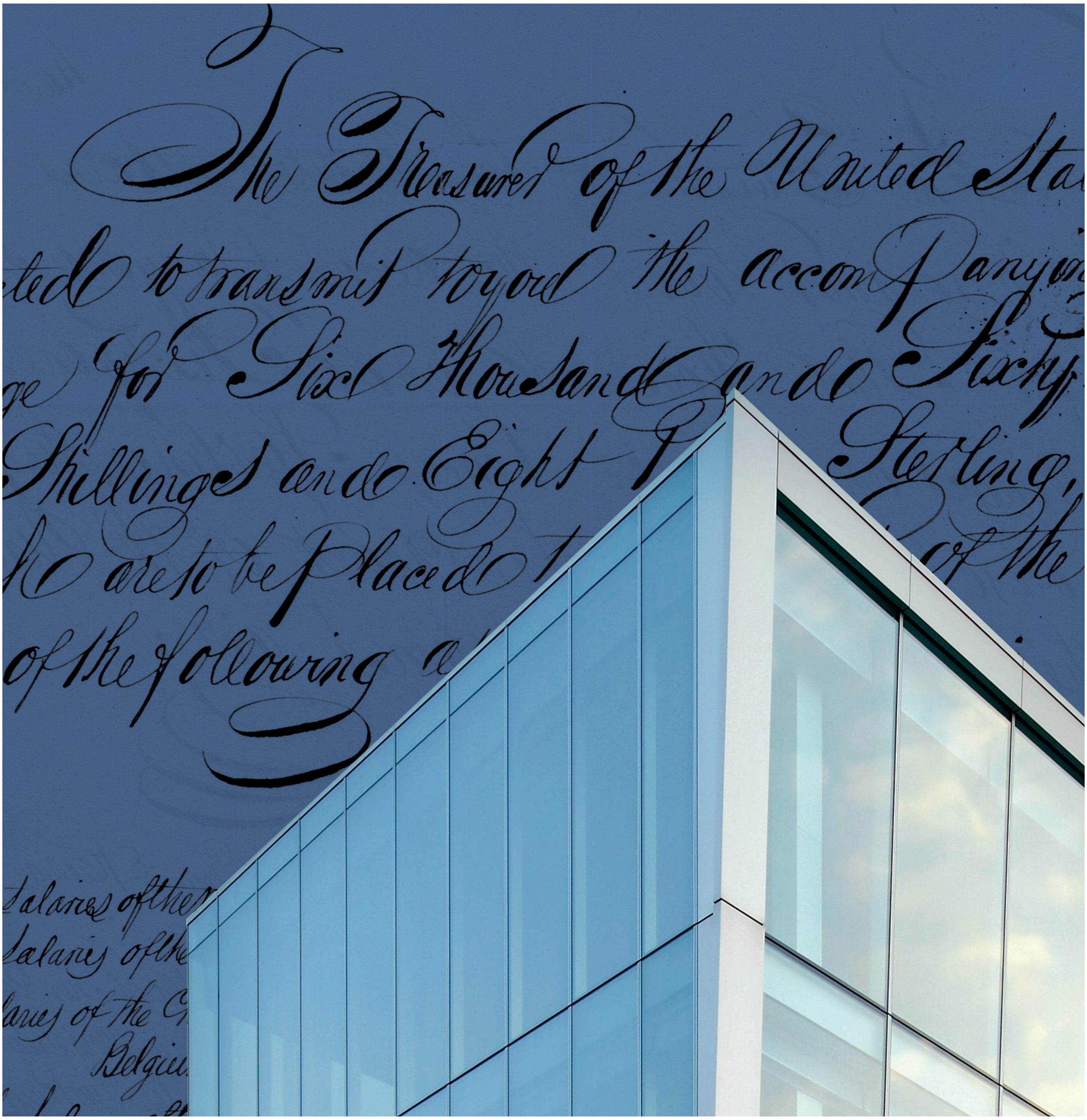
Market Perspective

Non-event risk

Issue 92 | April 2017



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Foreword

For some months now we've suggested that the most visible clouds in the investment sky are political, not economic. Though unsettling, they have not been large or joined up enough, we've thought, to threaten an altered investment climate.

We still think this is the case, but are those clouds quite what they seemed?

