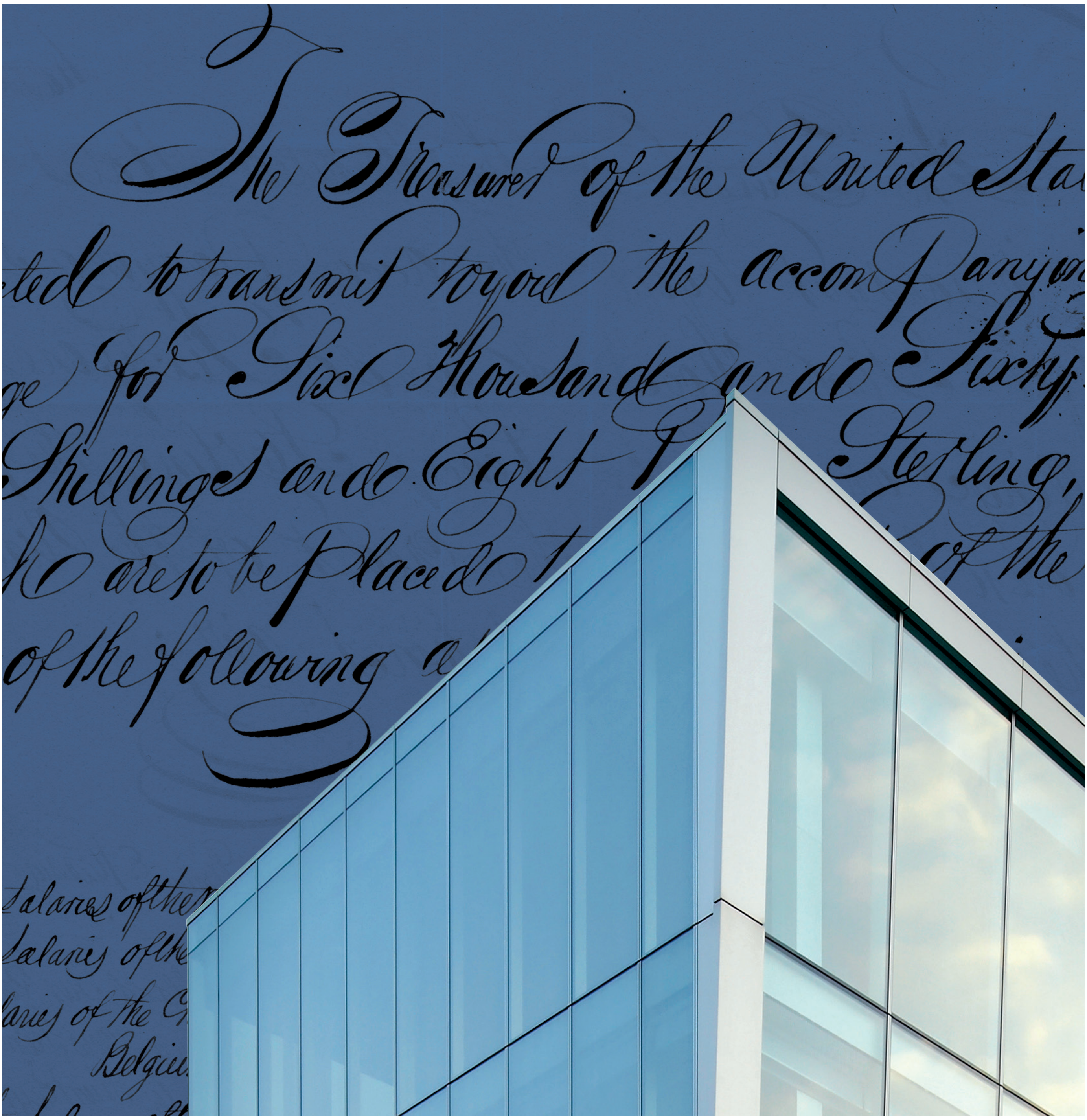
Market Perspective

Absent negatives | Re-emerging markets?

Issue 93 | May 2017



Rothschild
Private Wealth

Foreword

Politics remains the big talking point in markets. In recent weeks investors' concerns should have faded a little further.

Again, it is not so much a case of positive news, perhaps, as an absence of potential disruption.

It has been confirmed that France is not about to reject the euro and turn its back on the possibility of liberal economic reform.

The probability of Chancellor Merkel remaining in office this autumn still seems to be rising.

