Market Perspective

Angels and demons

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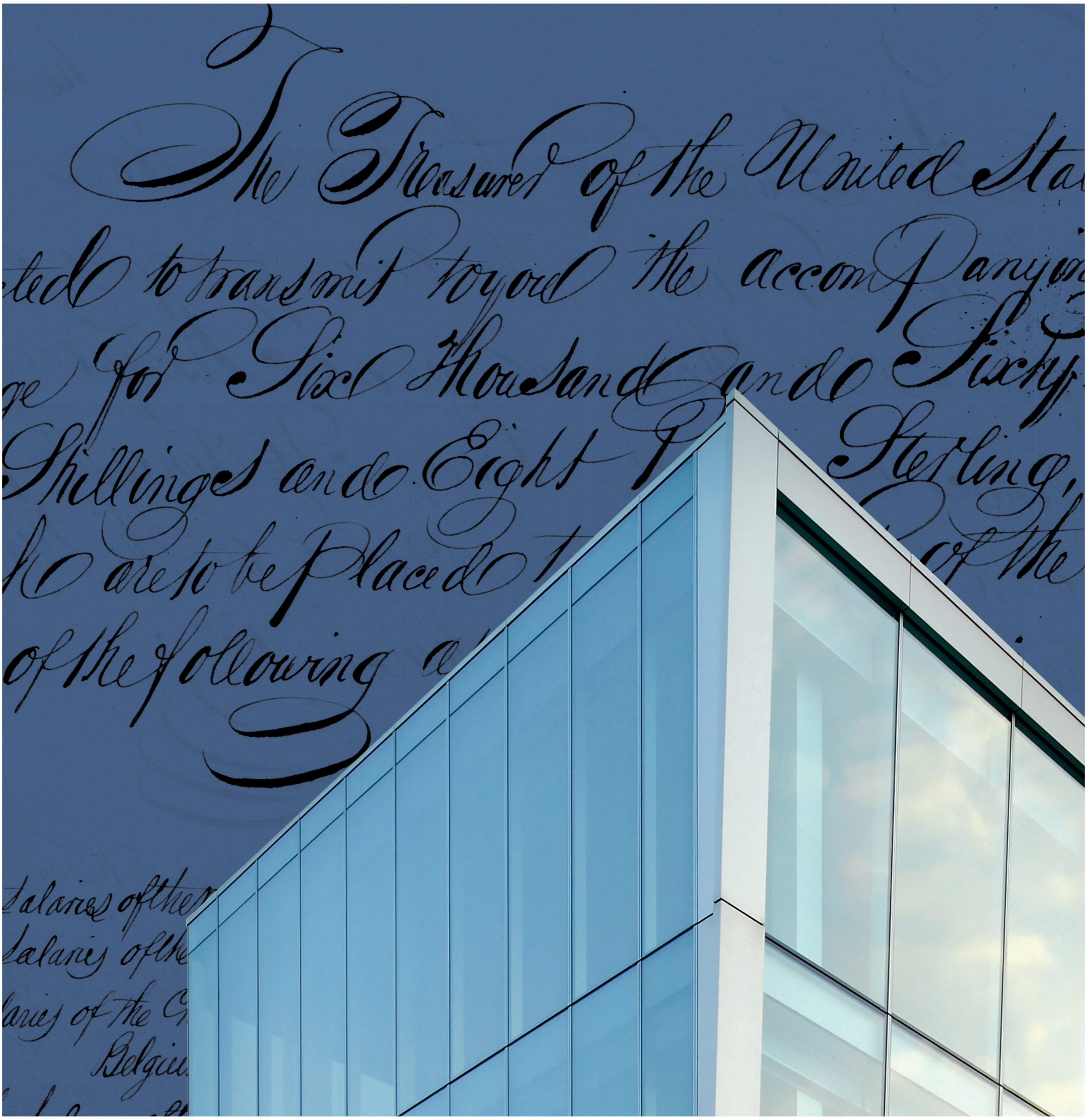

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Foreword

"We are not enemies, but friends. We must not be enemies. Though passion may have strained it must not break our bonds of affection. The mystic chords of memory, stretching from every battlefield and patriot grave to every living heart and hearthstone all over this broad land, will yet swell the chorus of the Union, when again touched, as surely they will be, by the better angels of our nature."

