Market Perspective

Political economy | Elephant in the room?

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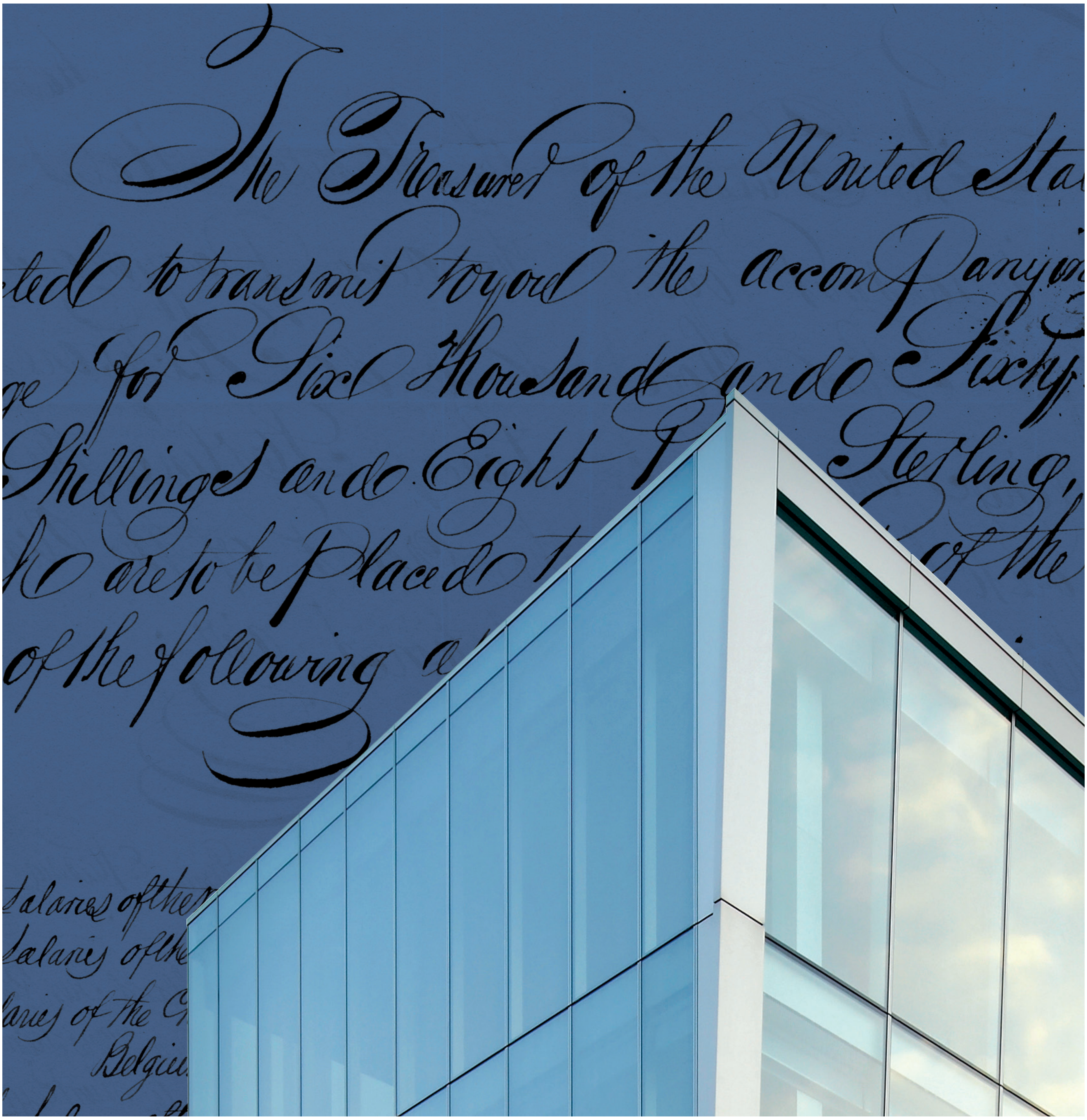

Rothschild
Private Wealth

Foreword

"O Freunde, nicht diese Töne" – Schiller/Beethoven/European Union

"Cheer up, Brian!" – Eric Idle, "The Life of Brian"

All those 2017 previews are the financial equivalent of Christmas cards – colourful, nice thought, but no shelf life.

So please don't be offended we're not sending you a fancy one. This *Market Perspective* contains no newly revised, spuriously precise predictions for the year ahead. Appropriate advice is not just for Christmas.