The risks associated with the new US administration continue to look less urgent as it confronts the 'complicated' reality of governing.

Geopolitical flashpoints remain, and a snap UK election has been added to the diary. But our belief that the political backdrop is less unsettling than feared, and less potentially hostile to business, has been reinforced.

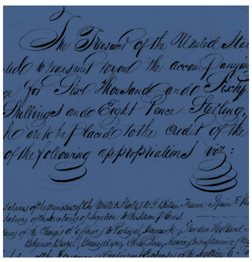
Meanwhile, the current business cycle seems still to be alive and well. The US and UK are not as fragile as recent GDP data suggest; the eurozone is gathering momentum; and China continues to defy predictions of a debt-burdened "hard landing".

If anything, the most unsettling thing we've heard on the economic front of late is the news that the International Monetary Fund (IMF) sees "spring in the air" for the global economy. IMF forecasts are not noted for their optimism – or accuracy.

As we have written often recently, a setback for markets feels overdue. Some gauges of financial volatility have been flirting with record lows.

However, low volatility need not signal investor complacency, and we think the financial climate, if not the weather, can remain benign. Our main concern remains an eventual revival in inflation, not economic weakness. We'd use a setback to build, or add to, positions in growth-related investments.

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: May 2017.
Values: all data as at 30th April 2017.
Sources of charts and tables: Rothschild & Co and Bloomberg unless otherwise stated.

Absent negatives

Good enough for now

Safer politics, stable economics

Populism won in France after all – just not the strain that the pundits warned us about.

We won't know for weeks or months if French liberalisation is really on the cards. But if it is, and President Macron combines with a re-elected Chancellor Merkel this autumn in a re-energised EU, then a year that began with political risks tilted towards disruption may yet end with unexpected upside.

President Trump continues to compromise with reality. Reportedly, the US will now not leave NAFTA; neither Mexico nor US taxpayers seem keen to pay for the wall; and trade negotiations with China remain constructive (influenced doubtless by the Realpolitik of dealing with North Korea).

His downscaled tax plans do have a good chance of reaching the statute books, but not fully, and not quickly. A 2018 fiscal stimulus might not be priced in: markets have been climbing the proverbial wall of worry, not being "irrationally exuberant".

In the UK, if we count the 2014 Scottish referendum as having nationwide implications, the electorate now faces a fourth important vote in as many years. Add the electoral reform vote in 2011, and the 2010 general election, and there have only been two years in the last eight in which voters' views have not been solicited.

It sounds churlish to talk of electoral fatigue. The right to vote is precious. But UK tradition distinguishes between representative and delegatory democracy, and too much of the latter can be damaging.

A little-remembered 1970 satire, "The Rise and Rise of Michael Rimmer", portrayed the country grinding to a halt as a referendum-wielding populist politician consulted voters (by post) on everything. An equally obscure theory in economics, Arrow's 'Impossibility Theorem', shows mathematically why this could happen.

The point being that the winning party on 8th June may have an implicit mandate to "just get on with things". Political stability, not a specific form of secession from the EU (which the UK government may not be able to deliver in any case), may be the relevant outcome from an investment viewpoint.

As political risk has perhaps become less daunting, the global economy has indeed been getting on with things – growing steadily.

That may not be obvious from disappointing US and UK GDP data, but these may be erratic: it would not be the first time they have misled in this cycle. Eurozone GDP has been stronger, and fits more neatly with labour market and survey data that remain relatively upbeat on both sides of the Atlantic.

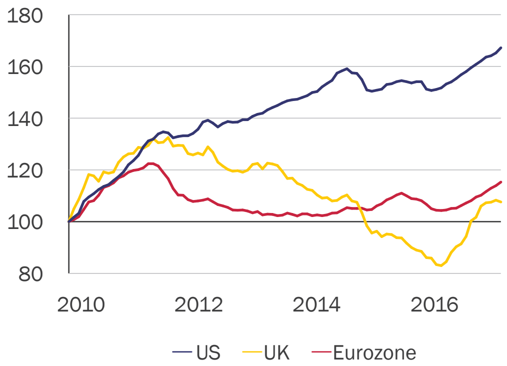
It looks as if peak "globalisation backlash" may have coincided with trough growth in world trade. Global exports seem to be rebounding from their spell in the doldrums. The rebound doesn't need to be dramatic for investors to gradually realise that (again) their worst fears – rising protectionism, stagnating profits and living standards – may have been overstated.