The Trump administration may have more in common with its predecessors than feared. And not just because of the checks and balances, which are only relevant if there is something to check and balance. Of course, "business as usual" in the US is hardly risk-free.

In Europe, the populist "Big Picture" looks (even) less credible after the Netherlands and Saarland votes in March. The conclusion of the French presidential election campaign is now less than a month away: whoever wins, we think the country will remain committed to the EU and single currency.

More parochially, Article 50 has finally been posted, but despite sub-editors' best efforts, it likely heralds tedium not drama. We continue to see UK's exit as costly but not a game-changer.

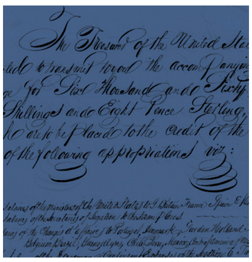
Meanwhile, a gap between "soft" and "hard" US data need not be troubling, particularly at this time of the year. Ongoing growth with modest inflation risk is (again) not a bad investment backdrop.

Some setback for markets still seems overdue: March's brief dip does not qualify. Several potential geopolitical flashpoints outside the US and Europe could trigger one. The calendar itself is becoming less friendly.

However, we remain wary of trying to time a short-term correction. Despite – perhaps because of – an ongoing wall of worry, we believe the investment climate can remain a constructive one. April showers perhaps, but not yet the next perfect storm?

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, 21st November 1834 concerning general business transactions. Courtesy of The Rothschild Archive.

Publication date: April 2017.
Values: all data as at 31st March 2017.
Sources of charts and tables: Rothschild & Co and Bloomberg unless otherwise stated.

Non-event risk

Subtle politics, straightforward economics

“I will do such things—
What they are yet I know not, but they shall be
The terrors of the earth.”
King Lear

“This is the way the world ends
Not with a bang but a whimper.”
The Hollow Men

Those political clouds: update
Has the nature of the political uncertainty posed by the new US administration been misunderstood?

Received wisdom has focused on the prospect of alarmingly bold, mould-breaking policies: tariffs, walls, repeals and reforms.

However, while the president talked of a break with established Washington ways, his cabinet appointments have been conventional – antidisestablishmentarian, perhaps? Now some recent local accounts suggest he is not so much draining a swamp as lost in one.

In truth, the re-emergence of Realpolitik is not surprising. It might, however, reassure nervous investors worried about protectionism – perhaps the most obvious threat to the world economy posed by the new administration.

Thus the first US-China summit passed without incident.

We have noted before that China, not the US, is the most protected big economy (figure 1). China’s leadership is not just well aware of that fact, but planning slowly to change it. How else can China take what it perceives as its rightful place in the global economy and capital markets?

So president Xi is reportedly conceding some ground that he would likely have given up at some stage anyway. And it may be gratefully received by a president Trump needing a public win, but warned by his advisers of the economic danger, and the bureaucratic difficulty, of using the big stick he waved on the hustings.

Meanwhile, president Trump’s response to the latest grim events in Syria has been surprising because it is almost conventional: other recent presidents might have done the same thing.

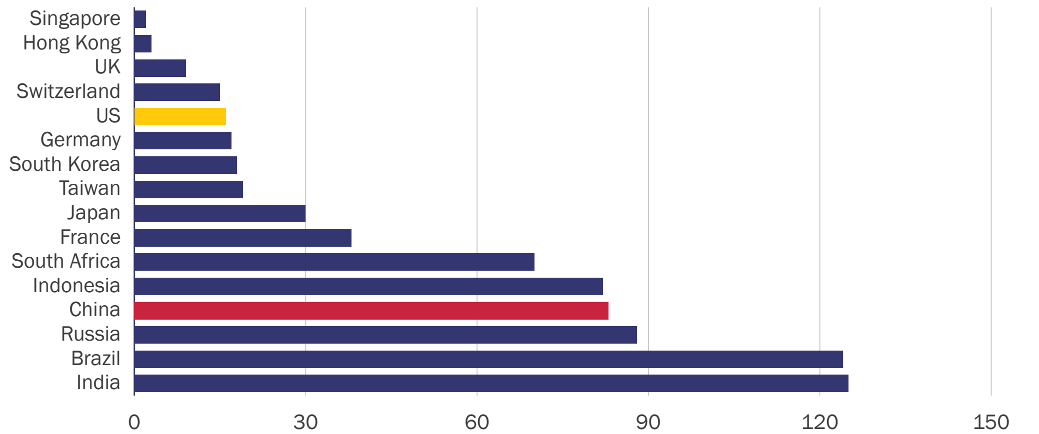
More generally, our post-November emphasis on the US’s fabled constitutional “checks and balances” has assumed there would be something to check and balance. But what if there is even less direction to the new president’s strategy than we’d imagined?

