Market Perspective

Passionately unconvinced | China's debt

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Rothschild
Private Wealth

Foreword

The biggest news since the last *Market Perspective* has to be the UK general election result. Much of the rest of the world has been quietly getting on with business.

President Macron has won a mandate for (attempted) liberal reform, and the Trump administration's potentially alarming worldview remains confined within 140 characters. Economic growth remains respectable, and is accompanied by only modest (as yet) inflation risk. While this risk stays modest, the prospective rebound in global interest rates remains a gradual one.

Overall, we still view the global investment climate constructively, and advise using any (long overdue) setback to add to long-term positions in growth-related assets.

But that UK result was a surprise. In these unusually sunny times, the political ice-cream sellers are not standing back-to-back in the middle of the beach but at its furthest ends. Voters cluster in the middle, but the choices they're being offered have shifted to the fringes.

It is probably too soon for local investors to be alarmed. A big increase in business taxes, and/or a reckless U-turn in fiscal policy, though closer than we'd realised, is far from a done deal. The sort of Brexit we'll get has always been largely up to our EU partners.

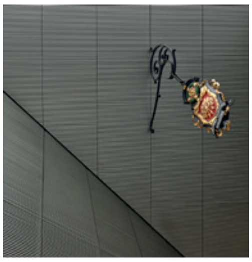
The enfeebled UK government can borrow a bit more, if it chooses to, at real rates unimaginable to most of its predecessors (even after gilt yields' recent bounce). And it is not just the government that lacks coherence.

More generally, the lesson re-learned these past 40 years is surely not forgotten. If we try only to make the cake bigger, we get unfair slices; if we aim only at equal slices, we get a smaller cake. But local investment risk is higher than we'd realised.

Market Perspective will next be published in September, though if necessary we will of course be in touch sooner.

Kevin Gardiner

Kevin Gardiner
Global Investment Strategist
Rothschild 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.

Publication date: July 2017.
Values: all data as at 30th June 2017.
Sources of charts and tables: Rothschild & Co or Bloomberg unless otherwise stated.

Passionately unconvinced

Keeping an open mind

*"The best lack all conviction, while the worst
Are full of passionate intensity."*
WB Yeats

Growth and low inflation (continued)
We've come a long way.

The US economy has just entered its ninth year of expansion, with private sector demand having grown at a compound rate of 3% so far – little different to the pace in the previous cycle. We doubt this is attributable entirely to loose policy.

Globally, for most of the past eight years the talk has been of an over-borrowed, demographically shackled, resource-depleted, decadent, dangerous, deflation-prone and robot-threatened economy ("the future is not what it was"). But the world economy is roughly 33% larger in real terms (22% on a per capita basis) than at its Global Financial Crisis (GFC) low in 2009, and 31% larger than at its pre-crisis peak.

Unemployment is at multi-decade lows in Germany, Japan, the UK and (almost) the US (figure 1). Inflation is well-behaved. China's economy has not collapsed under its supposed internal contradictions (see second essay).

And in the face of a widely proclaimed "low return environment", annualised compounded global stock and bond market returns have been some 14% and 4% in US dollars since the crisis trough, and at 3% and 4% respectively have still beaten developed inflation even from the previous peak.

This broad outcome has not been a surprise, even as individual years' growth, interest rates and stock market levels have confounded forecasters (as they usually do).

The public economic debate is dominated by sensation-seeking participants, but in reality, after the debacle of the GFC, a prolonged period of recovery was always feasible, whatever the "secular stagnation" headlines suggested.

"Big Picture" investing, like thematic investing generally, is great for marketing departments but not so good for portfolios.

So what next? Our lower-key "muddle-through" approach will surely stumble at some stage, and PR economics will have another day in the sun. History rhymes, not least because free enterprise and liberal capital markets are driven by people and their extrapolative and contagious emotions. Having learned from our mistakes we are capable of repeating them exactly (as Peter Cook said).

But for the time being, we think the next cyclical downturn and/or financial crisis remains over the horizon.

Talk of a global populist backlash has been wide of the mark – the UK election result (see below) notwithstanding – and, far from collapsing, the EU may even be about to get a shot in the arm.