Corporate profits are responding as we'd thought they could (figure 1). Europe may have most upside from here because of the bigger hits taken recently from banking difficulties (in continental Europe) and from oil and mining (in the UK).

The US expansion is poised next month to enter its ninth year. But the excesses that might herald the next recession still seem to be missing. Instead of borrowing recklessly, consumers are still supplying liquidity to the wider economy. Visible froth – for example, in US (and UK) auto financing – does not seem big enough, or close enough to bank balance sheets, to cause systemic risk.

Figure 1: Corporate earnings are growing again

Consensus estimates of year-ahead earnings (indices, local currencies)



Source: MSCI, Bloomberg, Rothschild & Co

Similarly, the Chinese economy – many pundits' nomination for the-most-likely-to-trigger-the-next-crisis award – continues neither to hard nor soft land, but instead to cruise at some altitude.

China faces unresolved banking (and shadow banking) issues, and credit growth remains too fast for comfort. But it has no net international debt, and the people on the bridge of this economic supertanker have more levers to pull than most. Its structural growth is (only) one of the reasons for our positive view on emerging Asia (see next article).

Our main concern remains groupthink at the major central banks, and the longer-term threat it poses to price stability. Economists are again urging them to raise their inflation targets, an experiment that – like the mooted 'helicopter money' – would likely end in tears. Inflation, if re-awakened, would surely prove much less friendly than they expect. But for the time being, it seems still to be slumbering more soundly than we'd have guessed a year or two back.

Investment conclusions

Again, there has been much discussion among our investment team, but no change in view.

As noted, a workable majority for a liberalising government in France, and/or significant US tax cuts, may not be priced in to markets, and could offer more headroom for markets. But even without them, stocks remain our preferred asset.

Some wariness is warranted. There has not been a significant market setback now for more than a year, and the US expansion is mature: the tactical and cyclical clocks are ticking. Monetary normalisation may yet pick up speed. Statistically, the summer months have been less good for investing (as in "sell in May…").

Nonetheless, we take a long-term view, and think that the investment climate – growth with modest inflation risk – remains temperate.

- We do not see stocks as troublingly expensive. They are still the most likely asset to deliver inflation-beating returns. Restructuring portfolios in an attempt to avoid a 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 as portfolio insurance.
- 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 are still pricing in more imported inflation than has yet shown up.
- Our top-down regional conviction on stocks remains low, though we prefer them to bonds in most places. We are most positive on Europe ex-UK and emerging Asia; least on the UK. We still prefer a mix of cyclical and secular growth to more defensive bond-like sectors.
- Positive change in France might yet overturn our residual skepticism on the euro. We still think the pound over-reacted to the referendum result – even if Brexit turns difficult. With low conviction, on a one-year view we still rank the big currencies, from most to least attractive, as sterling, dollar, franc, yen, euro and yuan.

Re-emerging markets?

Cyclical and structural appeal

Emerging markets (EMs) have regained short-term leadership in global markets in the last year or so, and seem an obvious and compelling place in which to look for longer-term investment opportunities too. Emerging economies contain most of the world's population, and will eventually contain most of its economy and capital markets, as liberalisation spreads and living standards converge. Many governments have made big improvements to their fiscal and monetary policy frameworks: they have low levels of public debt, increasingly independent central banks and in some cases significant foreign exchange reserves.

Emerging assets remain a relatively high-risk investment. It would be a brave – or foolhardy – investor who assumed that crises (Mexico (1994), Asia (1997), Russia (1998), Brazil (many), for example) and hype (such as the BRIC and commodity exporting fads in the noughties) are confined to the past. Private sector borrowing can still give rise to concern – particularly when in hard currencies.

But relative vulnerability at least may have been reduced. And we were reminded in 2000 and 2007/8 that the developed world is hardly immune from fads and crises. Our primary focus on wealth preservation means we'd be unlikely to recommend a majority holding in emerging assets until they have indeed more fully emerged, but our portfolio managers are open-minded about seeking opportunities there today.

What's in a name?

EM investing was popularised in the modern investment world in the 1980s and early 1990s, with the best-known dedicated fund dating from 1989. There are many different classifications of EMs and economies, but at its simplest level the term refers to countries that are – or recently have been – relatively poor, with potential to catch up.

Stock and bond market index compilers such as MSCI, Bloomberg and JP Morgan operate rule-based definitions based on size, liquidity, creditworthiness and accessibility, but those rules differ in detail.

