Market Perspective

Warming up | Change

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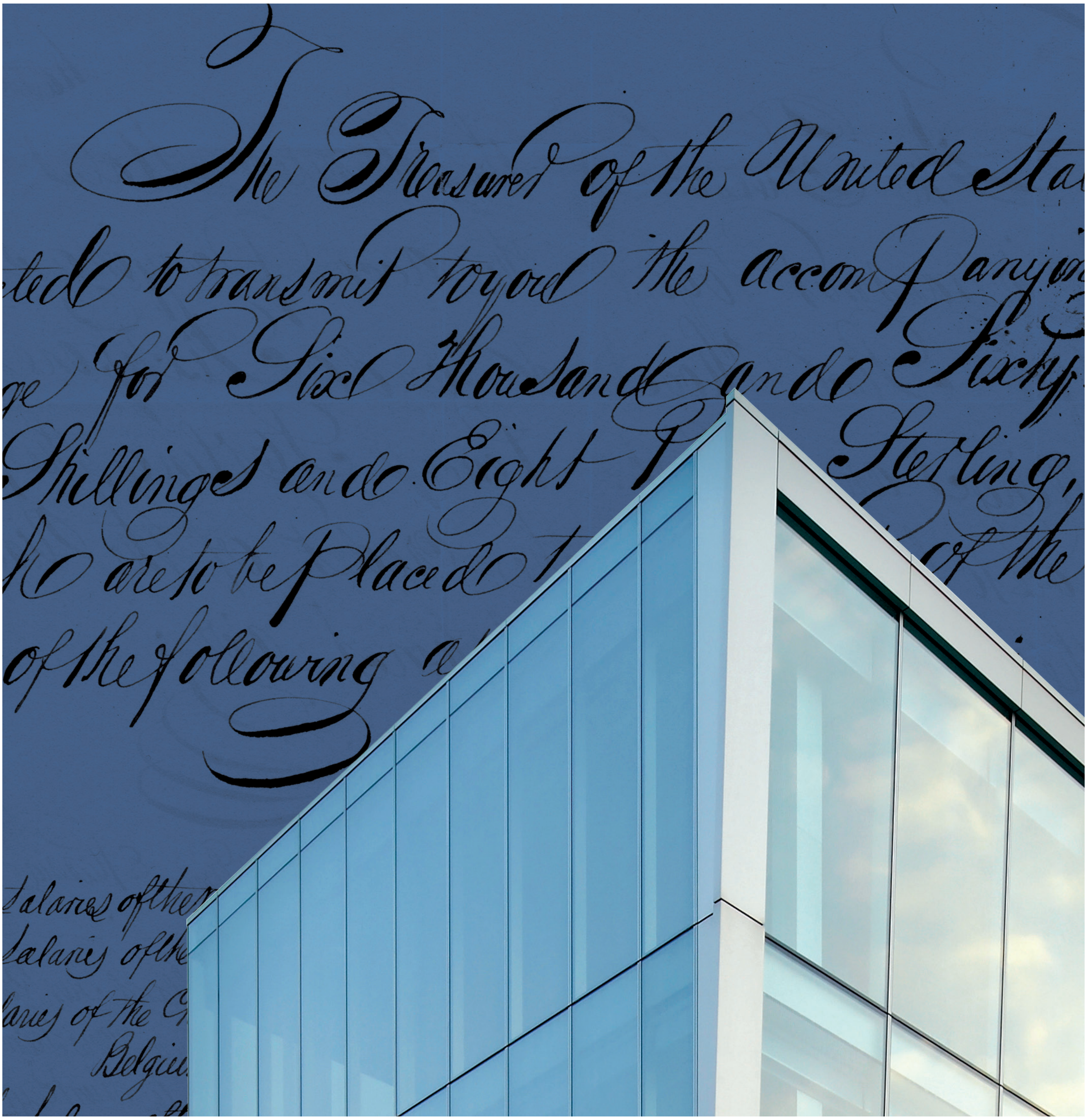

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Foreword

"I don't care to belong to any club that will have me as a member."
– Groucho Marx

Some important economic indicators are no longer simply close to trend, but flirting with historical highs. Having argued for many months that this mature business cycle still has legs in it yet, we're wondering if we understated our case.