— Lincoln, first inaugural address, 1861

We could do with some rhetorical balm at the moment.

Western received wisdom is still reeling from the result of the bad-tempered US poll and the prospect of Brexit, and faces an unappetising French presidential race. Tension envelops the Middle East, the refugee crisis continues, and the world waits nervously to discover if China's newly discovered role involves gaining an empire.

How can the global economy and investment portfolios not be tested severely in these circumstances? We don't pretend to have a crystal ball. No one knows, or can know, what comes next. But we can offer slightly different perspectives on the starting point.

The global economy has more momentum than imagined on 8th November, and so may be more resilient than feared – at least cyclically.

Those political risks themselves may be overstated. Even if they are not, past events have not always affected investments in the way that might have been expected. And as with the economy, the geopolitical starting point may be more resilient than is generally realised.

Our conclusion – as it has been throughout the varying moods punctuating the post-2008 period – is that the investment climate can remain a temperate one, and it is still too soon to batten down the hatches. A "wall of worry" suggests some bad news is still implicitly priced in, even at today's market levels.

Kevin Gardiner

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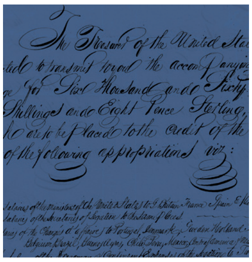


Cover image:
Foreground: Our office at New Court, London
Background: A letter to Nathan Mayer Rothschild from the American Treasury Department, 21st November 1834 concerning general business transactions. Courtesy of The Rothschild Archive.

Publication date: February 2017.
Values: all data as at 10th February 2017.
Sources of charts and tables: Rothschild & Co and Bloomberg unless otherwise stated.

Angels and demons

Political risk is not always market risk

Many neat policy assumptions have come unfastened. Protection looms larger than it has done for many years, the fragmentation of the euro and the EU is a serious possibility, and some long-standing geopolitical alliances – and stand-offs – are being questioned.

We are told that this is a time of great uncertainty; that geopolitical tension has rarely been higher. It would be foolish to ignore the risks.

But these may not be quite such exceptional times. And even if they are, they may not affect investments quite in the way expected.

The global economy has some momentum
A subtle but important point perhaps.

For the first time in a couple of years at least, expectations for economic growth have recently been firming up.

This has had little to do with any deliberate new global "reflation". Talk of that has been popular since the US election, but is as yet prospective supposition rather than reality.

If the global economy looks more resilient than feared at the start of November, it is because it was in better underlying shape to begin with (as we'd suggested might be the case).

We often note that developments need to be considered in their wider context: there are many moving parts in the investment world. This is another example of that.

If the world has become more risky, it has been doing so alongside a coincident improvement in the global business cycle. The risk has been very visible to consensus thinking; the improved cyclical backdrop less so.

In other words, if perceived risk had not increased, we might collectively be looking at an unambiguously brighter investment outlook. As things stand, a net deterioration should not be taken for granted.

Moreover, two specific considerations suggest that the stock market outlook in particular could be more robust than we'd guessed. In the US, the possibility of a large reduction in business taxes is something that was not taken seriously before 9th November. In the UK, a currency-led surge in corporate earnings was not looking likely until mid-2016. It will come partly at the expense of non-UK quoted companies, but the gains will be much more visible than any losses.

Both suggest our conventional projections of likely market returns – routinely driven partly by prospective earnings growth – might have needed to be revised upwards independently of the economic outlook.

