Market Perspective

Noises off | Uncharted waters

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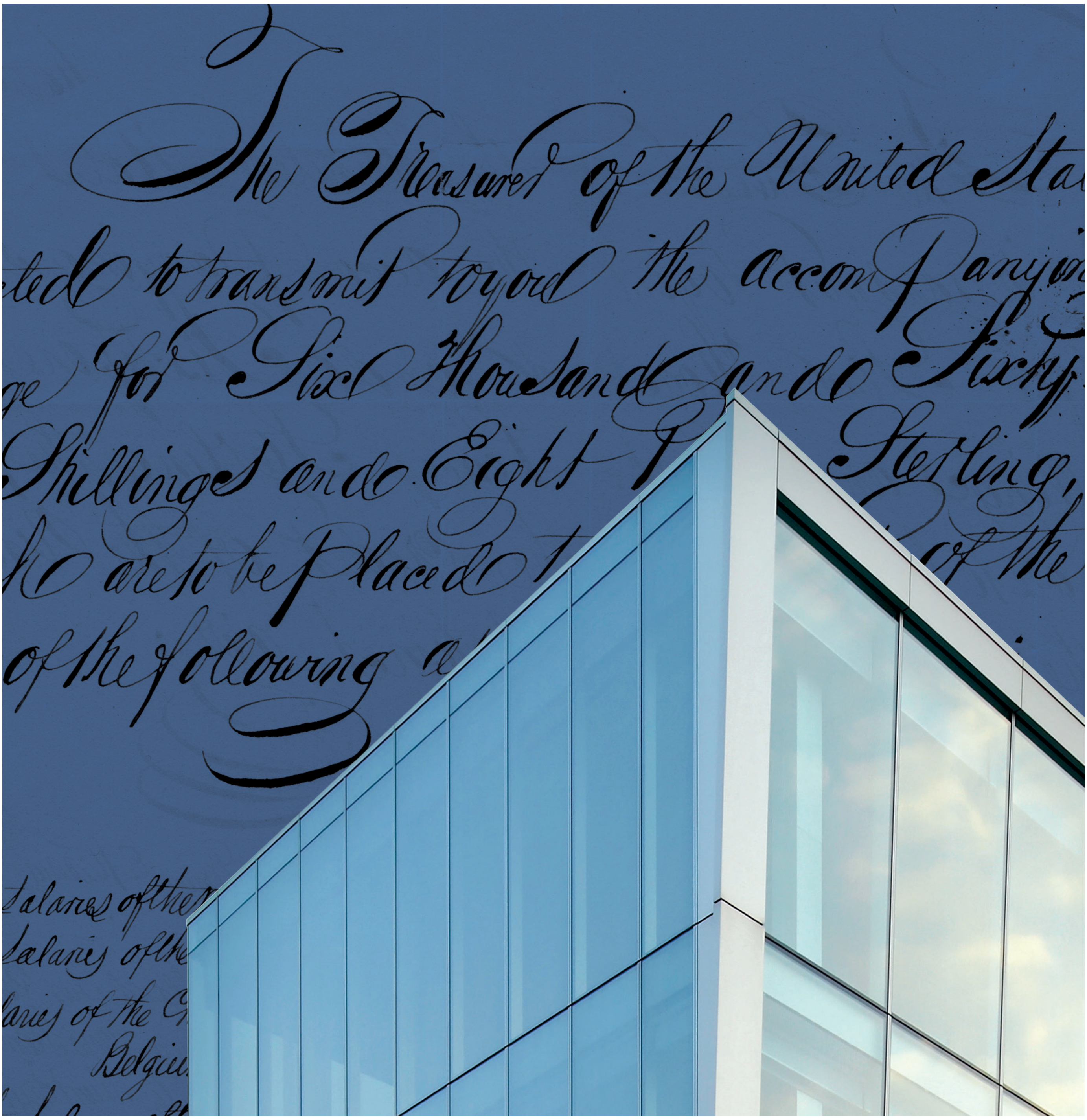

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Foreword

In case a mature business cycle, unconventional monetary policy and "secular stagnation" weren't enough, this last month we've been grappling with: "hard" and "soft" Brexits; possible "Quitaly"; nail-biting US election hustings; and retrospective back-seat bank regulation.