If so, it's not all plain sailing. Markets could be in for a bumpier ride for a while. Solid growth boosts profits, and underpins stock valuations. But it also eats up spare capacity, fosters inflation risk and – as we're about to see again perhaps at the Federal Reserve (Fed) – pushes interest rates higher.

Net, the good news can outweigh the bad, and this is still how we see things currently. Higher interest rates in the US – and perhaps later this year in the UK – are part and parcel of a return to business as usual.

As such, and like those political clouds we've talked a lot about recently, they may signal short-term volatility, not a worse investment climate. Some setback is statistically overdue: the last time the S&P 500 had 100 trading days without a 1% fall was in 1995.

There are still few signs of the excesses that have often preceded more dramatic corrections in the past. And recent economic strength has not been uniform: the more positive pundits do not yet constitute the sort of complacently clubbable consensus that would trouble (Groucho) Marxist contrarians.

So we still advise using such setbacks to add to, or to open, long-term holdings in growth-related assets.

Meanwhile, whatever happens cyclically, fears of more profound political and economic change seem misplaced. We suggest that the dramatic progress of modern times need not suddenly stop or be reversed.

Kevin Gardiner
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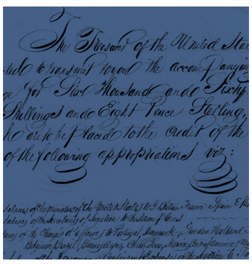

Cover image:
Foreground: Our office at New Court, London
Background: A letter to Nathan Mayer Rothschild from the American Treasury Department, 21st November 1834 concerning general business transactions.
Courtesy of The Rothschild Archive.

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Sources of charts and tables: Rothschild & Co and Bloomberg unless otherwise stated.

Warming up

Growth may nudge rates higher

The political clouds are still there, but the skies are again a bit clearer economically.

Political clouds: squall not storm?
We can't predict election results or presidential tweets, but we still see the populist Big Picture as a misleading caricature. Potential outcomes are not quite as one-sided as many fear. If the road to hell is paved with good intentions, perhaps the opposite can sometimes be true.

President Trump's policies are not all bad for business, remember, and his strategy of talking loudly and carrying a big stick might yet spark a better economic détente with China. But even as the US administration continues to seek its feet, the markets' gaze is switching to Europe, looking beyond the imminent Dutch election to France and the presidential elections in April/May.

Reasons for voter disenchantment are not hard to find (figures 1 and 2) but anger may not translate into a repudiation of the euro. Nationalists do not have a monopoly on populism, and the parliamentary elections in June could deliver a different result.

Above-trend growth?
Some long-established business surveys in the US and UK suggest order books and output expectations are close to the highest levels seen in recent years, hinting at something more than just continuing respectable growth.

There is no guarantee that materially higher inflation will follow: econometric rules are made to be broken. For example, strong growth coincided with falling consumer prices in much of the late nineteenth century. In the UK, where roughly a third of what consumers buy is imported, the fact that core inflation has risen by just two-tenths of a percentage point some seven months after a double-digit fall in the value of the pound is remarkable.

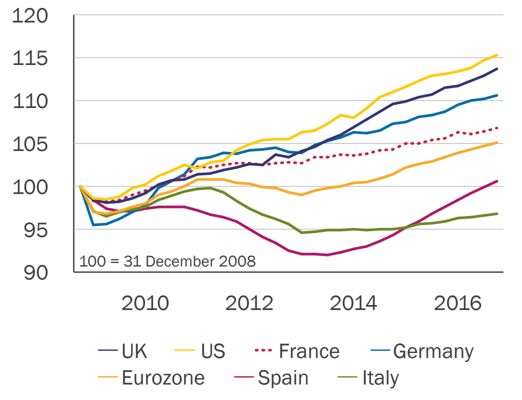
Nonetheless, the chance of some eventual upturn in core inflation rates has probably risen further. As we write, the Fed seems poised to nudge US interest rates higher again in response. And having almost completed its extra bond purchases, we think the Bank of England may feel the need, possibly later this year, to reverse its post-referendum rate cut.

The ECB remains firmly dovish, but in a slightly more nuanced fashion as inflation risk has risen even in the eurozone. And even as the ECB and Bank of Japan continue buying bonds, 10-year German bund and Japanese government bond yields have drifted higher.

Growth in China still remains below trend, but fears of a debt-driven collapse always looked overdone, and should have faded further. Producer prices point clearly to inflation risk there too, but its relevance to capital markets is more limited.

