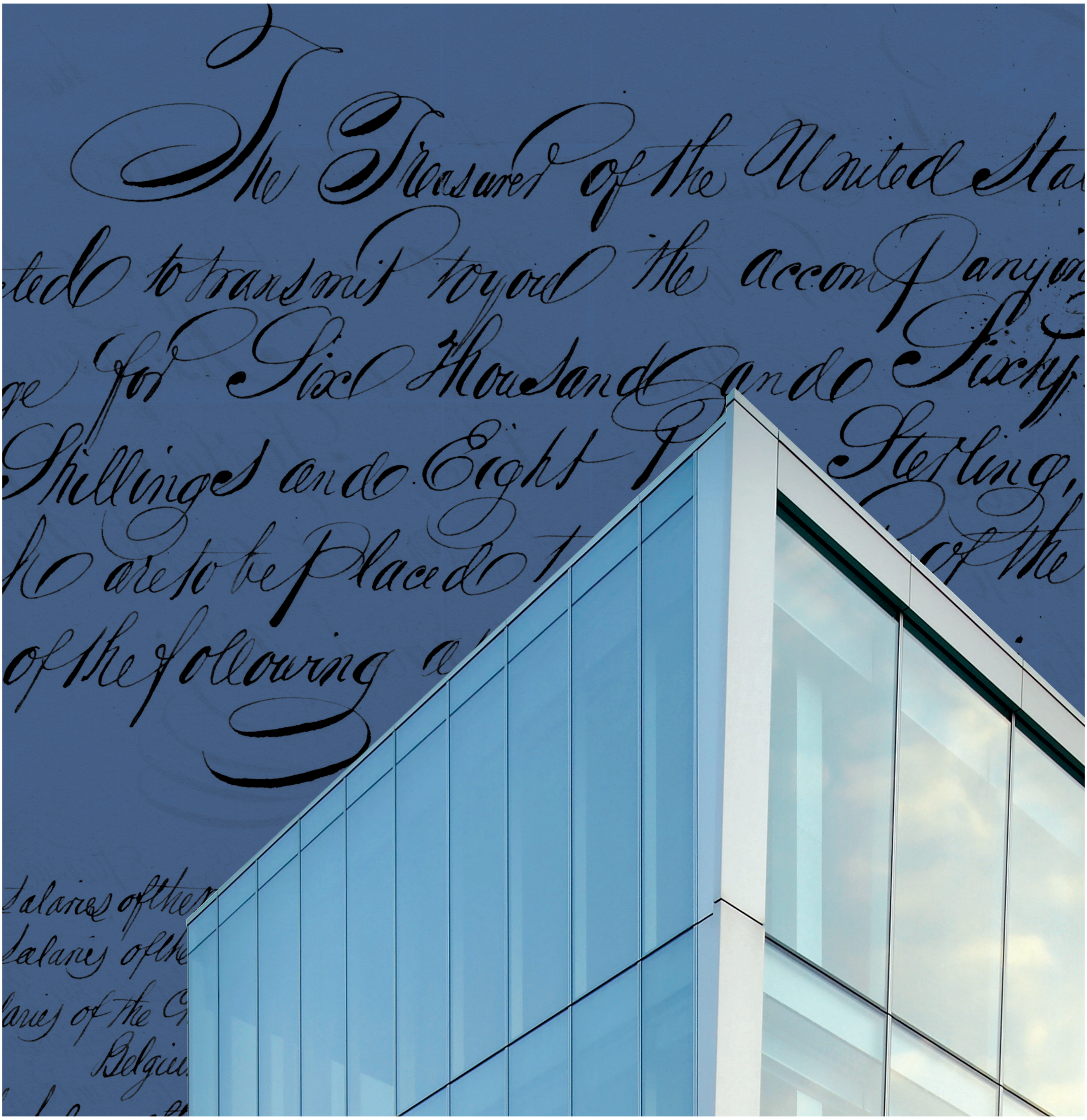
Market Perspective

US Inc: Ain't Misbehaving | The CPI files

Issue 88 | November 2016



Rothschild
Private Wealth

Foreword

"…the people had forfeited the confidence of the government
And could win it back only by redoubled efforts.
Would it not be easier in that case for the government
To dissolve the people and elect another?" – Brecht

Democracy in crisis, or democracy in action? Some of the wilder comments on the US election – like responses here to the EU vote – seem a bit patronising. The alternatives are worse, remember.