The business cycle currently seems almost the least of our worries: growth remains respectable, even using official data. This does mean that US interest rates will eventually head higher, but more importantly it also means that corporate profits will revive after the hit to oil and mining earnings.

And we argue here that in a narrow portfolio context, negative interest rates may not be quite as unsettling as they seem. We worry that policy doesn't need to be this lax – as noted last month, we don't buy "secular stagnation" – but not urgently.

It is more difficult to gauge the off-stage developments.

Notions of a "soft" Brexit may reflect remainers' wishful thinking. That said, we have argued that while the UK economy would do best within the single market, it can survive and eventually thrive outside it too.

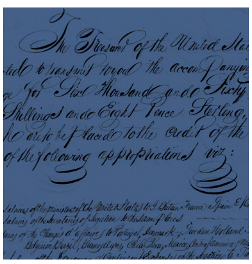
An Italian EU exit is possible, but it is surely less likely than the UK's – not least because a "no" vote in the constitutional referendum would work against decisive action of any sort (a sort of EU Catch-22).

We also still think that a shock US election result need not be the financial calamity feared, though investors might prefer not to find out.

The accidentally destabilising intervention by US authorities in European banking is sobering. The immediate risk is containable, but this is a new can of worms (as it were). What price anyone's monetary sovereignty if banking stability can be so directly shaped by another country?

So 2016 continues to pose some of the biggest tests yet for our long-standing muddle-through worldview. But it remains intact nonetheless.

Kevin Gardiner
Global Investment Strategist
Rothschild Wealth Management



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: October 2016.
Values: all data as at 30th September 2016.
Sources of charts and tables: Rothschild & Co and Bloomberg unless otherwise stated.

Noises off

Movements offstage may shape investment action

At the risk of tempting fate: there have been few big data surprises in recent weeks, and cyclical uncertainties seem unusually restrained.

Most importantly, in the US, business surveys have rebounded, and trend unemployment claims have hit new post-1973 lows. The trend in private sector cashflow, led by households, is still running in healthily-positive territory (figure 1).

US consumers are thus still a source of liquidity for the wider economy, not a drain on it, and are not yet resorting to aggressive borrowing to finance spending. Even after another long expansion – now into its eighth year – there are still few signs of cyclical excess.

Increasingly, the onus is on the Federal Reserve to explain why it is not raising interest rates rather than why it might do so.

Headline US inflation is rebounding from low levels as falling oil prices drop out of the calculation (indeed, if OPEC does mute output as agreed in September, headline inflation globally may get an added lift from rising oil prices).

More importantly, with a tight labour market, and inventories and industrial capacity usage likely stabilising after their oil sector-related setbacks, core US inflation is slowly firming.

The Federal Reserve's chosen inflation index is (unusually) a deflator, which more quickly reflects shifting patterns of spending and so is likely to lag conventional price indices, but even that is showing signs of nudging towards the targeted 2% (figure 2).

Increasingly, the onus is on the Federal Reserve to explain why it is not raising interest rates rather than why it might do so.

From an investment perspective, the timing of higher US interest rates is likely less important than the context within which they take place.

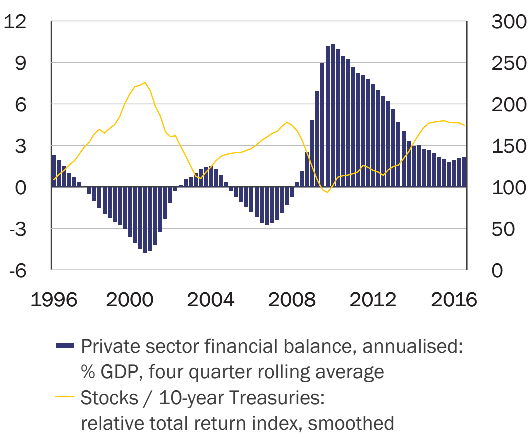
If they are accompanied, as we expect, by resumed growth in corporate profits – as the hit to the energy sector fades, and other businesses benefit from ongoing consumer-led growth – then equity markets are quite capable of shrugging-off the volatility associated with rising rates.