Figure 1: France has lagged some big economies

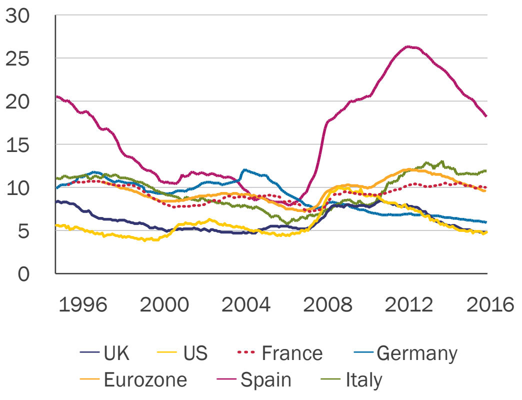
French GDP: index, end-2008 = 100



Source: Bloomberg, Rothschild & Co

Figure 2: French unemployment has stayed high

Unemployment rates (%)



Source: Bloomberg, Rothschild & Co

The US can live with higher rates

Figure 3 reminds us that rising US interest rates do not always herald recession. Circumstances vary. In the early stages of a rate cycle, particularly one that started with rates at record lows, and with few signs of reckless private borrowing, cause-and-effect likely still runs from the economy to rates, not vice versa.

Nor are rising rates an infallible guide to poor stock market returns (figure 4). On average, the US market has done best without rising rates – but the averages mask a wide range of outcomes, and there are several instances of rising rates being followed for some time by strong markets (most recently after 2004).

Investment conclusions

Economic momentum can help offset ongoing uncertainty about the new US administration and European politics. It may also bring a little inflation risk and higher interest rates, but we judge that in current circumstances it is still a net positive for long-term investment portfolios tilted in the appropriate (growth-related) direction. Better profitability, for example, could suggest a bit more headroom for stock prices. More specifically:

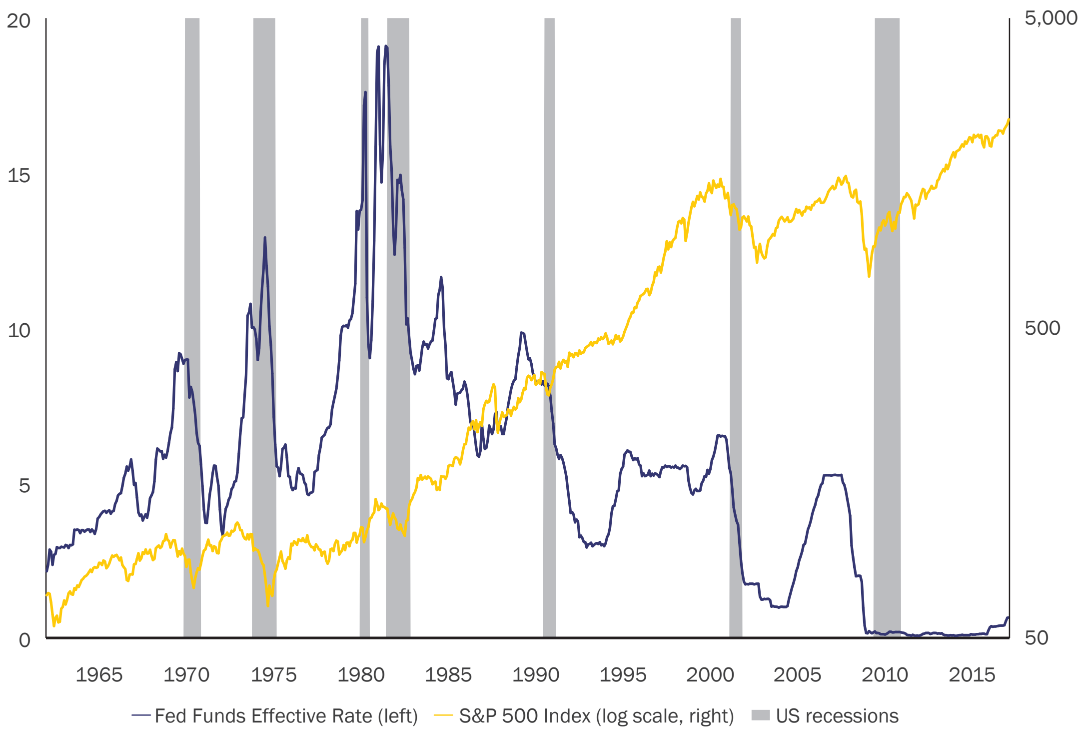
- The business cycle and valuations continue to favour stocks as the likely source of inflation-beating investment returns.
- Most government bond yields remain below current and (we think) prospective inflation rates, with the continuing most visible exception of long-dated US Treasuries, particularly after their rise in the last month.
- Equities are more fully priced than they were, but remain relatively inexpensive. Corporate earnings may rebound faster than we'd expected if economies stay firmer for longer.
- We still see bonds and cash largely as portfolio insurance, not sources of inflation-beating returns, and think they are best held in investors' home currencies. Interest rates are low in most markets, and hedging foreign exchange can reduce yield.
- High-quality corporate bonds (credit) still look to us to be preferable to government bonds, but as they have outperformed, their relative headroom has been further eroded. Like government bonds, they seem unlikely to deliver positive real returns. Emerging market bonds, even those in hard currency, may still be vulnerable to rising US interest rates.
- In US dollar portfolios, we are more positive on inflation-indexed bonds, and less on speculative grade credit. The duration call is becoming a closer one: higher yields have again trimmed market duration and mark-to-market risk for longer-dated Treasuries. Long-dated UK index-linked gilts have been pricing in some extra imported inflation, but, as noted, much of it has yet to show up.
- On a purely top-down view, our regional conviction on stocks remains low after last month's move down to a more neutral view on the US, and up to neutral in developed Asia ex-Japan (mostly Australia and Hong Kong). We prefer stocks to bonds in most regions. Favoured regions now are just Europe ex-UK and emerging Asia (despite US rate-related risk there); least favoured is the UK.