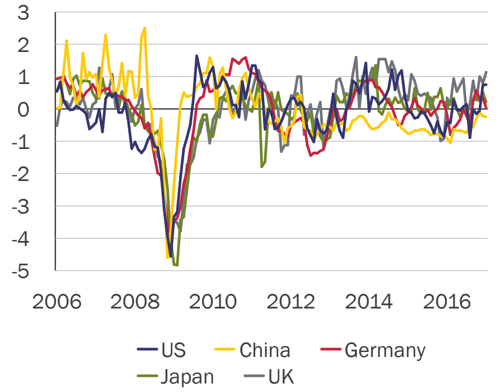
That is, the US and UK markets might not be quite as short of headroom – prospective returns might not have fallen much, even as the markets have risen – as our largely economy-driven projections of earnings growth might suggest.

Figure 1 updates some of the key economic indicators that we follow – forward-looking components of some widely watched and credible manufacturing surveys. It suggests that talk of the next US recession, of collapse in China, and of a major post-referendum hit to UK growth has (yet again, in this extended post-crisis cycle) been premature.

GDP data for the big economies formally confirm this subjective impression for the fourth quarter of 2016 at least. Noteworthy developments include: slightly faster growth in the eurozone than the US (though this partly reflects a surge in US imports, possibly a sign of restocking there ahead of expected faster growth in early 2017); Spain remaining the fastest growing of the larger

Figure 1: Manufacturing surveys

Leading indicators suggest the global economy remains buoyant.



Source: Bloomberg, Datastream, Rothschild & Co

Western economies (followed by the UK); and again no noticeable slowdown in China (year-on-year growth in the 6.5–7% range for a seventh consecutive quarter).

Western growth at least has not been driven by reckless new borrowing. In the US, the private sector's cashflow remains healthily positive, even in the eighth year of expansion: cyclical excesses have been modest, and consumers in particular still have fuel in the tank.

We turn towards today's political uncertainties, then, thinking that the most pressing economic need may be the normalisation of monetary policy – higher interest rates – to head off some underlying inflation. The risk of imminent recession and deflation has faded.

That said, it still seems to us as if only the Federal Reserve is likely to raise rates in the months immediately ahead (it has raised rates twice to date, in late 2015 and late 2016, and several further hikes seem likely during 2017).

The Bank of England has now acknowledged that the UK economy is somewhat more robust than it had feared, and may start to reverse its stance on UK rates later in the year, but it shows few signs of feeling the need to act soon.

The ECB and Bank of Japan still seem very unlikely to even begin the process of normalisation this year (we do not count the ECB's modest "tapering" of the scale of its bond-buying as significant).

Political risk may be overstated

Political uncertainty has risen most in the West. But the policies of the new US administration may not do as much damage as feared; a Front National victory in France is not a done deal; and a hard Brexit ought to be neither a surprise nor a catastrophe for Britain (or the EU).

The checks and balances in the US constitution can be overstated, but they exist – as can be seen from the legal and political challenges to recent policies and appointments.

The reactions of America's trading partners to proposed tariffs and other protectionist policies may not necessarily play out as feared (remember, as things stand the most protected big economy in the world is China, not the US). The new administration appears to have had second thoughts on "one China".

Moreover, the new president's policies do not all point towards slower growth. Fiscal expansion – tax cuts and some infrastructure spending – are capable of providing a cyclical boost that could mute or reverse the net effect of his policies on US and global growth for a while at least.

A victory for the Front National in France on 7th May would, for the first time, leave a eurozone head of state advocating a break-up of the single currency. But she might not have the parliamentary means to make it happen. As we noted in December, voters' motives may not be what pundits say they are. Mr Macron's campaign reminds us that populism is not always the preserve of extremists.

> **The most protected big economy in the world is China, not the US**

The British Prime Minister, Theresa May, has effectively acknowledged in public what has always seemed pretty clear: participation in the single market may not be compatible with leaving the EU and restricting the free movement of people. We might suggest that ongoing talk of the UK having a meaningful negotiating position may still be wishful thinking – but we would also reiterate our long-standing hunch that Brexit, when it arrives, will be bad but not a game-changer for UK plc.

Other political risks include the possibility of an early election in Italy; and a eurosceptic winner in the Netherlands general election on 15th March.

We cannot add value by trying to predict the precise outcomes in any of these cases. But we can note that there is a wide range of possibilities – and they would not all be damaging to investments.