While we did not expect it, we suggested back in September that such an outcome need not affect the long-term investment outlook dramatically. Despite this and other political clouds, the macro outlook again looks almost settled. Growth data have taken a turn for the better, and talk of US Inc misbehaving looks overstated.

Meanwhile, a currently-popular conspiracy theory – the idea that central banks and governments will collude to inflate away the value of debt – looks mistaken to us.

Such theories – there were no moon landings, shots came from the grassy knoll, it's all about oil, the election will be rigged – are generally unconvincing. They assume someone has a complex and secret grand plan.

If only. And who would "they" be? A sinister, all-powerful group – or Gary Larson's recluse, furtively phoning from the attic? There is no hidden design to current affairs. Instead – and regular readers may have spotted this coming – we mostly muddle through.

We do worry about central bank mission creep. But trying to wipe out the real value of debt by deliberately creating inflation would be like dealing with damp by setting fire to your house.

All told, we again see few reasons for thinking that the business cycle and long-term investment portfolios are about to be derailed – whether by President Trump, EU politics, corporate excess or the Knights Templar.

Kevin Gardiner
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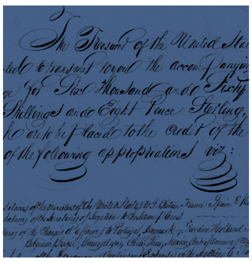


Cover image:
Foreground: Our office at New Court, London
Background: A letter to Nathan Mayer Rothschild from the American Treasury Department, 21 November 1834 concerning general business transactions.
Courtesy of The Rothschild Archive.

Publication date: November 2016.
Values: all data as at 31st October 2016.
Sources of charts and tables: Rothschild & Co and Bloomberg unless otherwise stated.

US Inc: Ain't Misbehaving

The most obvious clouds in the investment sky currently are political, not economic

Donald Trump will be the 45th President of the United States. Market volatility is hardly surprising – uncertainty has just risen substantially – but the lasting economic impact may be less profound than its political effect.

Our reasoning, first outlined in September (not that we expected this result), rests on the numerous checks and balances – implicit as well as explicit – that face even the most idiosyncratic president. It also recognises that global markets are driven by many moving parts. Protectionism would be unambiguously bad for global business – but US tax cuts and public spending increases might yet offer a cyclical boost, and it is not clear yet what the mix of the two will be. Markets are callous, and often indifferent to wider developments, however profound.

A cheap currency is hardly a viable strategy for long-term success, but it can offer cyclical support.

A second political cloud looms in the shape of Italy's constitutional referendum on 4th December. If the reforms are rejected, uncertainty will increase further and talk of early elections and a possible "Quitaly" will gather momentum. Italy is a founder member of the EU and the euro. If it were to walk away from the European project, it could be a seismic event for Europe and for global capital markets.

We think it is unlikely, however. The chain of events leading from a "no" on 4th December to Italy deciding to leave the EU would be very long and complex – and made lengthier and more complex still by the absence of the more decisive political process that the reforms are intended to foster. (Hence the notion of the EU "Catch-22" we suggested in October: an Italian voter wishing to leave the EU might best be advised to vote in favour of the status quo.)

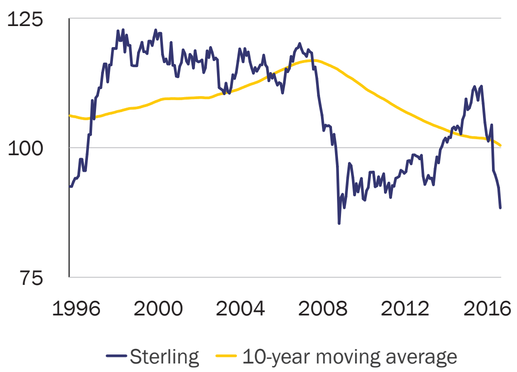
A third cloud is the vexed notion of what exactly Brexit means, when it will happen, and now how Parliament will be involved in the process. The immediate damage done to the UK economy was always overstated by emotional post-referendum surveys, but some real long-term damage will likely be done.

Even a "soft" Brexit would likely restrict business investment. A "hard" Brexit would see UK business facing greater friction (in the form of tariffs and/or regulation) in its future dealings with the EU partners.