But what a mood as the year turns! The UK is promised a "dreadful decade"; President-elect Trump has shocked many pundits out of their senses; and an elephantine Big Picture seems set to trample what's left of the EU into the ground.

The outlook currently seems highly uncertain. In reality, it always is. It is human nature to worry (media gloom is a response to customer demand). But contemporary concerns can be overstated.

We argue here that the current business cycle may still have legs, and we suggest in the second essay that the Big Picture may be mistaken. Until we see a clearer case for US recession, collapse in China, EU upset or similar, we think long-term portfolios should remain tilted towards growth-related assets.

Since this analyst started work, the UK economy has more than doubled in size. Unemployment has more than halved, inflation has collapsed and industry relates. China has lifted more people out of absolute poverty than any economy, ever. MAD is no longer a description of superpower foreign policy. Information and communication is largely free, and we can fit much of the world's artistic canon into our coat pockets.

None of this was predicted. Not at year-end, not at mid-year.

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

Kevin Gardiner
Global Investment Strategist
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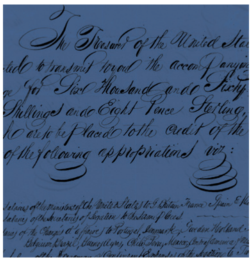


Cover image:
Foreground: Our office at New Court, London
Background: A letter to Nathan Mayer Rothschild from the American Treasury Department, 21 November 1834 concerning general business transactions. Courtesy of The Rothschild Archive.

Publication date: December 2016.
Values: all data as at 30th November 2016.
Sources of charts and tables: Rothschild & Co and Bloomberg unless otherwise stated.

Political economy

Political clouds needn't herald a stormy investment climate

Again, the most visible investment clouds at present are political, rather than economic. The global economy is – believe it or not – finishing 2016 almost on an upbeat note.

Growth in the US and Europe seems likely to have stayed close to trend in the final quarter, while China, far from collapsing as many feared, may have been gathering momentum (figure 1).

The US expansion is now well into its eighth year, making it another relatively lengthy one. Another recession is on the cards at some stage, but for now we continue to advise giving the US economy the benefit of the doubt.

Even at this advanced stage, the US private sector is still showing few of the cyclical excesses associated with the major financial embarrassments in 2000 and 2007. Free cashflow remains positive (figure 2), as US households, in particular, are collectively funding all current spending and capital outlays from savings.

This means, remarkably, that in the eighth year of expansion the US private sector is still acting as a source of liquidity, not a user of it. This does not mean a recession can't happen, but it at least removes one possible need for one.

We think the US remains the most under-rated big economy. Talk of secular stagnation looks wide of the mark: private sector aggregate demand has grown at the same pace (3%) in this upturn as in the last one, jobs growth has been healthy and measured unemployment is low. The popular "Big Picture" that purports to explain the election result looks unconvincing to us (see the second essay).

More relevantly for investors perhaps, despite a widespread belief that sales have been static in this cycle, and that companies have no "pricing power", revenue growth has been respectable and operating margins have hit rare highs. As we noted last month, the idea that US Inc has not been investing is also mistaken.

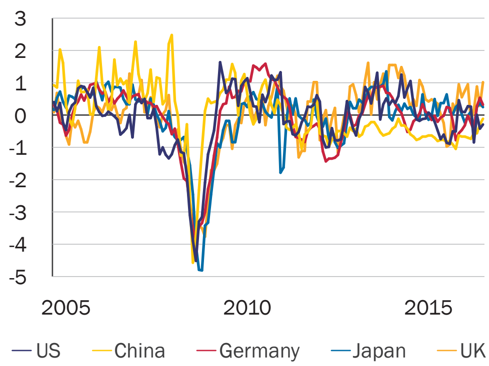
Revenues, margins and capex did take a dive in 2015 and early 2016 – but more than all of the drop was attributable to the oil and mining sectors, which are now stabilising.

In this context, we see the likely imminent (as we write) hike in US interest rates as confirmation that the Federal Reserve is very slowly coming around to our way of viewing things. If we're right, a quarter-point increase in rates should be water off this duck's back – indeed, the economy can be seen as driving interest rates, rather than vice versa. This is not however such good news for bond investors.