And to state the obvious: thinking that these political developments may not prove as damaging as feared does not imply support for them.

Dramatic events have not always hit markets

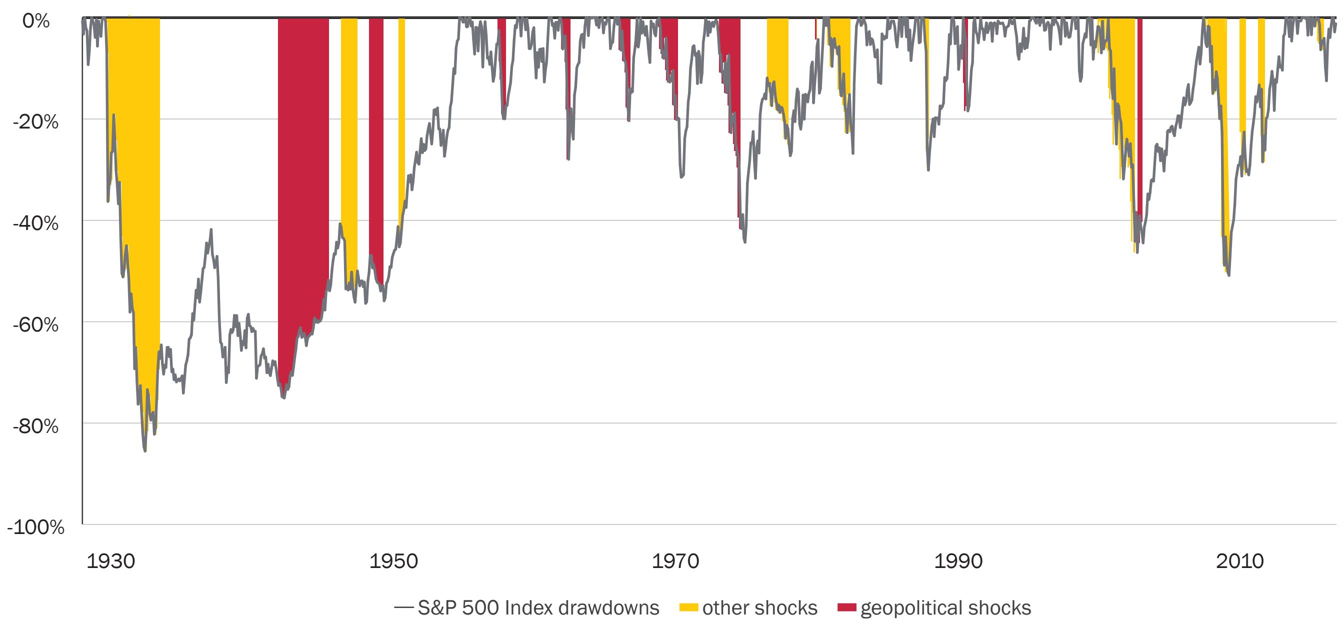
Some events do change the world. But they do not always have the economic and market impact that might be expected.

Markets can be narrow-minded: they often focus callously on the bottom lines of expected corporate profits and discount rates. Conflict and humanitarian crises can often leave them unmoved.

Sometimes, the economic impact of distressing events is (perversely) positive, as in the impact of rearmament on business. Sometimes, the chances of those events happening are implicitly priced-in to markets beforehand (a point made at length with reference to WWII by the late Barton