We have implicitly been assuming that the "hard" route is the one that will likely end up being taken. The notion of a "soft" option may be wishful thinking. The UK's bargaining power can be overstated, and the likely negotiating

Figure 1: The pound has rarely been cheaper

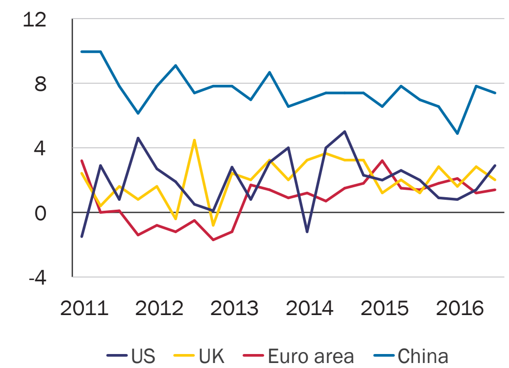
Sterling real trade-weighted exchange rate: index and 10-year moving average



Source: Datastream, Rothschild & Co

Figure 2: GDP growth has been respectable

Seasonally adjusted annualised pace, %



Source: Datastream, Rothschild & Co

dynamics are not easy given the partners' varying political cycles. The free movement of people is a key component of the single market.

That said, we have always argued that Brexit will not be a game-changer. As we are seeing, firms can view the UK as an attractive place in which to invest even net of those possible frictions.

The UK typically grows less sluggishly than the rest of Europe: it has more liberal domestic markets, favourable business taxes and a faster-growing population (even without further immigration).

The public debate also often forgets that growing economies are the norm. Damage done by Brexit means that living standards might be lower than they otherwise would have been, not that they will be lower in absolute terms.

Meanwhile, the pound has rarely been cheaper in real terms (figure 1). A cheap currency is hardly a viable strategy for long-term success, but it can offer cyclical support. Indeed, if we're right about the UK's likely resilience, the pound had already overreacted before the latest slide – as had the Bank of England.

Political clouds aside, the economic picture is again a relatively clear one this month. If anything, growth risks have tilted in a positive direction. Third-quarter GDP data show that China's slowdown has stopped for the time being, while US growth modestly pushed above trend after several quarters' disappointment. UK and Eurozone growth was – as we'd guessed, Brexit noise notwithstanding – close to trend (figure 2). Growth seems to have continued at a reasonable pace into the fourth quarter.

Against this backdrop, worries about deflation should slowly subside. Bond yields have indeed risen a little in recent weeks, albeit from historical lows. However, the Federal Reserve (Fed) is still the only big central bank likely to raise short-term interest rates soon (subject to post-election market volatility). The Bank of England's "forward guidance" has had to change yet again, becoming more hawkish this time, but the Bank seems unembarrassed about its August rate cut and is unlikely to reverse it soon.

Against this backdrop, the stage may be set for a positive reappraisal of corporate profitability and finances. Developed world profits are stabilising as oil and mining sector losses fade, and analysts' best guesses at the coming 12 months' earnings are moving higher again (figure 3).

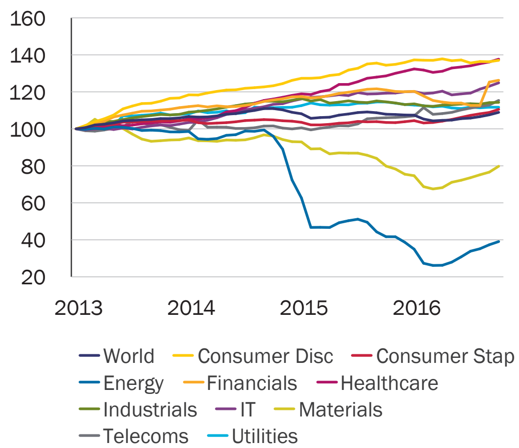
Many pundits still argue that in the US at least, corporate finances are precarious. They say businesses have been over-distributing, buying-back stock alongside regular dividend payments, thereby constraining investment and over-gearing balance sheets. We see few signs of this.

One of the many myths about the current cycle is the idea that US Inc has not been investing.

One of the many myths about the current cycle is the idea that US Inc has not been investing. It has: until the energy sector cut back on its spending last year, the volume share of business investment in GDP had not often been higher (figure 4: the cash share was more subdued, reflecting cheaper capital equipment). This is probably why we don't hear many businesses saying they simply can't meet demand: there is ample capacity (figure 4 again).

