rising stock prices after 2008 was that they were widely attributed to low rates – investors seemed to be gaining while economies were languishing.

However, we saw the post-2008 rebound in profits as the main driver of stocks, and saw healthy jobs growth as suggesting output was being under-recorded. Similarly, stocks' latest rebound likely owes more to the realisation that profits can revive, with the latest (small) reductions in interest rates and bond yields playing a subsidiary role.

Time horizons are long

In fact, we don't think stock valuations have ever fully reflected recent levels of interest rates. But even at higher rates than today's, prices would still implicitly be looking a long way ahead. Losing this year's cashflow might eliminate a small portion only of market value (figure 3).

Of course, this is textbook theory. In practice, if it became clear that a full year's earnings were going to disappear, prices would doubtless temporarily dive as investors panicked anew.

In 2001 and 2008, earnings did indeed disappear. But rebounds were predictable – balance sheets (telecom, media and technology goodwill in 2001, bank assets in 2008) could only be written off once. A rebound is predictable now – lockdowns are easing.

That said, cyclically adjusted estimates suggest stocks are now neither especially cheap nor dear. We have been happy to hold and top-up positions throughout, but those positions are no smaller or bigger than usual.

What next?

Amid such seismic upheaval, it is hard to imagine "business as usual". There will be many changed working arrangements and spending patterns. But we continue to think that the future will resemble the past more closely than many commentators are so confidently asserting.

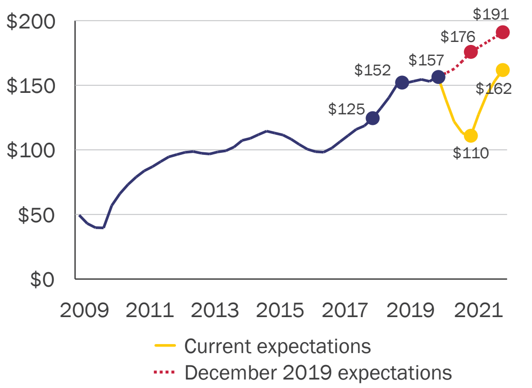
Memories can be short. People's tastes may not change much. International comparative advantage still exists. Not everyone can afford to abandon materialism. When it comes to the really big questions – such as how best to organise economies – there are fewer available alternatives than people imagine anyway.

So we advise continuing to keep "big picture" analyses at arm's length, and to focus on pre-existing trends, such as an increasingly online, virtual and contactless economy; the gradual end of the oil age; and sustainable and responsible investing.

And prepare to return to an investment world in which US–China trade tensions, China's sovereignty in Hong Kong, the EU's approximating federalism, the presidential election (US corporate tax increases if Biden wins?) and Brexit once again feature prominently alongside economic indicators that (eventually) lose their sensational edge.

Figure 2: Looking across the valley

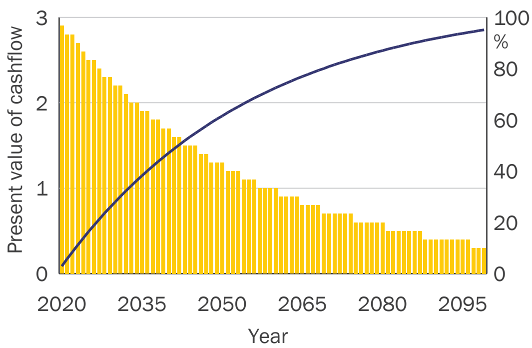
Expectations for S&P 500 operating earnings (per share)



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

Figure 3: Stock market value

Annual dividends and their cumulative contribution to market value



Source: Rothschild & Co.
Note: Assumes dividend growth of 3.5%, a riskless interest rate of 3% and a risk premium of 3%.
Past performance should not be taken as a guide to future performance.

The bill

What might an economic reckoning look like?

If stock prices agree that the long-term damage done to quoted businesses may not be as large as feared in March, what can we say about the wider economic impact?

There will be all sorts of indirect as well as direct economic effects of the disruption. Identifying them all, and their consequences, is impossible. How to gauge the lost human capital and opportunities from closing schools and universities? Can we quantify the increase in inequality?