Figure 2: Cumulative declines in US equity market from peak to trough

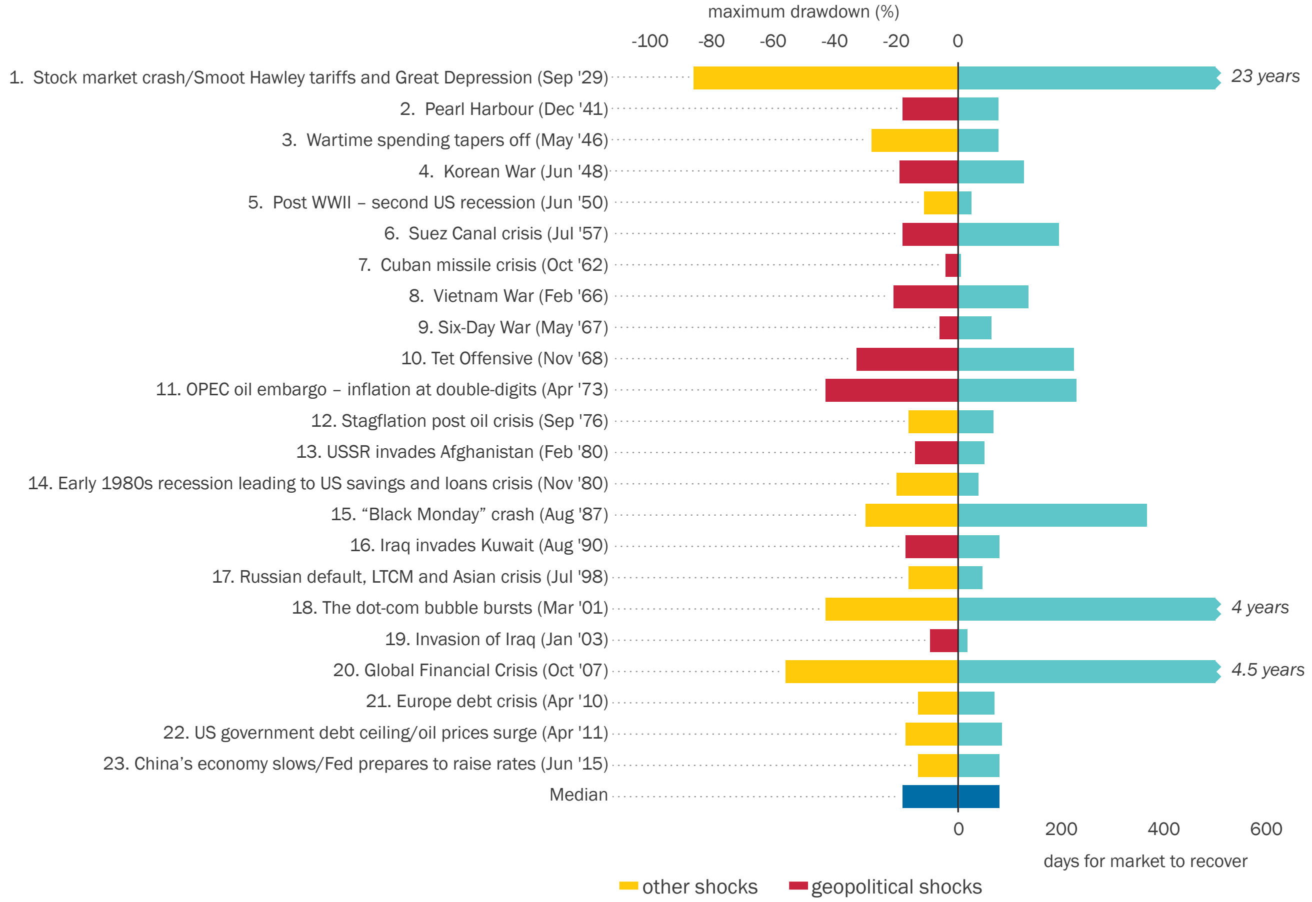
The S&P 500 Index has suffered significant market drawdowns associated with selected world events (see figure 3 for details).



Source: Bloomberg, Rothschild & Co

Figure 3: Selected world events

S&P 500 Index drawdowns and days taken for market to recover.



Source: Bloomberg, Rothschild & Co

Drawdown data for the selected world events reflects a degree of subjectivity with each shaded period commencing one month prior to the start of each event. The shading does not reflect the full duration of each event, but rather reflects a reasonable period that may be clearly depicted on the chart for formatting purposes.

Biggs in *Wealth, War and Wisdom*). As usual, in financial markets, context is everything.

Figure 3 superimposes selected geopolitical shocks and crises on the US stock market, and shows that some very threatening events were associated with negligible or even positive market moves: the Cuban missile crisis, the 2003 invasion of Iraq, Pearl Harbour even.