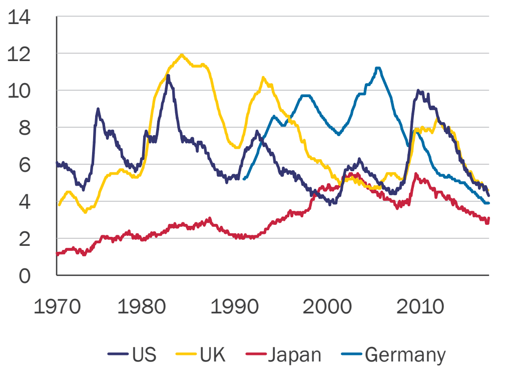
President Macron may only have an outside chance of liberalising the French labour market, but just three months ago few commentators suggested he'd even be there, backed by a parliamentary majority, to try. Chancellor Merkel looks increasingly likely to remain in office this autumn. The Italian government has at last embarked on – and is partially financing – a restructuring of its weakest banks.

President Trump retains the potential to shock, but still has yet to turn his attention to significant economic policy matters – and perhaps may never do so.

Meanwhile, economic indicators show continuing healthy growth, with the eurozone still, unusually, leading the positive surprises. In the US and eurozone, there are few signs of cyclical excess; in the UK, there are such signs, but they are being amplified by the pound's recent weakness

Figure 1: Germany, Japan, UK, US: close to full employment?

Standardised unemployment rates, %



Source: Datastream, Rothschild & Co

(though further secular risk perhaps lies ahead – see below). Worries about a possible hard landing in China have ebbed further.

The Federal Reserve is no longer the only big central bank to recognise that some normalisation in monetary policy is appropriate. The ECB is sounding less lenient, as is the Bank of England (and not just in the forward guidance offered by the Governor, whichchanges often, but in the MPC's votes).

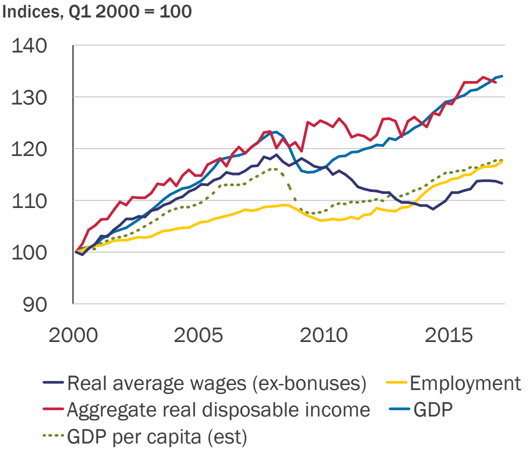
But the pace of global monetary tightening – which, without much immediate inflation risk, will translate into higher real interest rates – is likely to be gradual. And in these circumstances, we see such normalisation as a good thing. It will help reduce distorted bond prices and facilitate more accurate pricing of capital once again – not that risk assets look to us to be fully reflecting today's low interest rates to begin with.

Turning to that UK election, we suggested in May that "political stability... may be the relevant outcome from an investment viewpoint". Little did we know.

We are unconvinced about the durability of the feelings that delivered the result. Reports of the death of self-interest seem premature – students are no more immune to temptation than taxpayers – and the government presented its case poorly.

It might have suggested, for example, that while UK average real wages are below their 2007 peak, that peak was historically elevated and based on unsustainable bank balance sheets – and in the meantime, employment has risen to new highs, along with aggregate disposable incomes, and national income per capita (figure 2). In more considered times, such gains might have helped balance the losses in voters' minds.

Figure 2: UK real pay and employment



Source: Datastream, Rothschild & Co

But the public mood seems especially febrile, and has been made more so by subsequent sad events. We have to acknowledge that UK-focused investments face a little more medium-term risk – from taxation and inflation – than they did.

Investment conclusions

Stocks remain our preferred asset. We find ourselves warning yet again that there has not been a significant setback for some time (more than a year), and that the cyclical clock is ticking (see above). Nonetheless, we think that the investment climate – growth with relatively modest inflation risk – remains temperate.

- Stocks still do not look to us to be troublingly expensive, and remain the most likely asset to deliver inflation-beating returns. Restructuring portfolios in an attempt to avoid a short-term setback could leave us stranded if markets rally.
- Most government bonds do look expensive: yields remain below likely inflation rates. We still prefer high-quality corporate bonds (credit), but they are also unlikely to deliver positive real returns. We view bonds and cash currently as portfolio insurance.
- We continue to favour relatively low-duration bonds, but have become more neutral in US dollar portfolios, where we are also more positive on inflation-indexed bonds. In the UK, even after last month's acceleration in inflation and some likely increase in prospective medium-term inflation, index-linked gilts still look expensive.
- We continue to prefer stocks over bonds in most places, even in the UK (where the large-cap indices are in any case driven by global trends). We still prefer a mix of cyclical and secular growth to more defensive bond-like sectors.
- The positive developments in the eurozone noted above have now cancelled our residual scepticism on the euro, and we are correspondingly less positive on the dollar (despite our ongoing confidence in the US economy). Valuations have long pointed in this direction, and may start to matter more. We still think the pound over-reacted to the EU referendum, but our conviction there has fallen on the UK election result, even as rising interest rates loom a little larger. With even lower conviction than usual then – and one should rarely have high conviction here, as it is not possible systematically to add value by trading currencies – on a one-year view we rank sterling highest, the yuan lowest, and the other big currencies somewhere in between.