But is the impact best thought of as a "cost" at all?

Incomes, output and expenditures (GDP)

Total incomes (GDP) have fallen sharply. We might compare its path with the trend it might otherwise have followed, but that assumes we know what the alternative path would have been, and we don't. A simpler estimate of the impact is the cumulative shortfall from the starting point. The sort of fall in global GDP estimated by the International Monetary Fund, with the starting point being regained some time next year, might suggest a cumulative loss of GDP that is a multiple of the loss sustained in the Global Financial Crisis (GFC).

But has this been avoidable? What were the alternatives? Would GDP have followed its "trend" path anyway? A counter-factual world with higher fatalities and health services pushed beyond breaking point would also have seen big damage – certainly in human terms, and likely economically too. Sometimes there are only bad outcomes to choose between.

Balance sheets

Capital markets show the evolving value of businesses that have issued securities. With a lag, we will be able to see how household borrowing has risen. Data for private businesses and much real estate are patchy – and late. We can only guess there will be big and permanent losses.

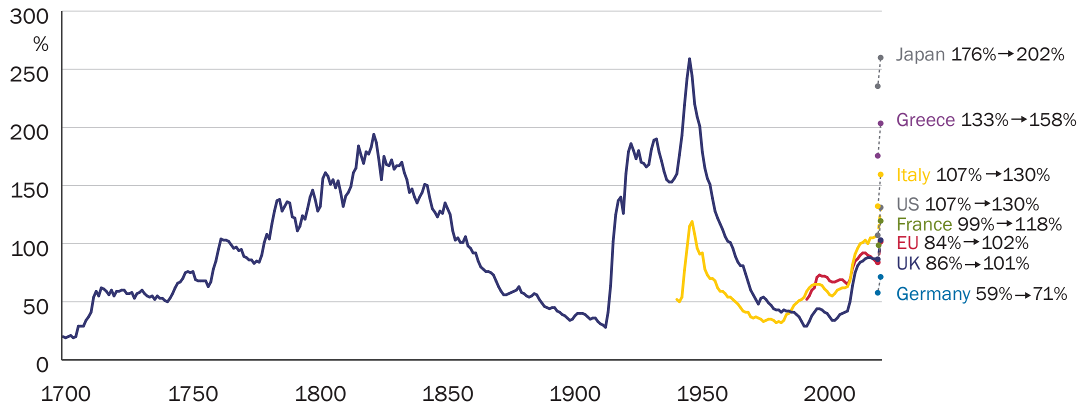
Government liabilities are very visible, and rising quickly with those support packages. The scale of the debt overhang will depend on how much of the contingent support is taken up. Plausible estimates of government debt to GDP ratios after this year's surge are shown in figure 4. Remember, debt is rising as GDP is falling – a double whammy for the ratios.

They are rising faster than in the GFC, and to higher levels. However, the wide range of ratios across countries, and history in the UK, suggests it is far from clear at what level they begin to cause problems. There is as yet no sign that the prospective borrowing is unsettling lenders. The yields on high-quality government bonds have been at or close to all-time nominal lows, and in real terms are firmly negative in most places.

Arguably, the creation of national debts, funding infrastructure and fostering liquid capital markets, was one of the key drivers of economic development.

Figure 4: The government debt overhang

General government gross debt to GDP ratios (%)



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

None of this stops people worrying about it. Debt can be a crushing burden for individuals and businesses. And clearly, there are limits even to public borrowing. The US government can borrow as much as it wants in its own currency, but Venezuela's can't borrow in any currency at any price.

The debate is one of the fiercest in finance. Again, we suggest keeping the dramatic assertions at arm's length. The world cannot be insolvent, though it can be illiquid. We cannot "borrow from future generations".

Taxes may rise – current effective rates are not high. But they may not have to (and surely not soon – what would be the point?). Borrowing charges are low, and resumed growth will cut deficits: big tax increases and spending cuts are economically and politically a last resort.

And again, what were the alternatives? If government borrowing hadn't risen, the damage to longer-term GDP and private balance sheets would likely have been bigger.

Borrow or print?

So entrenched is the distrust of borrowing that many economists – and central bankers, who should know better – are suggesting a riskier alternative, namely: the printing of money.