Admittedly, this is before the president-elect's policies take effect. These will likely have not just US but global consequences. But as we've noted before, viewed with a dispassionate analytical eye, they may turn out to be expansionary, not

Figure 1: Key cyclical indicators close to trend

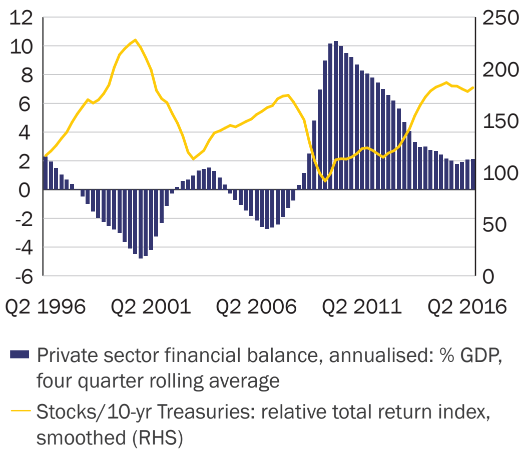
Selected manufacturing surveys, standard deviations from trend



Source: Datastream, Bloomberg, Rothschild & Co

Figure 2: Still few signs of US excess

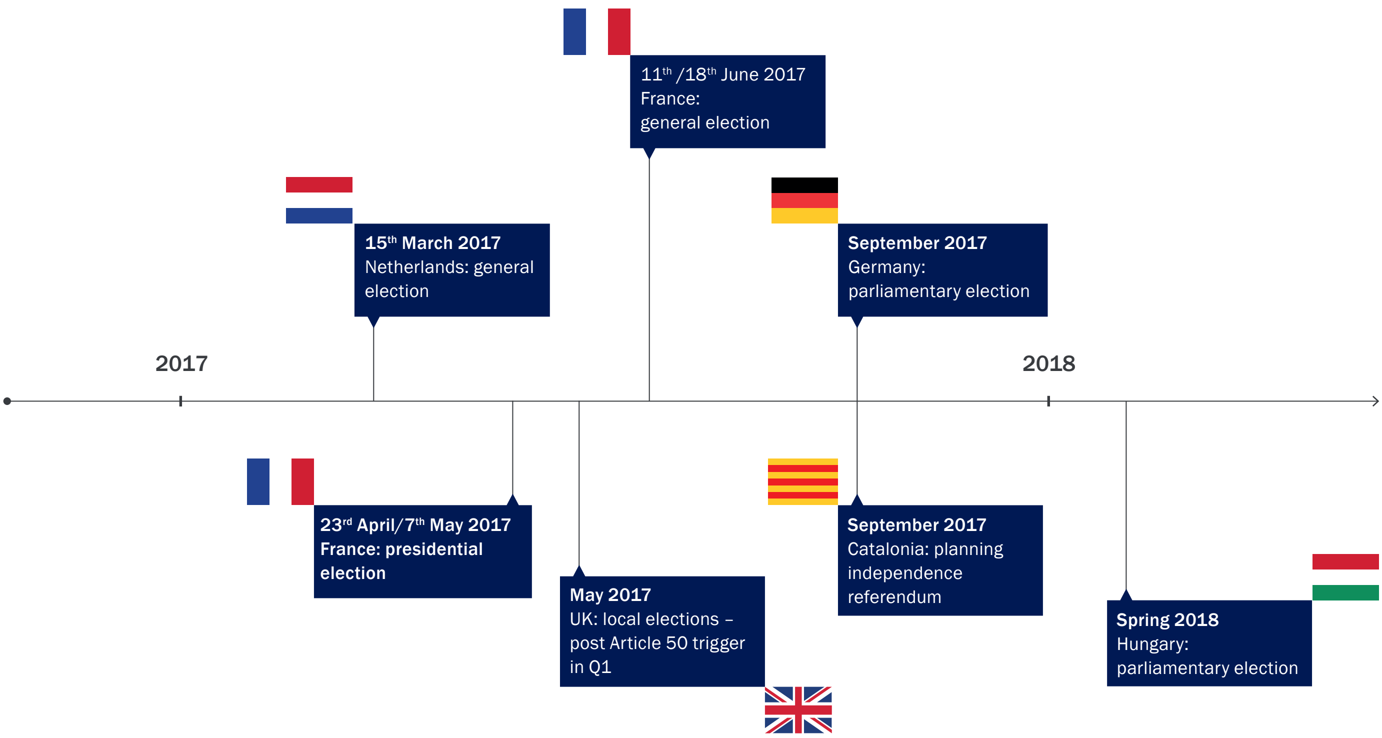
Private sector financial balance, % GDP, rolling 4-qtr mav



Source: Federal Reserve, Datastream, Rothschild & Co

Figure 3: A busy period for Europe's politicians

Following the UK's surprise decision to quit the European Union, there are plenty of opportunities ahead for further political upsets across the region.