What if the real risk is instead one of (resumed) dysfunctionality at the heart of US policy making?

If so, investors don’t get to relax. In place of high-profile imminent event risk, they may face an increasingly bad-tempered stalemate that

Figure 1: China is the least open big economy

Composite indicators of economic openness: selected countries, average rankings (1=best)



Source: Heritage Foundation, IBRD, World Economic Forum, Rothschild & Co. The chart shows the average rankings of the Heritage Foundation’s 2017 “Economic Freedom” report, the IBRD’s 2017 “Ease of Doing Business” report and the World Economic Forum’s 2016 “Enabling Trade” report.

eventually undermines American governance and leaves a vacuum, rather than a whirlwind, at the centre of geopolitics – a sort of "non-event risk".

As we've suggested, even a Republican "controlled" Congress may not always do the president's bidding – as we saw with the health care non vote. Mid-term elections that might see some Democrat bounce are just 19 short months away. Meanwhile, another budget-related government "shutdown" is a possibility from May. Same old same old?

On this view, US political clouds are very much still there. But they may be further away and less distinct than initially feared.

In Europe, though, the sky may have lightened a little: the populist Big Picture perhaps looks less convincing than it did (and we were sceptical about it to begin with). Recent developments include:

- Populists turned out to be less popular than expected with Dutch voters;
- Chancellor Merkel proved more popular than expected in Saarland;
- One of the French populists looks popular with investors; and
- British populism, with Article 50 now formally submitted, has so far brought tedium not drama (headlines notwithstanding).

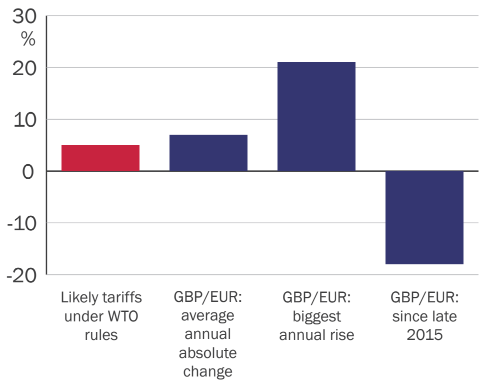
Brexit update

On that parochial point, it may be worth reminding readers why we see the likely investment impact of the UK's pending secession from the European Union as staying relatively low key.

It is not because we expect a rapid and favourable resolution. We've assumed the eventual outcome will be towards the "hard" end

Figure 2: Estimated tariffs and exchange rate volatility

Likely tariffs under WTO rules on UK exports and imports, and sterling fluctuations since 1996 (%)



Source: Civitas, Datastream, Rothschild & Co

of the 57 varieties of Brexit being touted.

The UK's negotiating position is somewhat weakened by its partners knowing our reserve price: the UK is going to leave the EU and tighten immigration controls. Moreover, the partners have less at stake than the UK: the proportion of UK GDP represented by visible exports to the EU (12%) is much bigger than the amount of EU GDP represented by similar exports to the UK (3%).

The UK does have a combined goods and services trade deficit of 2% of UK GDP with the EU, and some pundits suggest that it could stop trading with the EU and be better off by this much. In reality, the UK doesn't make many of the things it imports, and ceasing to trade altogether would be like cutting off our nose to spite our face.

A more realistic "worst case" outcome – the World Trade Organisation (WTO) option – is perhaps less daunting than it sounds.

A failure to secure new trading agreements, and a consequent return to the "most favoured nation" approach embedded in the WTO's rules, would not mean that UK-EU trade ceases, or that the UK "loses" access to EU markets.

Instead it would likely mean the reimposition of tariffs on at least the portion of the UK's exports that go to the EU (and probably on UK imports from the EU, unless the UK feels especially magnanimous or liberal).