Sometimes, there is a direct and damaging market follow-through. The Smoot Hawley tariffs did worsen the economic climate badly from 1930. OPEC's price increases in 1973/4 contributed clearly to Western stagflation. Elsewhere, the St Petersburg market closed for 74 years in 1917.

...though markets can fall for other reasons

We should, of course, remember that not all economic and market shocks are political. Indeed, some have no immediately obvious cause: triggers/catalysts can be elusive.

For example, the output/inflation mix had already deteriorated markedly before OPEC pushed oil prices up fourfold. The crash of 1987, the boom and bust around 2000, and the Global Financial Crisis of 2008, had their origins in the subjective workings of markets themselves.

Figure 3 contains the most visible declines in the US stock market: roughly half of them can be said to have clearly political triggers.

Geopolitics may not be so grim to start with

It is human nature to worry – no one lives forever. And every generation likes to think it is living in special times. The last decade or so has not, however, been the most dangerous epoch in history, but probably the least.

It is obvious when you think about it. Disease, catastrophes, violent crime, civil wars and organised conflicts are less common than at any time in recorded history, a trend recorded carefully and readably in Steven Pinker's *The Better Angels of Our Nature* (2011). The defence policies of the US and the Union of Soviet Socialist Republics used to be literally MAD ("Mutual Assured Destruction").

This peaceable trend can't be taken for granted. The classic anti-war film, *La Grande Illusion*, echoed in 1937 the title of a book published in 1910, *The Great Illusion*, which had argued that a European war was unthinkable: unlucky timing for both. And today, nation states are not the only potential users of weapons of mass destruction. But progress has been real, and catastrophe is not inevitable.

Why then does it feel as if it is?

We don't register today's relative stability partly because, as Pinker says, individuals matter more now. When much of the world was governed ideologically, religiously or simply feudally, individuals didn't count. Stalin is supposed to have said that "the death of an individual is a tragedy, but the death of a million is a statistic" – and his ideology did more than anyone else's (bar Mao) to deliver such statistics.

Partly too it is because when something grim happens today, we know about it instantly, in graphic detail, via social media and the internet.

The media also plays a role, though not perhaps the one commonly attributed to it. It does not invent our worries, but it does reflect them back to us with leverage, often wrapped into convincing narrative and accompanied by a Big Picture.

Media revenue is not driven by getting analysis right – who audits the accuracy of even the cleverest commentators? – but by maximising circulation and advertising income. And few people are likely to pay to read that today's events may have little significance.

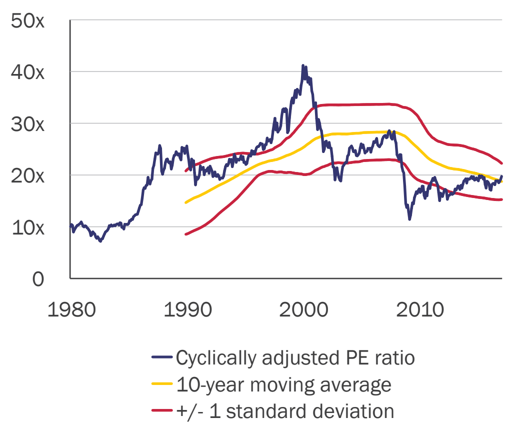
We noted in December how we distrust the currently popular Big Picture depicting Brexit, Trump, the Italian referendum and EU scepticism generally as symptomatic of a backlash against globalisation.

We wondered instead whether the thing that these events and sentiments really have in common is simply voters' desire to blame somebody for their perceived misfortunes – nothing more or less coherent than a desire to "stick it to the man" now, once.

There is no deterministic model, and Big Pictures are often caricatures. If pushed, we'd suggest the proclamation of the end of liberal economics is premature. With apologies to history buffs, this means, with reference to Francis Fukuyama's

Figure 4: Stock valuations are still unremarkable

Developed world cyclically adjusted PE ratio.



Source: MSCI, Datastream, Rothschild & Co

1992 book, that we could instead be facing the end of the end of *The End of History*.