Source: Rothschild & Co, Bloomberg, The Economist, Financial Times

deflationary. Cyclically, tax cuts could trump protectionism (as it were).

The risk of US-led restrictions on trade, and of increased geopolitical tension more widely, is the source of some of those political clouds. As 2017 progresses, and the exposition of US economic and foreign policy extends beyond 140 characters, we will discover which of them are benign and which herald thunder.

At this stage, we advise keeping an open mind – not easy, admittedly, when such an idiosyncratic POTUS is involved. But if we lack the imagination to see that some of the clouds could be benign – and that even if not, they need not coalesce with those in the European sky to create that Big Picture – then we are not doing our job as investment advisers properly. There is almost always an alternative outcome possible.

This could be so even in the high-risk area of trade talk, which is where the president-elect's policies are understandably arousing most concern. Protection is usually bad, even for the protected industries (it makes them less able to stand on their own two feet).

As things stand, the most protected big economy is not the US, but China, and by a mile (probably followed some way back by Japan). What if the president-elect's awkward and alarming rhetoric were to have the effect of spurring an increased dialogue, and more, not less, openness?

It doesn't feel likely in the short term admittedly. If anything, China seems to be trying recently to limit the cyclical decline in its currency by reducing the permeability of its markets. But while the yuan may have been cyclically expensive, it has always been structurally cheap. IMF data on purchasing power parity (a sort of economy-wide "Big Mac" index of absolute currency valuation) show it to be perhaps 40-50% undervalued against the dollar.

President Xi's advisers see the same IMF data as the president-elect. China's capital and other controls are even more directly visible. The playing field is far from level. China's companies can buy overseas companies with ease, but taking over a Chinese company is difficult. Chinese consumers can buy freehold property in London, but British consumers cannot easily do the same in Beijing.

Suppose the new US president, talking loudly and carrying a big stick, were to stumble into an improved economic detente, Reagan-like. Even the possibility of such an outcome is not contemplated by the current consensus, but surely needs to be considered in appraising the prospects for growth-related investments.

Political clouds need not herald stormy weather even in Europe. The electoral roadmap in 2017 is a congested one, and the French and German elections certainly have the potential to be game-changers.

The economic data in Europe, as in the US, have been resilient

If anything, figure 3 understates things: early parliamentary elections in Italy are possible (to be fair, they usually are – and the constitutional referendum result did not change our view that the chances of "Quitaly" are slim).

However, the Republican primaries in France delivered an unexpectedly clear result. If Mr Fillon is no less acceptable to the effectively disenfranchised left, he may yet be a tougher opponent for the Front National to beat. (Their leader is the only senior politician in core Europe willing to take an explicitly anti-Europe and anti-euro stance.) Mr Fillon's liberal policies could also be economically friendly – a structural boost for employment and business – in their own right.

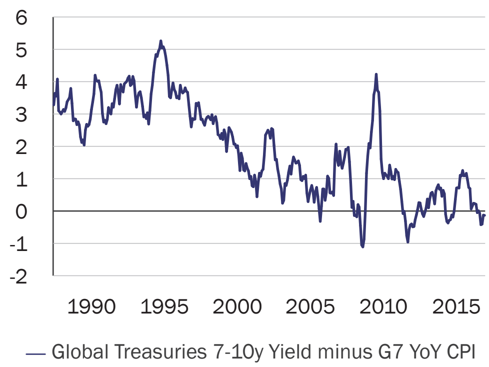
Chancellor Merkel's decision to stand again is another potential boost for the status quo (and testimony to her daunting stamina).

Again, this is not to suggest market-friendly outcomes will necessarily prevail – only that the chances of their not doing so may have been overstated. And when we look at all these various clouds, we do not see the Big Picture that others do.

Meanwhile, the economic data in Europe, as in the US, have been resilient. Not, yet, sufficiently

Figure 4: Bonds: still expensive

Developed world government bond yields less current inflation (%)



Source: Bloomberg, Datastream, Rothschild & Co

so for the ECB to countenance withdrawing its support – indeed, it has just decided to buy bonds for even longer, albeit at a tapered pace – but enough to allow unemployment to continue to drift lower and corporate profits, as in the US, to resume growing.