Countries' living standards vary tremendously within, as well as across, the variously defined emerging and developed blocs, as figure 2 reminds us. Indonesia (a still-poor commodity exporter), South Korea (a wealthy, technologically advanced country), India and China are all in "Asia", but otherwise have little in common. The more fashionable 'BRIC' quartet is Brazil, Russia, India and China.

There have been suggestions of a new approach to classifying the bloc according to key economic components, but a consistent methodology has yet to be adopted and is likely to remain elusive. And lurking below the radar screen for most private investors are the smaller, poorer, highly illiquid and even more volatile "frontier" markets such as Nigeria and Vietnam.

Historical performance

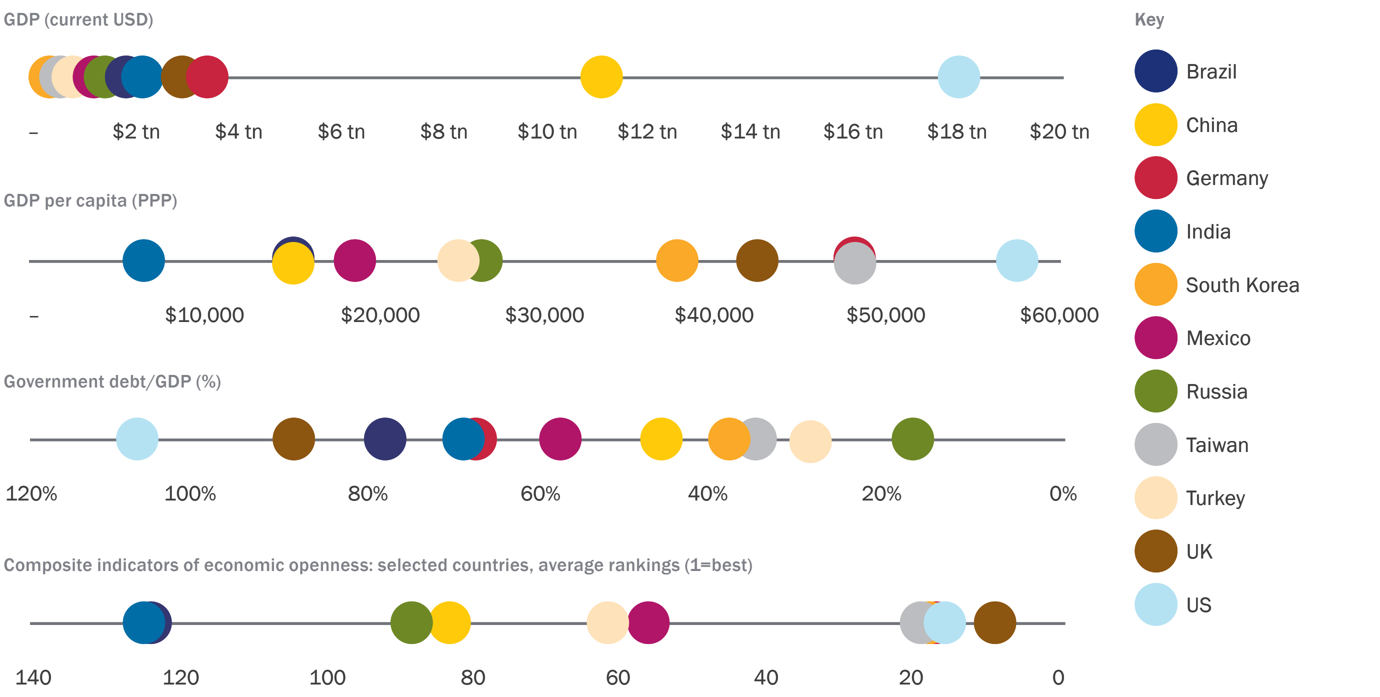
The natural focus for private investors currently is the emerging stock (as opposed to bond) markets, which represent the most direct play on the open-ended growth that gives EM investing its intuitive appeal.

Emerging stock markets' progress has not been a straight line. Investing fashions ebb and flow, and the pace of economic development is rarely smooth.

Taking the last 20 years, and viewing results in dollars in order to take into account the additional volatility of emerging currencies, the widely followed MSCI index of emerging stocks has in fact lagged developed markets on average by 0.6% per annum (figures 3 to 5). It has done so moreover with greater volatility and larger drawdowns (short-term losses).