Cyclical indicators elsewhere also point to trend-like growth continuing. Business surveys in Continental Europe and in the UK have been steady, and even those in China have stabilised in recent months (figure 3).

In the UK in particular, it is now clear that it was sentiment, as we'd guessed, and not tangible spending or orders, that slumped on June 24th. This does not mean Brexit will have no impact – see below – only that its onset has been

Figure 1: Few signs of US cyclical excesses

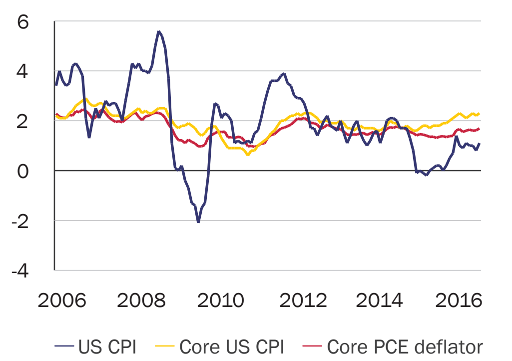
Private sector still in financial surplus



Source: Federal Reserve, Datastream, Rothschild & Co

Figure 2: US inflation is edging higher

Headline and core consumer prices (% year-on-year)



Source: Datastream, Rothschild & Co

exaggerated. For China, it still feels way too early to suggest that the slowdown is over, though we have never been in the "collapse" camp.

Despite continuing respectable growth outside the US, however, the Fed is likely to be the only central bank tightening policy for a while yet. Core inflation has nowhere shown signs of collapsing into outright deflation, but equally there are few signs of acceleration, and as we noted last month, the "secular stagnation" groupthink continues to dominate public debate.

The ECB's current programme of bond purchases is scheduled to end in March, and there is some talk of purchases being tapered beforehand, but there seems little prospect of any meaningful tightening of policy.

The Bank of England has yet to row back from its public worries about the referendum effect, and seems still to be considering further easing after August's rate cut and reintroduction of bond purchases, even as the exchange rate loosens monetary conditions a little further. We suspect a reversal in stance lies ahead, but not soon.

The Bank of Japan's latest monetary innovation is unusual. Targeting a cap on 10-year bond yields at zero is not really a meaningful change when current yields are still negative and they plan to continue with current bond purchases.

To make it so requires all sorts of supporting assumptions about inflation expectations, pending fiscal impulses and the like. We wonder, not for the first time of late, what exactly the question might be which requires such a convoluted answer.

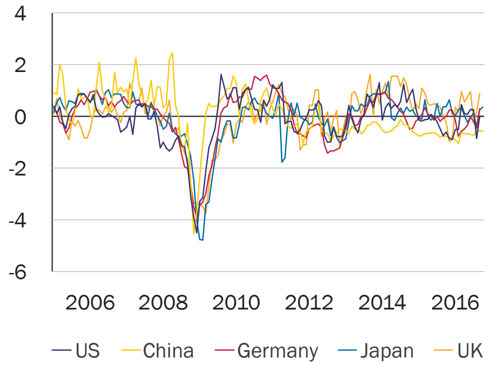
But there is no doubt that the Bank of Japan means to be dovish.

(More significantly, in our view, Japanese national accountants seem to be the latest to be grappling with the possibility that recent GDP growth may have been understated. Here in the UK a provisional report by Professor Sir Charles Bean reached the same conclusion at the end of last year.