Figure 3 also omits the ongoing Brexit discussions and negotiations that are certain to punctuate 2017. We continue to think that a "hard" outcome is most likely. In the "prosecco versus fish n' chips" context, we'd suggest the thing to remember is that while the EU partners sell to the UK perhaps 3% of their GDP, the UK's exports to its partners account for more than 12% of UK GDP. Moreover, there are 27 different national negotiators for the UK to appease, and its hands are tied by the referendum result.

But we've been arguing that even a "hard" Brexit need not be a game changer for the UK. In a worst-case WTO-type scenario, UK exporters of goods might find themselves facing tariffs of perhaps 5% (more on food and cars, less on others) – a modest competitive hurdle when considered alongside the lowered pound. Non-tariff barriers – customs delays, lack of financial service passporting – are likely more important, but sterling, like the Bank of England, may be over estimating the impact on UK growth.

Ironically, perhaps, in October UK retail sales volume recorded its fastest year-on-year growth rate since 2002.

Finally, 2017 will doubtless be punctuated by proclamations of a hard landing in China, just as the last few years have been. We still feel unable to jump on this bandwagon: that lack of openness means China is not as plugged into global capital markets, and even the global economy, as fully as people assume. Its debts are largely a domestic affair, and if we have been wrong on China in the last six months it's been because we thought the economy would continue to slow, and it hasn't.

We continue to think the yuan will drift lower – but a collapse seems unlikely with capital controls still in place and when in absolute terms it looks so undervalued.

Looking back at 2016, there were three big political upsets that we did not expect at the start of the year (Brexit, Trump and Matteo Renzi's resignation). In each case we were able to suggest that if they were to happen, their impact on risk assets might not be dramatic. Each time, their impact was even smaller than we might have guessed.

Does this mean investors are overconfident? We doubt it: we meet few complacent investors.

Rather we suspect there has been (even) more bad news implicitly priced in than we'd suspected, and the economic picture, in particular, has been much less grim than many feared.

Generally, there is a tendency to see politics as more important to markets than it really is. When things have a big impact on us personally, it is natural to think that they must have a wider effect. Natural, but possibly mistaken.

If we dare look ahead, we suspect 2017's political economy will again prove manageable. Our worries instead continue to focus on the longer-term risks associated with central bank mission creep and monetary policy being too loose for too long.

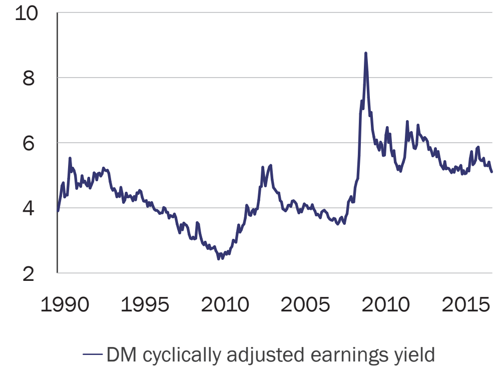
Investment conclusions

The US-led business cycle is mature, but not yet fragile. Inflation is more likely than deflation, but even in the US and UK there is little sign of a major surge, and we expect monetary conditions to normalise only slowly (led by the US, with perhaps the UK following suit in 2017). From a top-down perspective, these are the investment conclusions we draw from this ongoing "muddle through" scenario:

- The business cycle and valuations both favour stocks as the most likely source of inflation-beating investment returns. Bond yields have risen further, but most government yields are still below current inflation rates. Equities generally look less expensive (figures 4 and 5).
- We see bonds and cash currently as portfolio insurance and ballast. As such they are best held in investors' home currencies: foreign exchange risk makes them more volatile. Global interest rates may start to diverge, but only a little – especially when hedging costs are considered.

Figure 5: Stocks – valuations again unremarkable

Developed world cyclically adjusted earnings yield (%)



Source: MSCI, Datastream, Rothschild & Co

- We mostly prefer high-quality corporate bonds (credit) to government bonds, but they are also unlikely to deliver positive real returns. We see little attraction in emerging market bonds (even those in hard currency).
- In US dollar portfolios we are more positive on inflation-indexed and short-duration bonds, and less on speculative grade credit. Despite higher imported inflation, we remain wary of the valuations of long-dated UK index-linked gilts.