As the chart makes clear, however, there have been lengthy sub-periods during which emerging stocks have significantly outperformed – most notably from late 1998 to late 2010, by an average 5.5% per annum.

Figure 2: Selected emerging and developed markets: background data



Source: IMF, World Bank, Heritage Foundation, IBRD, World Economic Forum, Rothschild & Co

Currently, despite the last year's rebound, EMs do not look expensive, having previously underperformed between late 2010 and early 2016. We think the chances of longer-term outperformance are relatively high.

No guarantees

The appeal of EMs is their stronger economic and profits growth as they catch up with the developed world. Companies doing business there are not confined to those that are quoted on the local exchanges: many developed world companies have their fastest-growing operations in the emerging world, and offer an effective way of adding emerging exposure to portfolios.

Faster economic growth is not a guarantee of a successful investment outcome, as was seen in figures 3 to 5.

In China, for example, the profits of companies quoted in the MSCI index have for more than two decades lagged what might have been expected from China's faster GDP growth, and the index has underperformed the US market. We think this will change as the government interferes less in the economy – by refraining from telling companies where to invest, how to control product prices and so on.

Not all of the growing companies domiciled in EMs are easily accessible by international investors to begin with – most visibly China and India. China's onshore markets are slowly opening up, but have so far been excluded from the main international indices. In terms of market capitalisation, they are as large again as the MSCI Emerging Market Index in total, and have performed significantly more strongly than the much smaller MSCI China component (though with even more volatility).

As with the developed bloc, investors can use passive funds (tracker funds or ETFs) to access EMs. EMs' greater volatility, however, and less heavily researched nature, suggests more room for active managers to add value than in some of the larger, more technically "efficient", Western markets.

Asia preferred

The emerging bloc is very diverse, but some regions – Latin America, Eastern Europe (that is, Russia) and Africa – are overly reliant on commodities, have less robust domestic growth and worse governance. We favour Asia.

As noted, Asia's diversity does include some commodity producers – but the massive region offers by far the biggest spread of opportunities, has the least difficult governance, and the strongest economies. It includes in particular two of the most fully emerged EMs, South Korea and Taiwan, which offer high value-added branded products and significant gearing to reviving world trade.

Rising US interest rates and a strong dollar can hit the Asian markets, and our underlying keenness cooled in 2015/16. Currently, however, we think it can perform both structurally and cyclically – particularly if investors are worrying a little too much about protectionist policies and a "hard landing" in China.

Figure 3: Stock market performance

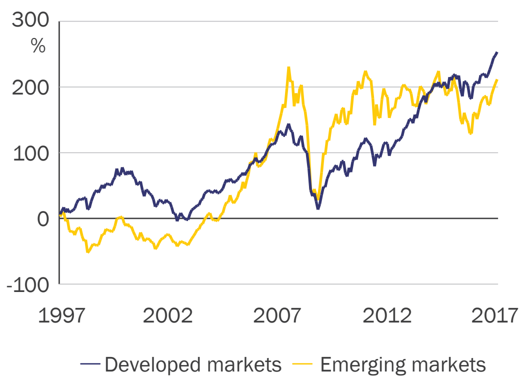
Total return, USD

	Year to date	10-year ann'd	20-year ann'd	Volatility	Maximum drawdown
Developed markets	8.2%	4.6%	6.5%	15%	-53.6%
Emerging markets	13.9%	2.8%	5.9%	24%	-61.4%