Estimates of these tariffs suggest that they might average around 5% across all visible trade. But routine exchange rate volatility is comparable in terms of its order of magnitude. Since 1996 the average absolute annual change in the sterling/euro exchange rate (or its equivalent pre-1999) has been roughly 7%, and in one year (1997) the rate actually rose by more than 20% without the world ending for UK producers.

Since late 2015, UK producers have benefited from an improvement in competitiveness as the exchange rate has fallen by around 18%.

Tariffs are permanent, while currency rates usually aren't – but a 5% burden is far from insurmountable. And they were perhaps twice as large when the UK joined the EEC in 1973: in other words, the shelter provided by tariff-free trade within the EU is today just half as valuable as it initially was, reflecting the steady liberalisation of the global trading environment.

Non-tariff frictions – inspections, certifications – may be as important, if reintroduced, as tariffs. Much manufacturing these days is vertically integrated across national boundaries, and just-in-time logistical arrangements are important. But such constraints, like tariffs, have not prevented other countries trading profitably with the EU.

We suspect that even the financial services sector will see life after the demise of EU membership. There is no “single market” in finance to be leaving, and the UK has a strong position by virtue of its culture, language and time zone. It has global strengths in areas such as specialised insurance and foreign exchange trading. Financial services have not arrived late at the UK’s economic party – they have been a significant part of UK output since before the industrial revolution.

In 5–10 years’ time, when the UK economy is comfortably bigger than today, dispirited “remainers” should expect to be told that such growth was the result of leaving.

This is not to say that we think leaving the EU will be good for business in the UK or the rest of the EU: we don’t. Much trade with the EU is currently close to being frictionless: it is hard to imagine we can do even better by leaving, or that losing free trade with the EU will be made good by improved trading arrangements elsewhere.

Moreover, as time passes, the sheer administrative and communicative burdens imposed by leaving get steadily bigger – to say nothing of the probability of having to pay a sizeable (2–3% of GDP?) exit fee. Are we the only ones who can’t remember seeing anything about that fee during the referendum campaign, even from the “remain” side?

But economies can be resilient, and the UK’s is relatively dynamic: taxes are low, the workforce is flexible and growing. We suspect that the costs, though real, may be lost in the wash.

Which means that in 5–10 years’ time, when the UK economy is comfortably bigger than today, dispirited “remainers” should expect to be told that such growth was the result of leaving.

Wider political risk and markets

If the threat of an immediate US or EU political shock has faded, however, some other geopolitical clouds may be growing in size. Middle East tensions, North Korea, South Africa, the South China Sea, Turkey, Ukraine and terrorism – all pose varying but very visible risks.

Remember, however, that financial markets are capable of being callously indifferent to political and humanitarian trauma. Unless the bottom lines of corporate profitability and discount rates are affected materially, capital markets are capable of ignoring even important political events.

Remember too that the starting point is a world which, despite all its rapidly and graphically communicated dangers, has recently been safer and less violent (and more prosperous) than at any time in recorded history, a point made compellingly in Steven Pinker’s *The Better Angels of our Nature*, 2011.

Favourable growth/inflation mix continues

The signs are that global economic growth has continued at a respectable pace into 2017, with only a modest increase in core inflation pressure.

It may not look that way in the US, where pundits are warning of a gap between strong “soft” data (such as surveys) and weak “hard” data (such as GDP). But we wrote here last year, and the year before, about the possible residual seasonality in the first-quarter GDP data, and the roles that can be played by the inventories and imports.

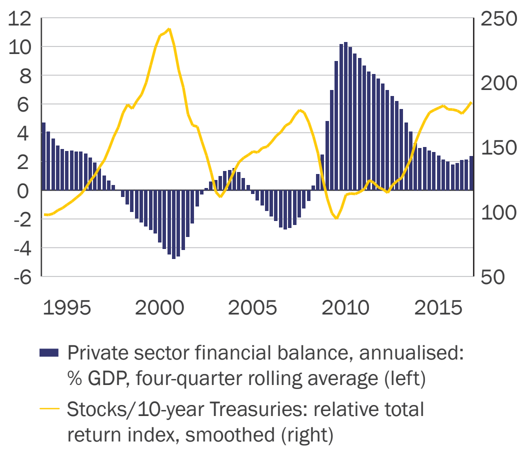
Not all “hard” data has been weak in any case: the trends in weekly unemployment claims, for example, continue to run at 43-year lows, and unemployment is back down at 2007 levels.