What's so alarming about monetary financing? Aren't banknotes just another negative real yield government liability, albeit a perpetual one?

They are. But deficits funded by bonds sold to the public are redirecting spending power that already exists. When governments print money, they create new spending power. And if they do so very publicly – not just via quantitative easing, but by boosting procurement and other spending and using newly minted cash to pay for it – then people may start to ask questions.

Most obviously, if there is all that extra money around, how can it be worth as much? And if it's going to lose its value, shouldn't we use it pretty quickly?

Monetary credibility and inflation risk

There is little inflation currently (figure 5), and with demand weak, little expectation of any (figure 6). US core consumer prices had a record fall in April. Even before the crisis, it was being widely suggested that a little bit more of it would be a good thing, and would help get rid of that (allegedly) unmanageable debt burden.

Now, as noted, government and central bank support has surged, and may not be taken off the table until well after the economic rebound is visible. If so, boosted public demand may be supplemented by reviving private demand, leaving aggregate supply trailing in its wake. We might yet face a classic demand-pull inflation – particularly if much of that demand is backed by printing. Cue those sceptical questions.

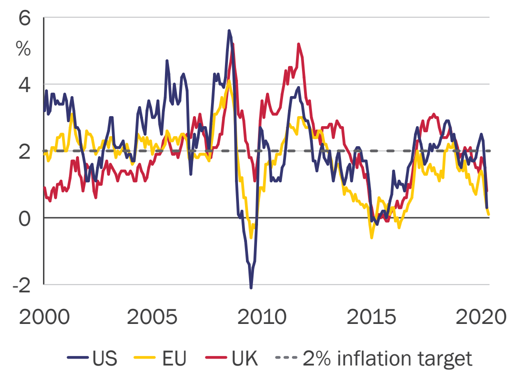
The proponents of "modern monetary theory" will be right – up to a point. We do not know when that point will be, but we can guess it will arrive sooner than the point when governments lose their ability to borrow. It took a long time to restore monetary credibility after the 1970s, but it may not take long to lose it again. When interest rates are so low, and savings plentiful, why take the risk?

Much is being made today – understandably – of the EU's potential "Hamiltonian moment". But Germany in particular is very aware that Hamilton's key insight was mutual borrowing, not printing.

We doubt inflation can be fine-tuned. Using it to tackle debt is like setting fire to your house to tackle a damp problem. The bill we worry most about facing, then, is an intangible one: the risk of lost monetary credibility, and a longer-term revival in inflation.

Figure 5: Inflation

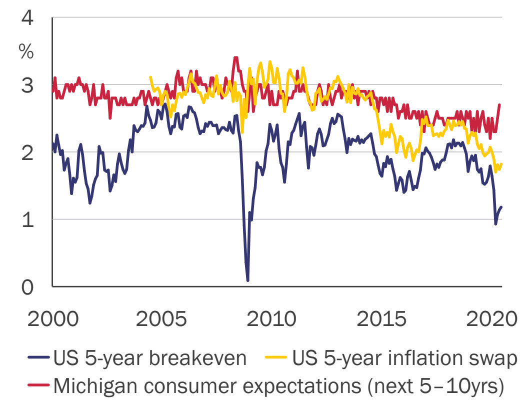
Headline CPI inflation rates (year-on-year, %)



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

Figure 6: US inflation expectations

Consumer and market-implied expectations (% per annum)

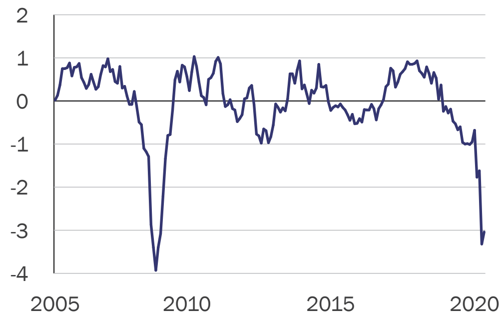


Source: Bloomberg, Rothschild & Co
Past performance should not be taken as a guide to future performance.