Rising US interest rates do not always herald recession.

- Again, we continue to prefer a mix of cyclical and secularly growing sectors – banks and energy, despite the latter's recent underperformance, and healthcare and technology – to bond-like sectors such as utilities, staples and telecoms.
- Currency conviction remains low, but we have reshuffled our preferences a little, lifting the Swiss franc and lowering the euro. On a one-year view this leaves us ranking the big currencies, from most to least attractive, as sterling, dollar, franc, yen, euro and yuan.
- We never expected the Swiss economy to collapse under the weight of the franc's 2015 surge, but it looks even more resilient than we thought. With eurozone political risk likely to stay elevated through 2017 even if Le Pen loses, the franc may retain some local safe haven appeal. It is expensive, but (like global bonds) may stay so for a while yet.
- Our patience on the pound is being tested, but we think it overreacted to the referendum and is now undervalued. In addition, UK interest rates may start to rise sooner than the market expects.
- The case for the dollar is stale but (to us) convincing: solid growth and rising rates more than offset uncertainties surrounding the new administration and a high (but not sensational) valuation. There is a certain irony in the Chinese authorities trying to stop the yuan from falling even as President Trump accuses them of manipulating it lower. China's economy looks relatively stable to us, but peak growth is far behind us and capital is trying to leave.