Investment conclusions

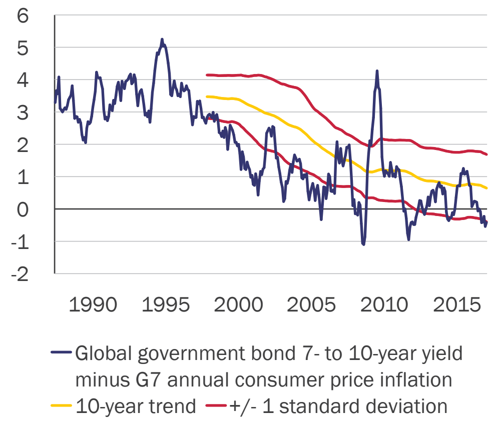
The global economy, led by the US, has some momentum – probably a little more than was generally anticipated in late 2016. This may help counterbalance the considerable uncertainty surrounding the aims and abilities of the new US administration – which may not in any case have as big a detrimental impact on business conditions as feared.

Meanwhile, US tax cuts, and a cheap pound, suggest that in at least two large markets there is the possibility of a positive surprise on profitability, suggesting headroom may not be as limited as recent market moves might suggest. We advise staying positioned for growth and some modest revival in inflation, and think that returns ahead of inflation are still achievable.

- The business cycle and valuations continue to favour stocks as the likely source of those inflation-beating investment returns. Most government bond yields – long-dated US Treasuries being an obvious exception – remain below current inflation rates, while equities continue to look relatively inexpensive (figures 4 and 5). Corporate earnings are growing again as the oil sector's losses fade.
- Stocks recently have been outperforming bonds again, and to such an extent that much of the relative ground lost since 2000 has again been made good. This sounds potentially alarming: 2000 saw the bursting of bubbles in technology, media and telecoms sectors. But stocks are less expensive, in absolute and relative terms, than then.
- We see bonds and cash currently largely as portfolio insurance, and best held in investors' home currencies. Interest rates are low in most markets, and hedging can be costly. Value is creeping back into US Treasuries, but yields are not yet compelling.
- We still mostly prefer high-quality corporate bonds (credit) to government bonds, but after strong performance they are running out of relative headroom, and are also unlikely to deliver positive real returns. We see most emerging market bonds, even those in hard currency, as being most vulnerable to rising US interest rates.
- In US dollar portfolios we are more positive on inflation-indexed and short-duration bonds, and less on speculative grade credit. That said, higher yields in recent months have trimmed market duration and mark-to-market risk for some bonds. We think index-linked gilts are already pricing in the imported inflation likely to follow the pound's fall.
- In stock markets, in our top-down views we have now cancelled a long-standing aversion (already reduced, as noted in December) to developed Asia ex-Japan (mostly Australia and Hong Kong), at the expense of a more neutral view on the US market (which has had a relatively good run in recent years). Our regional conviction is low currently: favoured regions now are just Europe ex-UK and emerging Asia (despite near-term US rate-related risk), and our least favoured is the UK. That said, we prefer stocks to local bonds in most regions.
- Continental Europe is likely pricing in a good deal of this year's political risk, while its relative growth looks a little less subdued than usual. Emerging Asia's leading indicators continue to improve, offsetting the risks posed by rising US rates, and its long-term appeal remains intact, even when China's slowdown resumes. Despite its resilient economy and earnings, the UK faces local concerns, and continues often to lag rising markets.
- We continue to prefer a mix of cyclical and secularly growing sectors to bond-like sectors such as utilities, staples and telecoms.
- Currency conviction remains low. On a one-year view we continue to rank sterling highest among the majors: we think it overreacted to the Brexit referendum, and see UK interest rates rising later in the year. We rank the dollar next, then the euro and yen, then the Swiss franc, with China's yuan bottom. Our dollar and franc views feel stale, but the cyclical arguments for/against them are intact and we keep them for the time being.

Figure 5: Bonds still expensive

Developed world government bond yields less current inflation (%).



Source: Bloomberg, Datastream, 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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