Market Perspective

Unfinished business | Echoes

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Rothschild
Private Wealth

Foreword

We are still in the positive phase of this lengthy business cycle.

A combination of solid growth with (so far) only modest inflation risk is offering investors a favourable mix of improving corporate profitability alongside the gentlest normalisation in interest rates.

Some indicators – particularly in the US and Germany – are running out of headroom, and are at levels from which they are more likely to fall than rise. But with few signs of economic excess, a descent from cyclical heights need not mean an imminent plunge into the abyss. The next recession may still be some way off.

The extended cycle may owe something to the oil and mining setback in 2015–16, which nipped some overinvestment in the bud, buying more time. It likely also reflects the sheer size of the hole into which we fell in 2008.

The geopolitical backdrop is more troubling, and stock markets are now on the expensive side. But political tension does not always translate into economic stress, and valuations are still not prohibitive – not least because corporate earnings are outpacing stock prices.

If the immediate investment climate remains temperate, however, the calendar seems to be full of significant historical echoes just now.

We are still working our way through the 10-year anniversary of the onset of the Global Financial Crisis (GFC).

The Bank of England held a conference in late September to reflect on 20 years of independence and inflation targeting.

And this month it will be 30 years since the biggest one-day stock market fall – and 100 years since Russia's October Revolution.

In the second essay below we explore the relevance of these anniversaries for today's investment decisions.

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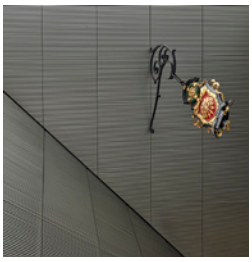

Cover:
A very public symbol of the heritage and values of the family business is the Rothschild shield positioned on the exterior wall of our New Court office in St Swithin's Lane, London. The five arrows combined with the family motto is the only advertisement for the business within.

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

Unfinished business

A sober sort of party...

"The Federal Reserve... is ... the chaperone who has ordered the punchbowl removed just when the party was really warming up" – *William McChesney Martin, longest-serving Fed Chairman (1951–70)*

Fuel still in the tank

This cycle may still have legs. For the corporate sector, the best – in terms of profitability – may yet lie ahead.

In the US, the most influential driver of the global business cycle, there is still fuel in the cyclical tank. Figure 1 shows the US private sector (driven here by households) remarkably still running a cashflow surplus as we enter the ninth year of an economic expansion. This overlooked indicator has consistently argued against the predictions of imminent US recession that have been a constant refrain since 2009.

Despite frothy credit (corporate bond) markets, there are still few signs at the macro level of reckless US consumer spending and borrowing. Net, US consumers are supplying liquidity to the wider economy, not borrowing it.

Higher-frequency business surveys continue to point to above-trend growth in the major manufacturing countries (page 6). The eurozone continues to make the running, both relative to trend and relative to expectations, with domestic demand demonstrating some momentum alongside the more traditional – but less independent – export driver.

This patch is one of the more synchronised expansions in recent years, and is pulling some unemployment rates down to multi-decade lows. It has arrived at a time when many prominent pundits have been predicting the opposite, namely a fragmented global downturn. It may yet disappear equally unexpectedly – but the starting point at least for any slowdown now is healthier than feared.

Little overheating – but better safe than sorry

Another striking element of the current cycle is the coexistence of respectable growth with only tentative signs of revived inflation (figure 2).

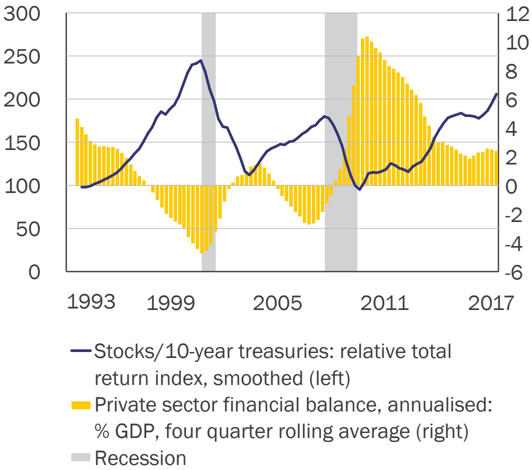
We are still not yet ready to take this for granted. Prudent monetary management requires some normalisation of interest rates before inflation revives – and the party really gets going.

Real (inflation-adjusted) interest rates are not as historically low as nominal rates, but they are also below trend, and it is increasingly clear that the global economy does not need such support. (In our view, it hasn't for some time). Central banks are (at last) more visibly on the case.

The Federal Reserve (Fed) has already raised interest rates four times since December 2015, with further moves likely in the months ahead, and is this month starting to slowly reduce its balance sheet.

Figure 1: Cyclical fuel still in the tank

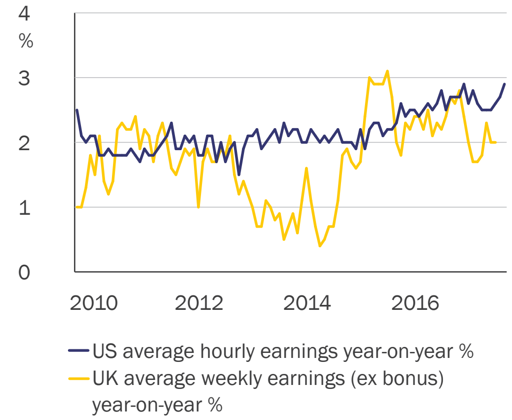
US private sector financial balance (free cashflow), % GDP, 4-quarter moving average



Source: Federal Reserve, Datastream, Rothschild & Co

Figure 2: Wage inflation still subdued in two fully-employed economies

US and UK wage inflation, % y-o-y



Source: Datastream, Rothschild & Co

The Bank of England has indicated that it may start raising rates soon. Its "forward guidance" has not always been reliable, but with UK inflation above target – albeit because of the pound's post-referendum slide – and the tight labour market, circumstances are more compelling. As yet, however, it has no public plans for scaling back its bond holdings.