As ever, context is more important than decimal points. We continue to see the ongoing cashflow surplus in the private sector – reflecting healthy personal savings – as fuel in the tank for the mature US expansion (figure 3).

The bottom line for investors is corporate profitability, and the signs are that the first-quarter data will show a further rebound as the oil sector’s weakness fades further and other sectors continue to move forward.

Figure 3: US private sector’s financial surplus

Private savings less investment as % GDP, 4q mav, %



Source: Federal Reserve, Datastream, Rothschild & Co

Growth also looks relatively healthy – around a more subdued longer-term trend – in the eurozone. In China, we are seeing the softest of soft landings – so soft in fact that it could be confused for a renewed take-off.

All of which leaves us focusing on the normalisation of interest rates as the most likely economic hurdle investors will encounter in the months immediately ahead. As yet, however, it is still only the Federal Reserve (Fed) that has begun formally to do so. After three rate rises since late 2015, with more likely in the balance of 2017, the Fed is at last talking of normalising its balance sheet too – that is, of allowing its holdings of bonds to gradually mature.

The People's Bank of China has nudged some short-term money rates higher in recent months, but its high-profile benchmark rate remains unchanged. In the eurozone, the UK and Japan, the respective central banks remain publicly accommodative.

Which is why we continue to think that resumed inflation, fanned by overly generous monetary policy, is the underlying economic risk we should worry most about. But as yet, even in the US and the UK, growth in pay and prices remains relatively sluggish.

Investment conclusions

There has been much discussion among our investment team, but no change in views.

If markets had risen solely because of assumptions about president Trump's likely policies, and it now looks – as discussed above – that his administration has little momentum, then we might need to revisit our investment advice.

However, we have been emphasising that the global economy and corporate profitability were likely in better shape than generally recognised to begin with. The new administration's initiatives – when/if formulated and implemented – might offer further headroom (as might some reduction in political risk in Europe).

Some wariness is warranted. There has not been a significant market setback now for more than a year – the brief post referendum sell off in June, and the small dip mid-March, don't really count – and the US expansion is well into its 8th year: tactical clocks are ticking. That monetary normalisation may yet pick up speed. The calendar is turning less friendly (as in "sell in May…").

Nonetheless, we take a relatively long-term view, and we still think that the investment climate is broadly constructive for growth-related assets.

- Stocks are not cheap, but nor are they alarmingly expensive, and we think they are still the most likely source of inflation-beating investment returns. In this context, restructuring portfolios in an attempt to avoid a setback could leave us stranded if markets rally.
- By contrast, most government bond yields remain below current and (we think) prospective inflation rates, and look expensive. We view bonds and cash currently as portfolio insurance, not sources of inflation-beating returns.

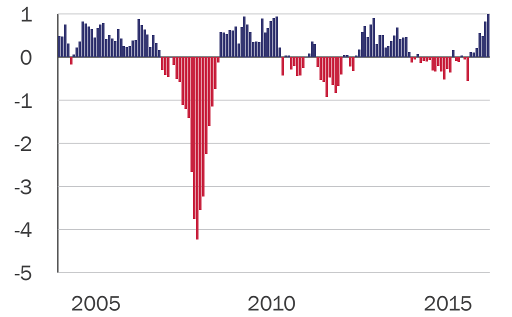
Restructuring portfolios in an attempt to avoid a setback could leave us stranded if markets rally.

- High-quality corporate bonds (credit) still look more attractive than government bonds, but their relative headroom now looks modest. They seem also unlikely to deliver positive real returns. Emerging market bonds, even those in hard currency, may still be vulnerable to rising US interest rates.
- Generally, we continue to favour relatively low duration bonds. In US dollar portfolios, we are more positive on inflation-indexed bonds, and less on speculative grade credit. UK index-linked gilts have been pricing in some extra imported inflation, much of which still has yet to show up.
- On a purely top-down view, our regional conviction on stocks remain low. We prefer them to bonds in most regions. Favoured regions are Europe ex-UK and emerging Asia (despite US rate-related risk); least favoured is the UK.
- We still prefer a mix of cyclical and secularly growing sectors to more defensive bond-like sectors.
- Currency conviction has fallen even further: eurozone growth has surprised most positively, undermining our confidence in our less positive call on the euro, and our patience on the pound continues to be tested (we think it over-reacted to the referendum result). Nonetheless, on a one-year view we still rank the big currencies, from most to least attractive, as sterling, dollar, Swiss franc, yen, euro and yuan.