Source: MSCI, Bloomberg, Rothschild & Co

Figure 4: Cumulative stock market returns

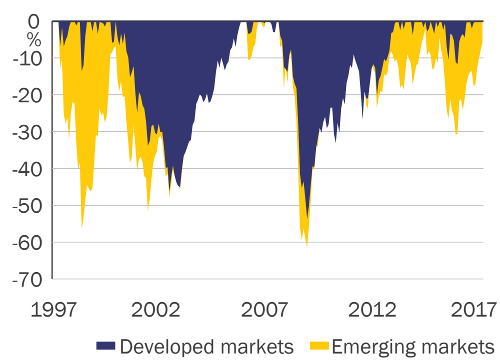
Total return, USD



Source: MSCI, Bloomberg, Rothschild & Co

Figure 5: Stock market drawdowns

Peak-to-trough losses

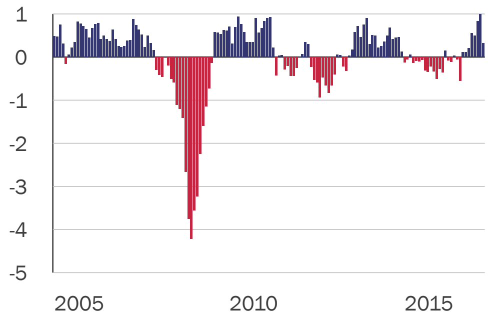


Source: MSCI, Bloomberg, Rothschild & Co

Economy and markets: background

Growth: major economies

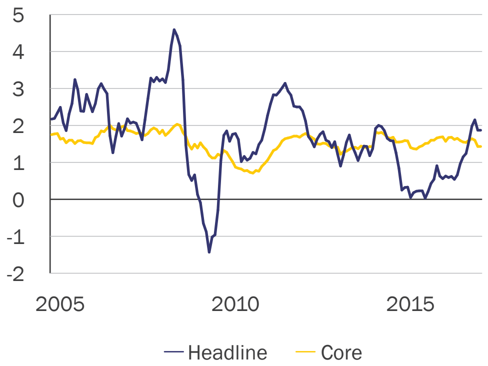
Business optimism: standard deviations from trend



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

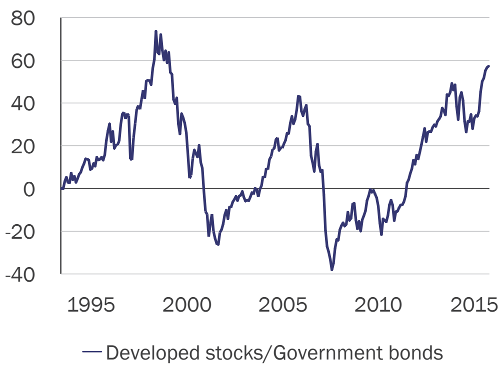
G7 inflation

%, year-on-year



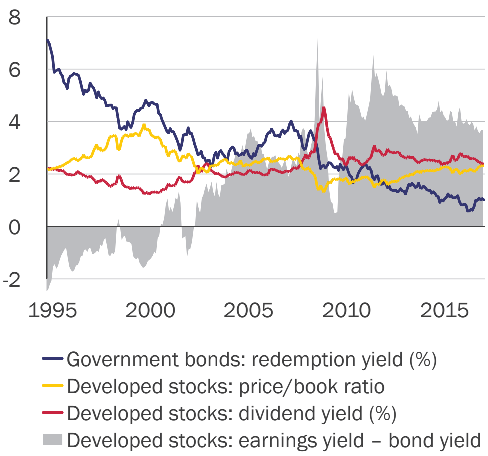
Source: OECD, Bloomberg, Rothschild & Co

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	-1.3	10.6
10-yr UK Gilt	1.1	6.3	20.2
10-yr German bund	0.3	2.0	13.7
10-yr Swiss Govt. bond	-0.1	-0.9	8.9
10-yr Japanese Govt. bond	0.0	-0.5	6.7
Global credit: investment grade (USD)	1.6	1.6	11.3
Global credit: high yield (USD)	5.3	12.9	18.7
Emerging (USD)	4.6	8.1	17.6

Source: Bloomberg, Rothschild & Co

Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

	Yield (%)	1yr (%)	3yr (%)
World: all countries	2.4	16.7	28.2
Developed	2.4	16.7	29.1
Emerging	2.4	17.1	20.8
US	1.9	16.8	33.0
Eurozone	3.0	18.0	27.5
UK	4.0	18.5	19.4
Switzerland	3.2	12.2	15.0
Japan	2.0	15.1	35.2

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (1980 = 100)

	Level	1yr (%)	3yr (%)
US dollar (USD)	334	5.7	25.9
Euro (EUR)	266	-0.3	-3.1
Yen (JPY)	481	-0.1	5.2
Pound sterling (GBP)	103	-8.2	-5.6
Swiss franc (CHF)	309	1.2	7.6
Chinese yuan (CNY)	35	-4.4	6.6

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	182	-0.8	-41.3
Brent crude oil ($/b)	51.7	7.5	-52.2
Gold ($/oz.)	1,268	0.2	-2.2
Industrial metals (1991 = 100)	227	15.6	-14.8
Implied stock volatility (VIX, %)	10.8	-28.9	-22.5
Implied bond volatility (MOVE, bp)	6.0	-6.9	1.8

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data correct as of 30th April 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