Figure 3: Corporate earnings growth is resuming

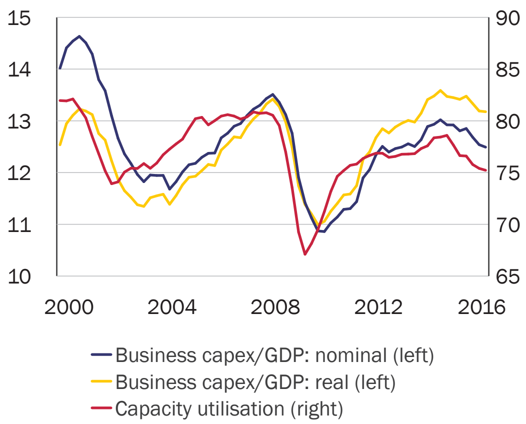
Earnings per share, indices, local currencies



Source: IBES, MSCI, Datastream, Rothschild & Co
Note: financial sector's surge in September reflects a recomposition

Figure 4: US business investment – no shortage of capacity

Non-residential private capital spending (% GDP, 4Q moving average) and industrial capacity usage (%)



Source: Datastream, Rothschild & Co

This capital spending has – as usual – been largely financed from internally generated funds (figure 5). There is a "financing gap", but it is unremarkable by past standards (meanwhile, remember, US consumers are still running a large cashflow surplus, and the private sector as a whole is, even in the eighth year of expansion, a net supplier of liquidity, not a user of it).

Bonds seem unlikely to preserve investors' real wealth from here, and longer-dated issues can be volatile.

Share buybacks have been commonplace now for the best part of two decades. They vary significantly over the cycle, with borrowing, not internal funds, being the most visible source of funds (figure 5 again).

This additional borrowing could be troubling if corporate balance sheets were fragile, but in aggregate they look solid. Liabilities relative to profits or net worth are not especially elevated, short-term borrowing has fallen relative to longer borrowing, and quick ratios (short-term assets relative to short-term liabilities) look healthy (figure 6). Interest charges and the share of floating rate liabilities relative to fixed coupon bond borrowings are also low (not shown).

On this reading, share buy-backs reflect a rearrangement of balance sheets rather than a potential constraint on operations. There is no sign of them doing material damage to potential US growth. Nor do they seem to have inflated stock valuations unduly (whether we might expect them to is a moot point in corporate finance theory).

There were always good reasons for thinking that this expansion would be a lengthy one, and there are still few signs of the corporate overconfidence that could be one of the eventual causes of its demise. There will be another US recession and financial crisis at some stage – the two do not always go together – but still, perhaps, not yet.

Investment conclusions

President Trump notwithstanding, we still favour the "muddle through" worldview.

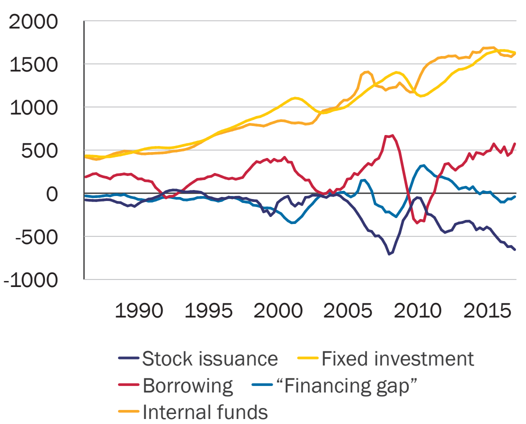
The US-led business cycle is mature, but not especially feeble, and still shows few excesses. We have long argued that China has been slowing, not collapsing, and recently it has not even been doing that. Continental Europe is showing signs of growing a little faster than its typically subdued trend pace; UK fears of a dramatic Brexit referendum impact were (as we'd thought) overstated. Meanwhile, inflation remains modest, and central banks – even the Fed, especially post-election – seem unlikely to normalise monetary conditions quickly.

From a top-down, or macro, perspective, these are the investment conclusions we draw:

- The business cycle and valuations both point to equity markets as the most likely source of investment returns.
- Bond yields have actually risen a little in recent weeks, but are still very low and in many cases are still negative. This is not quite as alarming as it looks. Net of current inflation, yields have been more negative in the not-so-distant past (figure 7). Nonetheless, bonds seem unlikely to preserve investors' real wealth from here, and longer-dated issues can be volatile.