We've long guessed that recent poor productivity data, and perceived "secular stagnation", may partly reflect statistical shortcomings rather than more troubling trends. It has been reported that the Bank of Japan is experimenting with an alternative GDP measure suggesting that 2014's growth may have been understated by more than 3% – the difference between the reported recession (a GDP fall of 0.9%) and healthy expansion. Reassuringly, taxes, employment and corporate cashflow are easier to measure than digital value-added.)

Figure 3: Cyclical indicators point to trend growth

Selected manufacturing surveys, standard deviations from trend



Source: Datastream, Rothschild & Co

Leaving the EU in order to limit the free flow of labour likely implies leaving the single market too.

Turning to those off-stage noises:

- Discussion of "hard" and "soft" Brexits is keeping pundits in work and the pound at bay, but we have been taking it for granted that leaving the EU in order to limit the free flow of labour likely implies leaving the single market too. It is easy to overstate the UK's bargaining power: economically, the rest of the EU is much more important to the UK than the UK is to it.

  But even a "hard" outcome – the one we've had in mind all along as the likely outcome of a "leave" vote – is unlikely to be a game-changer. We expect business investment eventually to suffer, and the City to be hit disproportionately, but when the dust settles we also expect the UK to remain one of the more dynamic large European economies. Most tariffs these days are small, the UK's population is growing, and its labour laws and corporate governance are relatively liberal.

- The Italian referendum on constitutional reform is now set for December 4th, which gives the government a little more time to try to gain support for it. A "no" vote – which polls suggest is likely – would be a big blow to the government and the status quo generally, and talk of Italy leaving the EU would gather momentum. Italy is a founder member of the EU and the euro, with a large economy and bond market, and its secession would be a much bigger financial shock than that of the UK.

But the chain of events needed for it to occur would be long and complex, and ironically would be made more so by an unreformed, cumbersome constitution. An Italian genuinely wishing to leave the EU arguably should vote in favour of it on December 4th – Catch 22 indeed.

- Another non-economic threat to market stability is the continuing absence of a government in Spain. New public spending and tax plans need to be agreed. The economy has been improving more briskly than many thought possible – unemployment has fallen from 27% in early 2013 to 20%, still too high but just 2% or so above its pre-euro trend – but likely budgetary overruns and the risk of EU action could be unsettling.

- Our advice regarding the US election is as set out last month: investors should not rush into changing long-term portfolios in anticipation, or on the news, of a shock result.

  We see five buffers against potentially extreme policies. First, Trump may not win. Second, he may not have made his mind up about the detailed policies he'd pursue in office. Third, he will have advisers who may try to change it once he has. Fourth, Congress – even a Republican one – can act as a brake. Finally, there are many moving parts: the economy and markets are not driven slavishly by any one policy, or indeed by government policies overall.

Ongoing growth points most naturally to equity markets as a source of investment return. So too do valuations.

  Trump's bellicose protectionism would be scary, but plans for fiscal expansion might actually give the economy a cyclical boost: meanwhile, the US and global economies are not standing still.

- During the Global Financial Crisis, the Irish government demonstrated that monetary policy can't be separated from banking policy (a point that had been very publicly overlooked by the UK government until then). If your banks are bust, your interest rate policies can't work. So if a systemically-important bank faces a potentially capital-threatening fine, it may compromise your attempts to reflate the economy. And if that fine is levied by a foreign administration, then your monetary sovereignty has arguably been partially illusory.

  The case in point currently does not appear life-threatening for the bank concerned: the fine may be negotiated lower, provisions exist, assets can be sold and capital can be raised. But a new source of risk may have arrived, and we can but hope that national governments resist the temptation to make banks the instruments of any protectionist urges.

  A final thought: many observers suggest that banking woes would quickly go away if bank capital were made massively bigger. They might, but such cheap (to service) capital may not easily be forthcoming from private owners.

Investment conclusions

Despite these added off-stage noises, then, we believe still in a "muddle through" worldview, not "secular stagnation".

The US-led business cycle is mature, but not especially feeble, and shows few excesses. China has been slowing, not collapsing; Continental Europe has been growing at its typically subdued pace; UK fears of a dramatic Brexit referendum impact look overstated. Meanwhile, inflation is modest: central banks are unlikely to normalise monetary conditions quickly.