The business cycle and valuations both favour stocks

- In stock markets we stay most positive on the US, Europe ex-UK, and emerging Asia (despite near-term US rate-related volatility). We are least positive on the UK (though even there we prefer stocks to bonds) and on developed Asia ex-Japan (though we are less negative there than we were).
- US stocks are more expensive, and face those higher interest rates, but growth may still not be fully priced in. Continental Europe is inexpensive, even allowing for its slower growth. Emerging Asia's leading indicators continue to improve, and the risks posed by a stronger dollar and rising US rates may be overstated. The region's structural appeal remains intact, even when China's slowdown resumes.
- The UK and developed Asia (ex Japan) face local and sectoral issues that may stop them sharing fully in global growth. However, if commodity prices remain stable, Australia in particular may continue to trade more strongly than we've been expecting.
- We prefer a mix of cyclical and secularly growing sectors – technology, banks and energy, for example, and now healthcare – to bond-like sectors such as utilities, staples and now telecoms. We stay indifferent towards non-oil commodity stocks.
- Currency conviction should be low. On a one-year view, after sterling – which we think overreacted to the Brexit referendum, and so moved up our cyclical currency rankings – we still rank the dollar high: like US stocks it is not cheap, but has cyclical appeal. We rank the Swiss franc and renminbi low: their cyclical position is weaker, and valuations (relative to trend) are more stretched.

Elephant in the room?

The popular Big Picture may be a misleading caricature

Brexit, Trump, Italy – what do they have in common?

The popular explanation is that they are part of the Big Picture illustrated by the widely-reproduced "elephant" chart below.

This chart ranks percentiles of the global income distribution horizontally, with the poorest on the left. The vertical axis shows growth in real incomes over the two decades to 2008, when global integration was fastest (remember China joined the WTO, and the BRIC marketing campaign was launched, in 2001).

The focus is on the low point of the elephant's trunk – the failure of income growth in the 75th to 85th percentiles to keep pace with the rest.

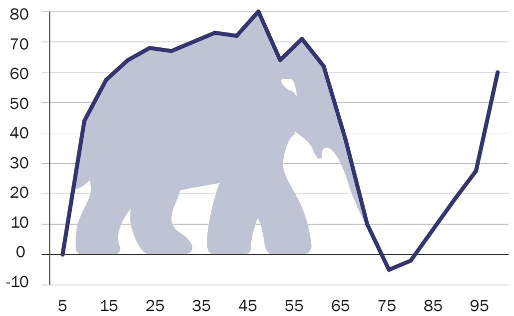
This is the developed world's "squeezed middle", it is argued. Frustrated at being left behind by globalisation, it has lashed out at the Western establishment. A thousand anecdotes in the UK, the US and Italy seem to back this up. Brexit, Trump, "No grazie" – all part of a backlash against globalisation.

Which, if true, might suggest upsets next year in France and Germany, an existential threat to the euro (seen as part of the globalisation enemy), and far-reaching consequences for business.

We are unconvinced. 2016's upsets had something in common, but not necessarily this.

Figure 6: Elephant in the room?

Changes in real income (vertical scale, %) at various percentiles of global income distribution, 1988–2008



Source: Lakner-Milanovic World Panel Income Distribution, Rothschild & Co

Broadsheet journalists are even more likely than tabloid pundits to fall for the "narrative fallacy": we don't pay premium subscriptions for clever journals to read that "nobody knows 'nuttin". But current affairs can be chaotic and random.

The people in each percentile have not been the same ones throughout. Emerging populations and incomes have been growing fastest, and in 2008 the higher percentiles will include more relatively prosperous emerging world workers than in 1988.

Similarly, the oft-reported fact that US median household incomes have barely grown in real terms in the last quarter-century partly reflects the changed composition of the workforce. Intuitively, static real incomes just don't fit with the dramatic changes in technology and product quality seen over this period.

For many Western workers, real pay did mark time for much of the last decade. But to focus on the real pay of people already in work ignores the welcome fact that there are lots more people in (full-time) work now.

If there really is a backlash against globalisation and the capitalist system, Mr Trump is an odd standard bearer. In the UK, a pro-business Conservative administration was elected only in 2015.

It would not be the first time in recent years that received wisdom has misread the popular (populist?) mood. After 2008, remember, pundits extrapolated the financial sector's foolishness into the downfall of capitalism (something predicted periodically and mistakenly since 1848 at least).

We are not saying there is no common factor. Clearly, there is: in each case voters have backed a movement or person blaming someone else for all their perceived problems. But this mood – the wish to "stick it to the man" – may not persist, however neat that Big Picture.

At the risk of stating the obvious: it is possible to believe that inequality is not the main driver of current affairs without being in favour of it.

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.

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