Economy and markets: background

Growth: major economies

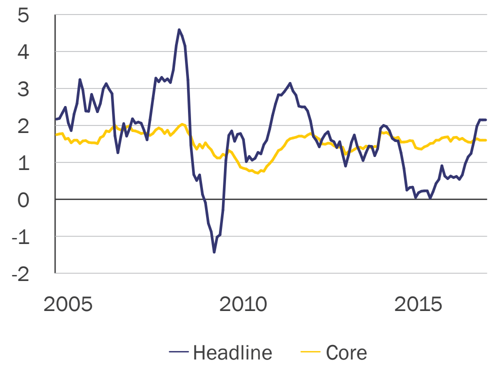
Business optimism: standard deviations from trend



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

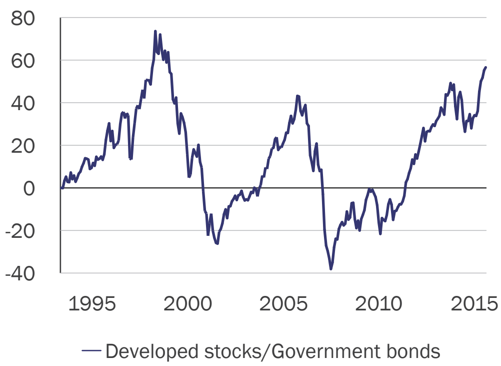
G7 inflation

%, year-on-year



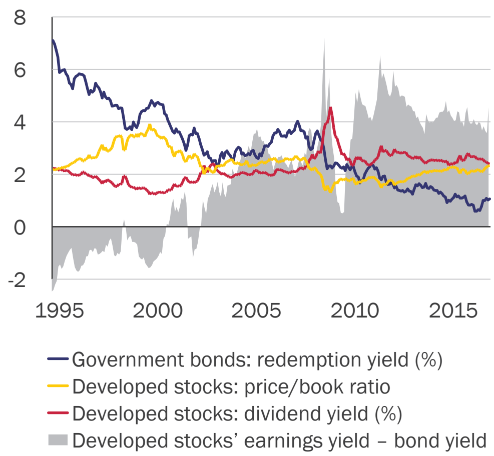
Source: OECD, Bloomberg, Rothschild & Co

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	2.4	-2.6	9.8
10-yr UK Gilt	1.1	4.5	20.5
10-yr German bund	0.3	1.4	14.3
10-yr Swiss Govt. bond	-0.1	-1.8	9.5
10-yr Japanese Govt. bond	0.1	-0.8	6.5
Global credit: investment grade (USD)	1.6	1.1	11.2
Global credit: high yield (USD)	5.6	15.1	17.8
Emerging (USD)	4.7	8.6	17.1

Source: Bloomberg, Rothschild & Co

Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

	Yield (%)	1yr (%)	3yr (%)
World: all countries	2.4	17.0	26.5
Developed	2.4	17.2	27.5
Emerging	2.4	15.1	17.8
US	1.9	16.7	31.3
Eurozone	3.0	19.7	24.6
UK	3.9	23.5	23.4
Switzerland	3.2	14.0	11.9
Japan	1.9	13.5	29.0

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (1980 = 100)

	Level	1yr (%)	3yr (%)
US dollar (USD)	334	5.2	25.8
Euro (EUR)	263	-2.3	-3.6
Yen (JPY)	481	3.4	5.7
Pound sterling (GBP)	100	-9.0	-7.2
Swiss franc (CHF)	310	0.7	8.4
Chinese yuan (CNY)	35	-4.7	6.0

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	186	9.0	-39.0
Brent crude oil ($/b)	52.8	33.4	-51.0
Gold ($/oz.)	1,249	1.4	-2.7
Industrial metals (1991 = 100)	235	26.2	-7.9
Implied stock volatility (VIX)	12.4%	-11.3	-10.9
Implied bond volatility (MOVE, bp)	60.7	-11.8	-1.8

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data correct as of 31st March 2017.

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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Important information