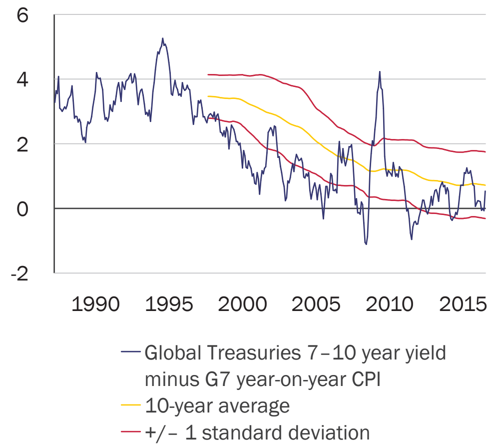
From a top-down, or macro, perspective, this is how we think this translates into portfolio advice:

- Ongoing growth points most naturally to equity markets as a source of investment return. So too do valuations.

- Negative bond yields look alarming, but net of current inflation, yields have been lower in the not-so-distant past (figure 4). Nonetheless, returns seem unlikely to preserve investors' real wealth, and long duration bonds can be

Figure 4: Bonds: expensive but not a bubble

Developed world government bond yields less current inflation (%)

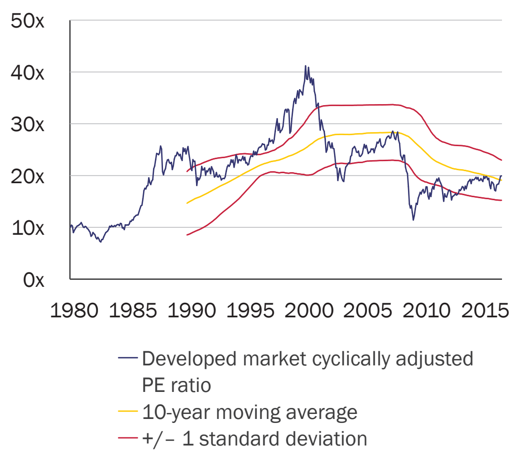


Source: Bloomberg, Datastream, Rothschild & Co volatile. Corporate bonds are less unattractive, but still unlikely to deliver real returns.

- Stock prices have risen a long way since the crisis, but so too – predictably – have corporate profits: most valuation ratios are well within historic ranges (figure 5). Recent falls in oil and mining earnings may have run their course, and have boosted the spending power (and earnings potential) of the wider economy.
- We see bonds and cash currently as ballast and insurance 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. We see little attraction currently in emerging market bonds (even those in hard currency), as they have already rallied some way and are not especially inexpensive.
- 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. We are wary of UK index-linked gilts given the high valuations at longer maturities.
- 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 market is relatively expensive, and faces higher interest rates, but growth may still not be fully priced in. Mainland European stocks are relatively cheap, even allowing for their slower growth. In emerging Asia, fears of another 1997-type crisis have been overdone, and the region's structural appeal remains intact, even as China slows.
- The UK and developed Asia (ex Japan) face local and sectoral issues that may stop them sharing fully in global growth.
- 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 have fewer sectoral views in Europe: we still think financial stocks can rebound further after the latest trauma, but this is a highly volatile sector.
- Currency conviction should be low. Apart from sterling – which we think is over-reacting to the Brexit referendum (figure 6), 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, on a one-year view, say, 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 5: Stock valuations still unremarkable

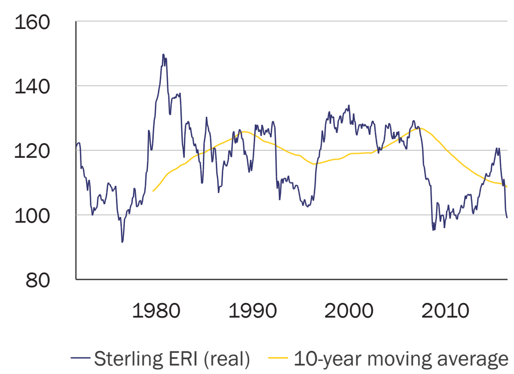
Developed world cyclically-adjusted PE ratio



Source: MSCI, Datastream, Rothschild & Co

Figure 6: Sterling is looking inexpensive

Real trade-weighted exchange rate index and trend



Source: Datastream, Rothschild & Co

Uncharted waters

But not quite as scary as they seem?