China's debt

A domestic matter

China's 19th Party Congress this autumn represents a key event in geopolitical as well as domestic calendars: the new leadership team will be revealed and the next five-year economic plan will be outlined. The world will be watching closely as it waits to see whether, and how, President Xi will tackle what many believe to be his greatest test: the matter of China's credit growth, and the threat of a broader systemic crisis.

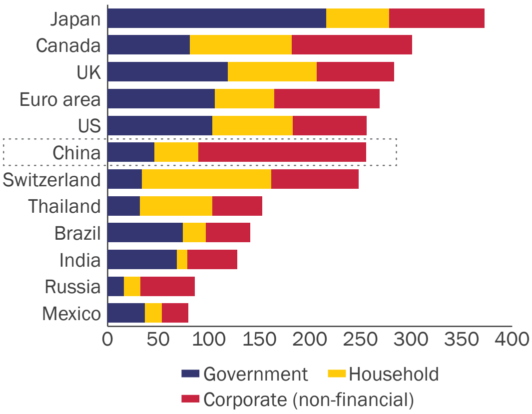
China's total debt has quadrupled over the past eight years, with aggregate debt levels now akin to that of developed economies (figure 3). Government debt remains modest at 40% of GDP, but households and in particular corporates are the main drivers of this precipitous rise in leverage.

Minksy: "stability leads to instability"

With overall debt continuing to rise, many economists are concerned that this "debt bubble" could trigger the next major financial crisis. A measure popularised by the Bank for International Settlements (BIS) – the credit-to-GDP gap – has shown to be a strong predictor of a looming financial crisis (figure 4). In each of these instances of above-trend credit growth, a financial crisis ensued, which had wide and adverse economic consequences. (The point at which it becomes clear that debt has reached unsustainable levels is known as a "Minsky moment", named after an economist who studied the credit cycle closely.)

Figure 3: Current levels of indebtedness

Debt as a proportion of GDP (%)



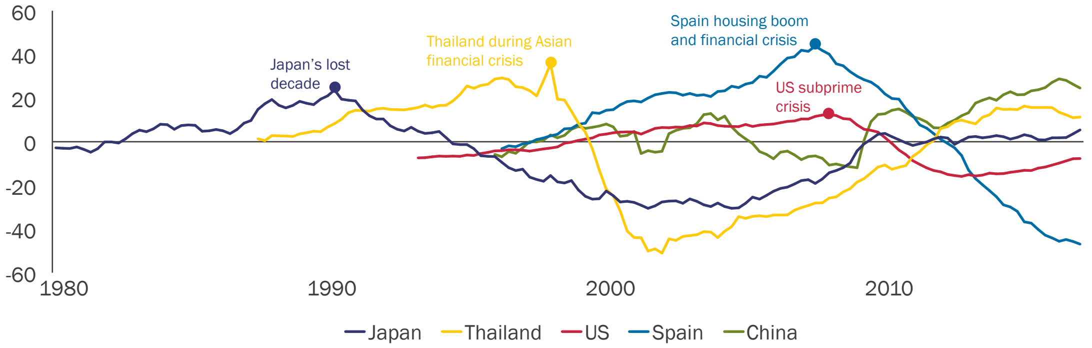
Source: IMF, BIS, Rothschild & Co
Note: Data correct to Q4 2016

Systemic threat is containable

However, the threat posed by total aggregate debt can be exaggerated: sectors lend to each other, and in a large economy, much of the overall exposure nets off. As a result, it is not always meaningful to focus on gross liabilities. Instead it may be more meaningful to focus on key sectoral exposures, and the varying abilities of sectors to withstand financial buffeting. This is particularly important in the case of China, whose position may be unique, and may not conform to the pessimistic pattern sketched by the BIS analysis.