Figure 5: US corporate capex is funded internally

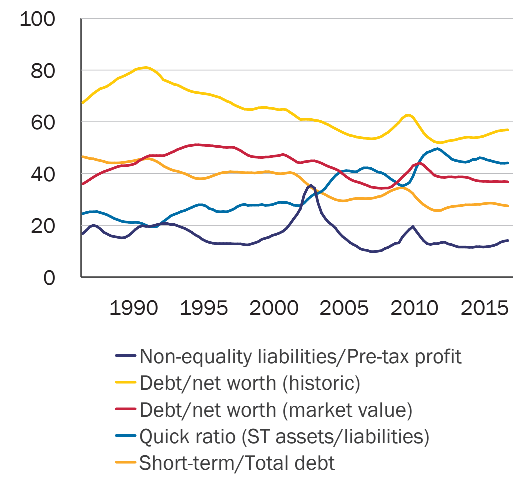
US non-financial companies' sources and uses of funds ($ trillions at an annual rate, 4Q moving average)



Source: Federal Reserve, Datastream, Rothschild & Co

Figure 6: US corporate balance sheets look unremarkable

Non-financial corporate borrowing and quick ratio

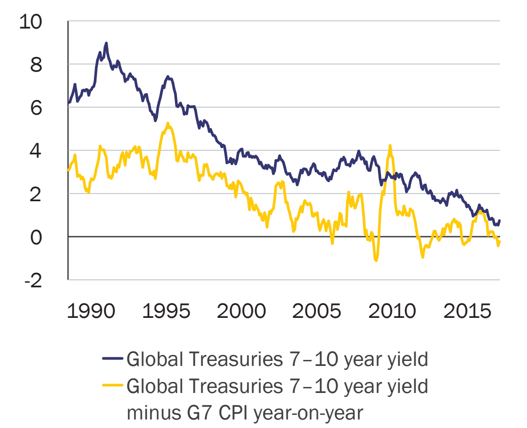


Source: Federal Reserve, Datastream, Rothschild & Co

- Stock prices have risen a long way since the crisis, but so have corporate profits: most valuation ratios are well within historical ranges (figure 8). Recent falls in oil and mining earnings have likely run their course, and total earnings are growing again.
- We see bonds and cash currently as insurance and ballast against a slower-growing world. As such, they should be held in investors' home currencies: foreign exchange risk makes them more volatile. Global interest rates have in any case largely converged, especially when hedging costs are taken into account.
- Some long-term normalisation of interest rates is likely in most regions, but cyclical outlooks vary. 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 currently in emerging market bonds (even those in hard currency).
- We think interest rates will rise, and creditworthiness deteriorate, sooner in the US than in Europe. As a result, 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 are still wary of the valuations of long-dated UK index-linked gilts.
- Stock prices can continue to trend slowly higher with profits and dividends, and we would be positioned regionally and sectorally for this.
- We remain most positive on the US, Europe ex-UK, and emerging Asia; and least so on the UK and developed Asia ex-Japan (though even there we prefer stocks to bonds). We think emerging markets may outperform (we held the opposite view until the spring).
- The US is relatively expensive, and faces higher interest rates, but growth may still not be fully priced in. Mainland European stocks also look inexpensive, even allowing for lower growth. In emerging Asia, fears of another 1997-type crisis were overdone, and its 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. Sterling's fall has boosted the UK's local currency returns, but it continues to underperform in dollar or euro terms.
- We prefer a mix of US cyclical and secularly-growing sectors – technology, banks and energy, for example – to bond-like sectors such as utilities and staples. We are still indifferent towards non-oil commodity stocks. We have fewer views in Europe: we think financial stocks can rebound further, but this is a highly volatile sector.
- Currency conviction should be low. Apart from sterling – which we think over-reacted to the Brexit referendum, and so has moved up our cyclical currency rankings – the big currencies have been relatively stable of late, despite pundits' bearish (euro, yen and renminbi) and bullish (dollar) predictions.
- Nonetheless, we still rank the dollar high (after sterling): like US stocks it is not cheap, but it has cyclical appeal. We rank the Swiss franc and renminbi low: their cyclical position is weaker, and valuations (relative to trend) are more stretched. China's loosening/leaking capital controls offset its trade surplus.