Half a dozen central banks are operating negative policy rates, and more than a quarter of developed government bonds have negative yields: these are uncharted waters. Why save or invest in expectation of a negative return? Surely these are the most testing times ever?

In fact, things may not be as alarming as they look; it can make sense to own negative yields; and saving has been tougher in the past.

Textbooks say that negative rates can't happen because if they did, savers would immediately switch deposits into banknotes. It is not that simple: safe storage costs something, and paper money is not always liquid.

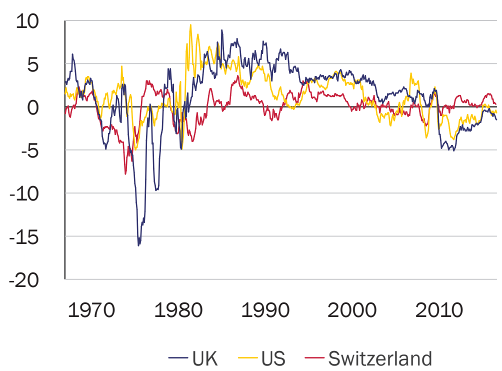
Interest rates reflect the interaction of millions of savers and borrowers. Willingness to hold liquid assets – which, just to confuse things, are not fixed in supply – is shaped by the business cycle, central banks, and such intangibles as risk appetite and production frontiers.

No model has yet succeeded in tracking them convincingly, nor is one ever likely to.

It feels as if rates should be positive. They always were; and the future is unknowable, and needs to be somehow discounted. But post-war UK rates had ranged from 2% to 17% even before 2008. And it would be a poor imagination that could not picture a collective despondency in which an unknown future is valued more highly than the present, if only temporarily.

Figure 7: Negative real rates are not so new

Bank rates less current inflation rates: US, UK, Switzerland (%)



Source: Datastream, Rothschild & Co

So sub-zero yields may not be crazy. And other assets might seem to offer bigger losses.

More importantly, if investors think inflation will be even more negative, expected real returns – which matter most – might actually be positive. And negative real rates are not so new (figure 7).

In the 1970s, UK inflation-adjusted rates were strongly negative (pre-tax). Bank deposits typically lost a quarter of their real value between 1970 and 1978, for example, and savers reacted by saving more of their incomes to make good the damage, hitting growth hard. That was a more testing time than today.

Headwinds greatest for bonds

None of this means we like bonds or cash as long-term investments currently: we do not. On our inflation assumptions, likely real yields are negative, not just some nominal ones. And at today's high prices, long-dated bonds in particular are anything but the stable assets they are supposed to be.

This is not about creditworthiness: most bonds will be redeemed at face value. Many are trading above par, so this implies losses, but those losses are built-in to the low redemption yields.

Instead, we worry about mark-to-market volatility. Long-term bond prices are especially sensitive when yields are low. This sensitivity, or "duration", means that (for example) an investor buying the 2026 gilt could face a loss of roughly 9% if long-term interest rate expectations were to rise by a percentage point (which would still leave them historically low).

The price would still return to par, but that could take a long time, and leave investors shaken or even compromised.

Of course, bonds can act as short-term portfolio insurance when they are negatively correlated with stocks. But over time, if interest rates slowly normalise, bonds are even less likely to match inflation than is (stable) cash.

As noted last month, we worry also about the policies keeping nominal rates so low – the mission creep as central banks flirt with "helicopter money" in tackling a "secular stagnation" that may not exist. That said, a re-run of the 1970s' inflationary trauma looks very unlikely.

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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