Figure 3: US recessions don't immediately follow rising rates

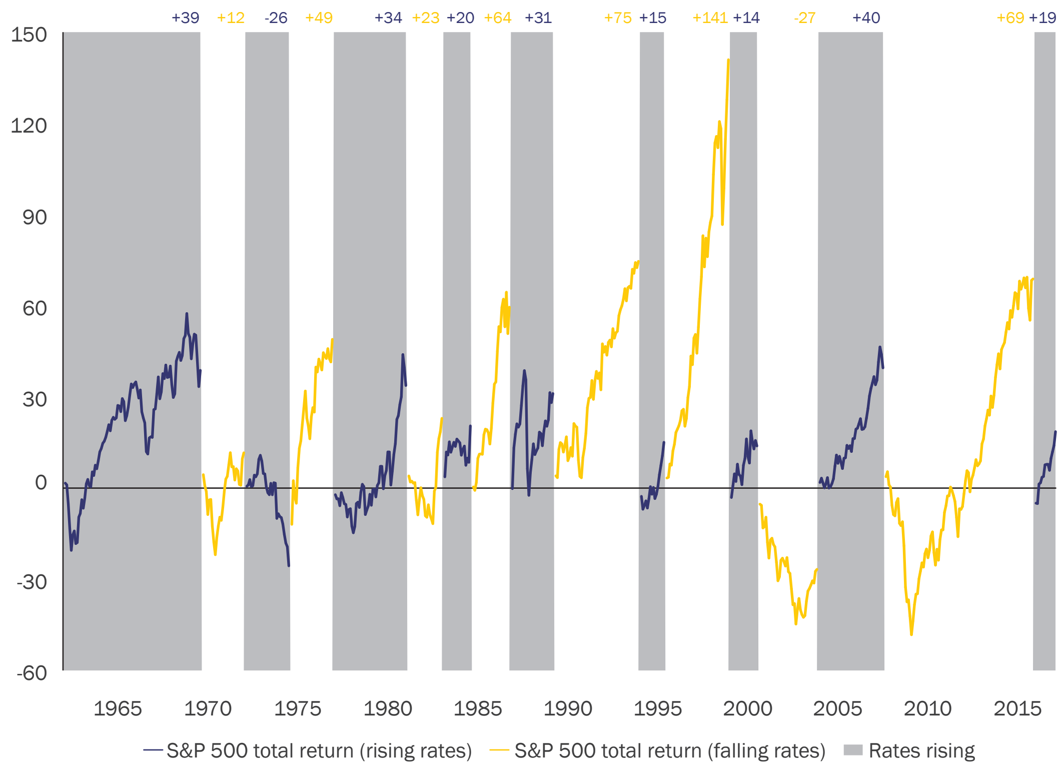
US interest rates (%), stock returns (nominal, index) and recession periods.



S&P 500 index returns are shown in local currency on a total return basis (net).
Source: Bloomberg, Rothschild & Co, NBER

Figure 4: Rising rates don't always hit the stock market hard

Periods of rising US interest rates and stock market returns (%, nominal, indices)



S&P 500 index returns are shown in local currency on a total return basis (net).
"Rates rising" reflect the start of a rate hike cycle through to the point at which interest rates start to decline and may include periods when interest rates have plateaued. The same applies to "falling rates" periods.
Source: Bloomberg, Rothschild & Co

Change

We are not doomed to decline

"Change? Aren't things bad enough already?"
– attributed to Lord Salisbury

Change can be unsettling. As we noted last month, there is a tendency to believe that these are special times, and that change is faster, and uncertainty more extensive, than ever before. City economists often start essays with the phrase "this is a particularly uncertain time".

In reality, the future is always profoundly unknowable. Most things that can happen from here were probably always capable of happening: we just didn't realise it. And an uncertain future does not have to be a poorer or more violent one. We are not doomed to decline.

The world is far safer and better off than it used to be. This progress was not widely predicted – and having happened, is often overlooked.

We have cited here before the masterly collation of the historical facts on violence, conflict and disease in Steven Pinker's *The Better Angels of Our Nature: Why Violence has Declined* (2011). It is too soon to conclude that this peaceable trend has to reverse.

A similar marshalling of the facts on living standards has been done more recently by Robert Gordon in *The Rise and Fall of American Growth: The US Standard of Living Since the Civil War* (2016). Again, we think it is too soon to conclude the best is behind us – though he is more sceptical about the future than Pinker.

Gordon reminds us that as relatively recently as the mid-nineteenth century, and in the country that today provides the benchmark for material success, life was much grimmer and shorter.

The average American then lived without running water (in either direction), and with inadequate heating (and cooling) and lighting. They ate poor, often adulterated and unrefrigerated food, and wore dirty and poorly made clothes. They were effectively confined to walking or horse-riding distance of their homes; there was little healthcare, and they enjoyed limited leisure and entertainment, and negligible retirement.

Think about that latter point with today's retirement worries in mind. The proportion of a typical male's lifetime waking hours spent at work was twice what it is today – and as Gordon notes, work then was more physical and dangerous. Those lifetimes were significantly shorter than ours, although average life expectancies at birth overstate things. Life then was more binary – if you survived infancy, you had a good chance of living to your sixties, but perhaps one in five didn't survive.

In reality, the *Little House on the Prairie*, for example, far from being the bucolic idyll of the TV series, would have been insufferably hot in the summer, freezing in winter, draughty, infested, badly lit and noisome.

Life in the city tenements that characterised much early urban living would have been similarly difficult. Conditions here in Europe would have differed in detail, but not substance.

The world is far safer and better off than it used to be. This progress was not widely predicted – and having happened, is often overlooked.