Economy and markets: background

Growth: major economies

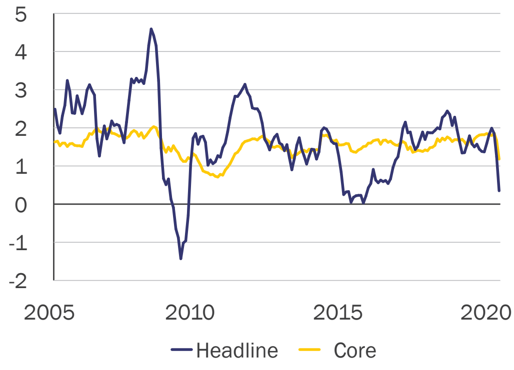
Business optimism: standard deviations from trend



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

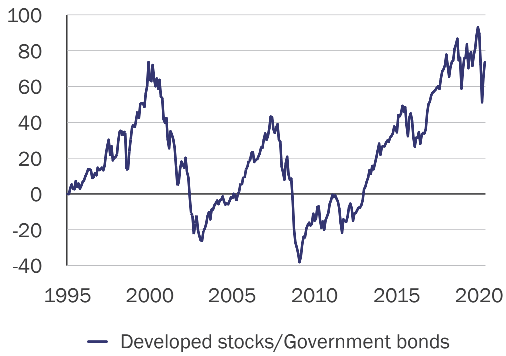
G7 inflation

%, year-on-year



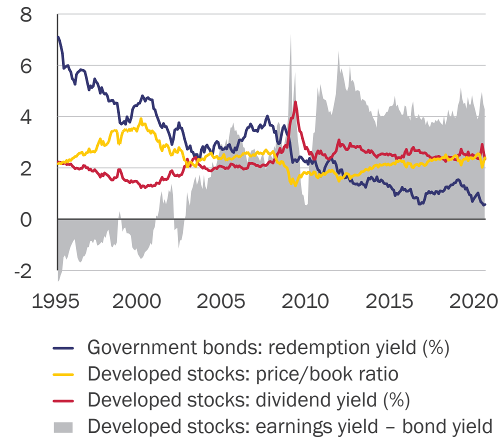
Source: OECD, Bloomberg, Rothschild & Co

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	0.7	15.1	21.5
10-yr UK Gilt	0.2	6.8	11.1
10-yr German bund	-0.4	1.5	7.1
10-yr Swiss Govt. bond	-0.5	-0.6	2.6
10-yr Japanese Govt. bond	0.0	-0.6	1.2
Global credit: investment grade (USD)	1.0	7.3	15.5
Global credit: high yield (USD)	7.4	-0.8	6.4
Emerging (USD)	5.1	3.3	10.3

Source: Bloomberg, Rothschild & Co

Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

	Yield (%)	1yr (%)	3yr (%)
World: all countries	2.5	5.2	17.8
Developed	2.4	5.9	19.2
Emerging	3.0	0.4	7.7
US	2.0	11.6	32.2
Eurozone	2.9	-5.8	-7.8
UK	4.8	-13.4	-10.8
Switzerland	2.9	5.0	17.7
Japan	2.5	4.5	7.3

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (2000 = 100)

	Level	1yr (%)	3yr (%)
US Dollar (USD)	114	4.0	6.6
Euro (EUR)	128	2.5	6.5
Yen (JPY)	97	3.5	7.6
Pound Sterling (GBP)	77	-1.0	0.1
Swiss Franc (CHF)	167	6.4	4.9
Chinese Yuan (CNY)	130	-1.6	0.4

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	132	-26.7	-27.3
Brent crude oil ($/b)	35.3	-49.1	-32.4
Gold ($/oz.)	1,730	34.9	36.6
Industrial metals (1991 = 100)	209	-11.1	-7.6
Implied stock volatility: VIX (%)	27.5	53.7	180.4
Implied bond volatility: MOVE (bps)	51.6	-18.4	-4.6

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data correct as of 31st May 2020.

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Notes

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Dusseldorf
Heinrich-Heine-Allee 12
40213 Dusseldorf
Germany
+49 211 8632 17-0

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

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

Zurich
Zollikerstrasse 181
8034 Zurich
Switzerland
+41 44 384 7111

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