Figure 4: Elevated levels of credit growth have previously been associated with major crises

The credit-to-GDP gap: the difference between the credit-to-GDP ratio and its long-run trend (%)



Source: Bloomberg, BIS, Rothschild & Co
Note: Data correct to Q4 2016

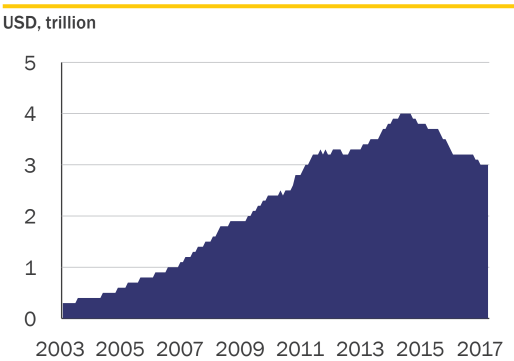
According to the IMF, the average Chinese company is only modestly leveraged, and the bulk of corporate debt is concentrated within state-owned enterprises (SOEs). Furthermore, and perhaps unsurprisingly, most of the rising debt is accounted for by companies in construction, mining, real estate, and utilities – sectors associated with the most aggressive investment-led growth over the past few years.

Independent estimates of corporate distress are higher than questionable official numbers. However, the structure of China's banking system – whereby state-owned banks (the "Big Four") lend to SOEs – suggests some implicit state backing for these companies. And as noted above, the government's explicit borrowing is modest, and its power to intervene is high. We think policymakers will use this power to manage systemic risk.

China has no net international borrowing: rather, it is one of the largest international creditors, with substantial foreign exchange reserves ($3 trillion). For many years now, China has come under scrutiny for operating a closed capital account, which limits foreign ownership of Chinese assets, including debt. But this limited reliance on external capital (only 5% of China's government debt is owned by foreign entities, while corporates are even less exposed), in contrast to the situation in other emerging Asian nations in the 1990s, and in Spain and Ireland in 2007, will help stem capital outflows and the risk of a credit-induced contraction. And its large foreign currency reserves (figure 5) represent a potential source of substantial "hard currency" capital, which the government can use credibly to plug likely holes in its banks' balance sheets.

Moreover, those banks fund most of their loan operations from deposits (70% of their wholesale funding) – a function of the high household savings rate, and consumers' low borrowings. As banks require little in the way of short-term funding from capital markets – relative to their US counterparts for example – a short-term "liquidity crisis" seems unlikely, even as the authorities nudge money rates higher.

Figure 5: China's foreign exchange reserves



Source: Bloomberg, The People's Bank of China, Rothschild & Co
Note: Data correct to Q1 2017

Paradigm shift?

Policymakers are aware that purely debt-fuelled economic growth is not viable over the long term, and there has been a subtle shift in emphasis from growth to financial stability. Steps have been taken to address some of the deeper systemic issues, such as the shadow banking system and speculation within the property market, albeit belatedly. The former in particular may be the source of some painful readjustment for industries dependent on shadow financing.

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From a macroeconomic standpoint, China's healthy current account surplus, capital controls and sizeable foreign exchange reserves should continue to keep a balance of payments crisis at bay.

However, while capital controls, restrictions on lending and tighter financial conditions may stabilise the market in the short term, they do little to address the probability that some businesses and sectors do have too much debt. Policies designed to prop-up over-leveraged SOEs are not sound economics. Ultimately, these measures will hamper productivity and long-term growth.

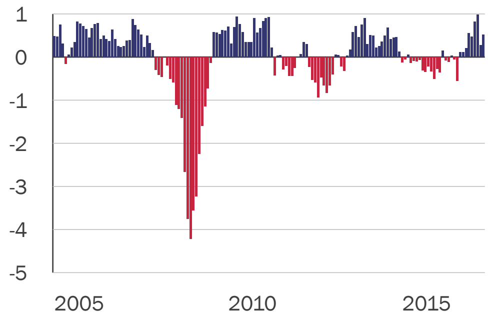
But it is one thing to say that debt growth needs to slow and that some sectors need restructuring, and quite another to say – as many have been saying, and for some time now – that credit expansion alone has been responsible for China's rapid growth since 2000.

In our view, the underlying case for Chinese growth has been rooted in market reform and increased availability and utilisation of labour and capital. And despite the excesses, sectoral inefficiencies and the possibility of some market volatility as frothier expectations evaporate and some balance sheets need consolidating, we continue to believe there are opportunities for the long-term investor.