The subsequent networking of US households – to water, sewage, gas, electricity, healthcare, transport (rail, road and air) and communications – has been a relatively modern miracle. The rise in welfare is understated by statistics that can't always capture the improved quality of goods and services.

The question now is whether such progress – the technological and organisational innovations that have boosted productivity immeasurably – has run out of steam (as it were).

Gordon concludes his magisterial (and readable) review by suggesting it has: the sheer scale of past technological and organisational progress, and its directly life-changing significance, make it unrepeatable. He also notes that the sensationally rapid growth in information technology (IT) capacity, epitomised in Moore's Law, may be slowing. And he echoes others in suggesting that the impact of IT – the only recent candidate for the pantheon of life-changing innovations – has been disappointing. Robert Solow, another respected US academic, has quipped for example that "you see computers everywhere except in the productivity statistics".

Noting slower GDP trends in recent years, and drawing attention to the alleged "headwinds" posed by inequality, education, demography and debt, this leads Gordon to assert that living standards can now grow only feebly.

For every pundit claiming we're running out of ideas there seems to be another saying that artificial intelligence and robots will soon be doing all the hard work.

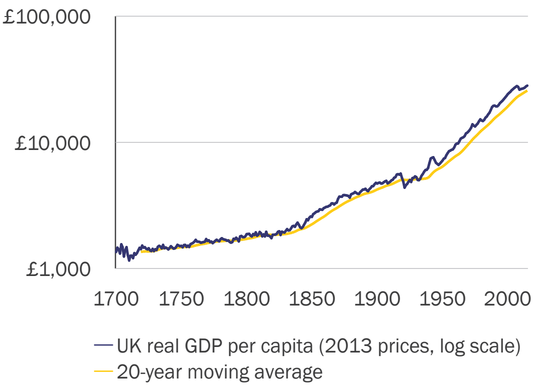
Here we respectfully differ. Even the most brilliant minds may not be immune to the "good old days" syndrome – even as they demonstrate that those days were anything but! Nobody expected the earlier progress. What is really missing now: the potential for further growth – or imagination?

The GDP data he cites may not be accurately reflecting qualitative change (a point he makes himself in another context). On the specific question of computers and productivity, one possibility – identified by Sir Charles Bean in his independent inquiry into UK data last year – is simply that "official statistics may be missing an important aspect of the contemporary economy". Measuring an increasingly services-oriented and digitised economy is not easy.

Who knows what the cumulative impact of (for example) innovations in intelligent software, robotics, the internet of things, nanotechnology,

Figure 5: Why should this trend suddenly stop or go into reverse?

UK real GDP per capita (2013 prices, log scale)



Source: Bank of England, Rothschild & Co

materials science, additive manufacturing and alternative energy technologies will be? The IT revolution is clearly incomplete; a life science revolution could lie ahead. More prosaically, technology is poised to change financial and legal services beyond recognition.

Indeed, for every pundit claiming we're running out of ideas there seems to be another saying that artificial intelligence and robots will soon be doing all the hard work. (Although who will they sell to if we are all unemployed?)

Meanwhile, among Gordon's "headwinds", demography, debt and inequality at least have been overstated as practical constraints on growth (as we have argued often here).

Sadly, we still face plenty of humanitarian, ethical and educational challenges. But just as the world does not have to become more dangerous, nor do the material conditions of life suddenly have to stop improving meaningfully. And at the very least, an awareness of the continuing possibility for positive change makes, we think, for more balanced investing.

The past was not perfect. The blue-remembered hills of childhood mask a greyer material reality. And claims that we have run out of headroom are unconvincing.

Finally, two of our favourite quotations on futurology. Simon's is the boldest; Macaulay's reminds us that distrust of the future is not new.

"This is my long-run forecast in brief: The material conditions of life will continue to get better for most people, in most countries, most of the time, indefinitely. Within a century or two, all nations and most of humanity will be at or above today's Western living standards… I also speculate, however, that many people will continue to ***think and say*** *that the material conditions of life are getting* ***worse****."*
Julian Simon (1932–1998)

"We cannot absolutely prove that those are in error who say society has reached a turning point – that we have seen our best days. But so said all who came before us and with just as much apparent reason… On what principle is it that with nothing but improvement behind us, we are to expect nothing but deterioration before us?"
Thomas Babington Macaulay (1800–1859)

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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