Figure 7: Bonds – expensive but not a bubble

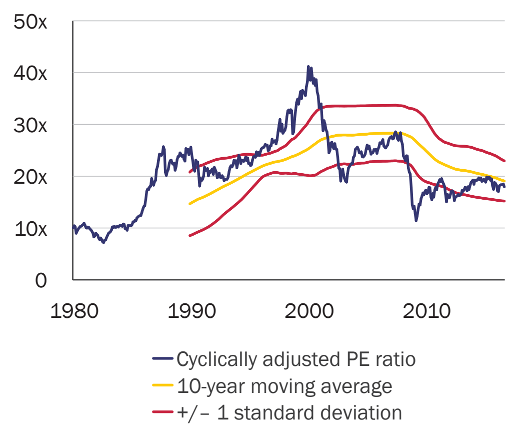
Developed world government bond yields less current inflation (%)



Source: Bloomberg, Datastream, Rothschild & Co

Figure 8: Stock valuations still unremarkable

Developed world cyclically adjusted PE ratio



Source: MSCI, Datastream, Rothschild & Co

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Hidden forces are probably not conspiring to inflate away debt

A big surge in inflation is not inevitable.

The chance of one arriving by natural causes seems very unlikely. There are few "cost push" or "demand pull pressures", and a third sort of inflation, led by self-fulfilling expectations – such as a "going rate" in pay negotiations – seems even more remote.

Admittedly, no inflation model works well: inflation could arrive unexpectedly. But equally, we could enjoy steady growth without any accompanying inflation – as in the late nineteenth century.

Trying to wipe out the real value of debt by deliberately creating inflation would be like dealing with damp by setting fire to your house.

The UK is most at risk. It is a previous offender, and the big fall in the pound is pushing up import prices. However, while imported inflation could add around 4% to the Consumer Prices Index (CPI), it could be a once-and-for-all increase, after which inflation might fall back – as in 2012. This hasn't felt like an old-fashioned "sterling crisis".

What about a policy-led surge? The big central banks seem to feel the need to do something about undershooting their inflation targets.

It is one thing to try to create a little bit more inflation for cyclical reasons. It would be quite another for them to conspire with governments to inflate away the real debt burden that is widely (we think mistakenly) said to be constraining growth.

We are not happy even with the "little bit more" idea. Inflation is not a "good" thing. It may not boost growth; US and UK unemployment is low, not troublingly high; and once out of the bottle, the inflation genie can be hard to put back in. Mission creep at central banks seeking to avoid a "secular stagnation" that may not exist is our biggest worry. But many pundits assume more drastic action.

We doubt the authorities would be so foolish. Trying to wipe out the real value of debt by deliberately creating inflation would be like dealing with damp by setting fire to your house.

There is no urgent question to which "helicopter money" is an appropriate answer.

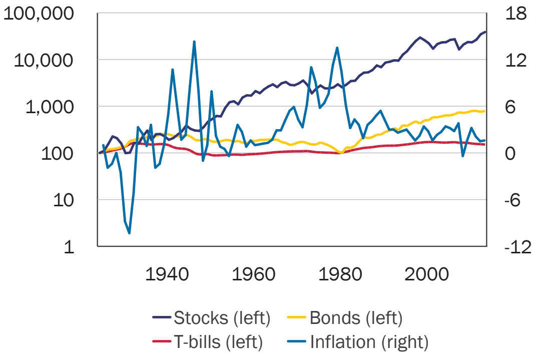
Liquidity from quantitative easing – central bank bond purchases – seems to have had a modest effect on inflation (as opposed to bond prices). But this does not mean that more direct injections would have similarly little impact. Policy acts discontinuously, like when you pull a brick across a table using a piece of elastic. You tug a bit, and nothing happens. You tug again – still nothing. You tug once more, and the brick flies across the table and hits you in the face.

Few things are more destructive than a collapse in the value of money: counterfeit cash is a wartime secret weapon. Eliminating debts sounds progressive, until you realise that people with big borrowings tend also to have big assets, that low income households are exposed alongside bondholders, and that the winners are probably those who are lucky enough to have most real assets to begin with.

We don't believe, then, that "they" will try to create a tidal wave of inflation, though some modest cyclical revival does seem likely (not just in the UK). There are no perfect hedges against even modest inflation, of course. Equities are a share in business, and might almost be seen as real assets, but as figure 9 reminds us, while stocks have most convincingly outpaced inflation in the longer term, they are not immune to short-term disruptions if it threatens to get out of control.

Figure 9: UK financial assets and inflation, 1920–2015

Real T-bill, gilt and equity prices (levels, indices, log scale) and inflation (% y-o-y)



Source: Barclays Equity Gilt Study, Datastream, Measuring Worth, Rothschild & Co

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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