Economy and markets: background

Growth: major economies

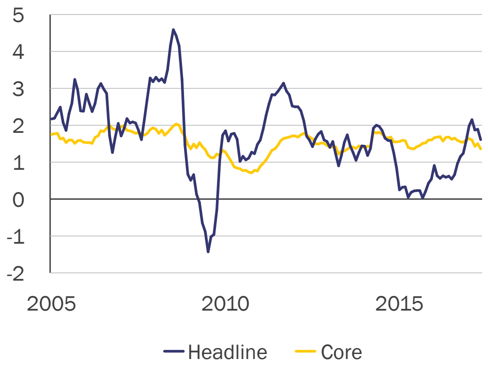
Business optimism: standard deviations from trend



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

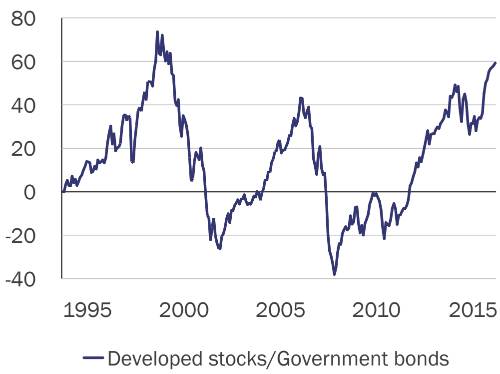
G7 inflation

%, year-on-year



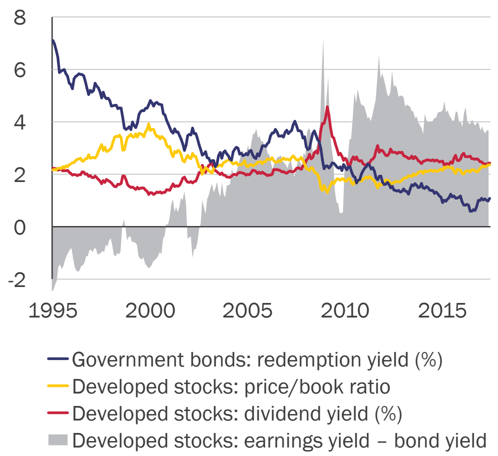
Source: OECD, Bloomberg, Rothschild & Co

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	2.3	-4.0	8.7
10-yr UK Gilt	1.3	-0.6	18.6
10-yr German bund	0.5	-3.5	9.5
10-yr Swiss Govt. bond	-0.0	-4.0	6.9
10-yr Japanese Govt. bond	0.1	-2.4	5.3
Global credit: investment grade (USD)	1.6	-0.4	10.1
Global credit: high yield (USD)	5.3	11.9	16.9
Emerging (USD)	4.7	5.6	14.1

Source: Bloomberg, Rothschild & Co

Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

	Yield (%)	1yr (%)	3yr (%)
World: all countries	2.4	19.2	24.8
Developed	2.4	18.8	25.4
Emerging	2.4	21.8	19.4
US	2.0	17.3	28.6
Eurozone	3.2	24.8	22.8
UK	4.2	16.7	20.3
Switzerland	3.2	14.5	13.8
Japan	2.0	30.5	30.4

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (1980 = 100)

	Level	1yr (%)	3yr (%)
US dollar (USD)	328	0.9	25.0
Euro (EUR)	276	2.9	2.2
Yen (JPY)	470	-9.0	2.2
Pound sterling (GBP)	100	-3.9	-9.7
Swiss franc (CHF)	314	1.3	10.1
Chinese yuan (CNY)	36	-1.4	7.8

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	175	-9.2	-43.3
Brent crude oil ($/b)	47.9	-3.5	-57.4
Gold ($/oz.)	1,242	-6.1	-6.5
Industrial metals (1991 = 100)	232	17.5	-16.2
Implied stock volatility (VIX, %)	11.2%	-28.5	-3.4
Implied bond volatility (MOVE, bp)	5.5%	-24.0	4.7

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data correct as of 30th June 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.

Brussels
Avenue Louise 166
1050 Brussels
Belgium
+32 2 627 77 30

Frankfurt
Börsenstraße 2 – 4
60313 – Frankfurt am Main
Germany
+49 69 299 8840

Geneva
Rue du Commerce 3
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 705191

Hong Kong
16/F Alexandra House
18 Chater Road
Central Hong Kong SAR
People's Republic of China
+852 2525 5333

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 Milano
Italy
+39 02 7244 31

Paris
29 avenue de Messine
75008 Paris
France
+33 1 40 74 40 74

Singapore
One Raffles Quay
North Tower #10-02
1 Raffles Quay #10-02
Singapore 048583
+65 6535 8311

Zurich
Zollikerstrasse 181
8034 Zurich
Switzerland
+41 44 384 7111

Important information