The European Central Bank (ECB) remains some way behind the Fed and the Bank of England in considering monetary normalisation, not least because it still faces a bigger margin of spare capacity. The eurozone unemployment rate is falling, but remains more than twice as high as those in the US and UK. That said, some further tapering of its bond buying – a reduced pace of monetary easing – may be announced soon.

When the dust has settled, we would not be surprised to find that the upturn in inflation turns out to be modest, and that the underlying trade-off between growth and price stability remains historically favourable.

Better safe than sorry, however. Recent academic discussion views the risks as symmetrical, but inflation is much more threatening than deflation. Societies have collapsed because of the damage done by hyperinflation, but there are no recorded instances of hyperdeflation.

Political risk need not do economic damage

Catalonia, North Korea, Washington, Westminster and the Middle East. Political uncertainty is all too visible, and unavoidable: many of the protagonists themselves don't know what they will do next. We would caution however against translating this into a bad investment outcome.

Remember, markets can be narrow-minded and callous: geopolitical and humanitarian crises often have little impact. President Trump has, as yet, done little. Protectionism is still possible – but so too are tax cuts. US bellicosity may stumble into detente much in the same way that President Reagan did. China is best placed to influence North Korea, and is also the most protected big economy.

In the eurozone, Chancellor Merkel's position is weakened, but compared with talk at the start of the year, the Franco–German axis is in better shape than feared.

Our portfolio managers are careful to hold diversifying assets, but from a macro perspective, the business climate, not political risk, remains the major influence on our investment advice.

Investment conclusions

Stocks remain our preferred asset. We have not had that long-awaited setback, and they are not cheap. But the investment climate – growth with only modest inflation risk – remains temperate, and geopolitical risk manageable.

- Stocks do not yet look troublingly expensive, and remain the most likely asset to deliver inflation-beating returns. Restructuring long-term 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 are more neutral in US dollar portfolios, where we also see some attraction in inflation-indexed bonds. We think speculative grade (high yield) credit has now run out of valuation headroom in Europe, and we no longer prefer it to investment grade. In the US we thought it ran out of cyclical upside a while back.
- We prefer stocks to bonds in most places, even the UK (where the large-cap indices are in any case driven by global trends). We continue to prefer a mix of cyclical and secular growth to more defensive bond-like sectors, which is a preference that has strengthened a little of late.
- Trading currencies does not systematically add value for investors, and our exchange-rate conviction remains even lower than usual. The dollar has most cyclical support, but is expensive, while the most positive economic and political surprises have been coming this year from the eurozone. The Swiss franc remains the most expensive major currency, and with the euro more stable this may matter again. We continue to think the pound has been oversold: our conviction fell after the election result, but higher interest rates may still not be fully priced in, even after the Bank of England's more hawkish guidance. Similarly, we still believe the yuan will falter again, but China's growth and slowed liberalisation is underpinning it still. On a one-year view we still rank sterling highest, the yuan lowest, and other major currencies somewhere in between.

Echoes

Four significant anniversaries

"Hegel remarks somewhere that all great world-historic facts and personages appear, so to speak, twice. He forgot to add: the first time as tragedy, the second time as farce."
Karl Marx

"I have learned from my mistakes, and am sure I can repeat them exactly."
Peter Cook

No apologies for reusing two favourite "history repeats itself" quotations: the calendar has rarely resonated so loudly. The four dates we're marking here have relevance today.

10 years gone (continued) – the GFC

The gradual onset of the GFC means that echoes are likely to continue through till early 2019 at least. We suggested last month some similarities and differences between 2007–09 and now.

The banking system is likely safer now, because capital and (inverted) leverage ratios are stronger. (Figure 3 shows that both ratios for selected large banks in the US, UK and eurozone have risen since the GFC.) At a recent seminar, several academic economists argued nonetheless for still higher capital.

We can see how a lot of extra capital could reduce systemic risk to minimal levels, but where would it come from? Private investors might be reluctant to subscribe. But a nationalised banking system would not be without risks of its own.

The general investment lessons may not be the obvious ones. It was bad not to spot the GFC in advance, but perhaps worse to sell at the bottom: the period since has been one of the best on record. Some who did foresee it had predicted earlier crashes that didn't happen. Others failed to close their bets, and gave back their gains.

If we thought another GFC was at hand we would take avoiding action, but the episode really underscores the difficulties of market timing, which can make fools of most of us.

Meanwhile, note that one of the features of the GFC is only now slowly beginning to fade: the Fed's quantitative easing (QE) will be replaced by quantitative tightening (QT) as its balance sheet starts to shrink.

Some economists argue that QE has been directly responsible for much post-crisis growth, and so reversing it will inevitably hurt. Talk of a "transmission mechanism", however, is misleading: there may be no mechanical link between central bank bond purchases and economic growth.

We see QE not as propelling the economy forwards, but as a crash barrier at the side of the road. On this reading, QE helped avoid disaster, but can nonetheless be gradually withdrawn now without slowing progress.

20 years of Bank of England independence

The Bank of England was made operationally independent in May 1997, and recently hosted a conference to reflect on the experience.

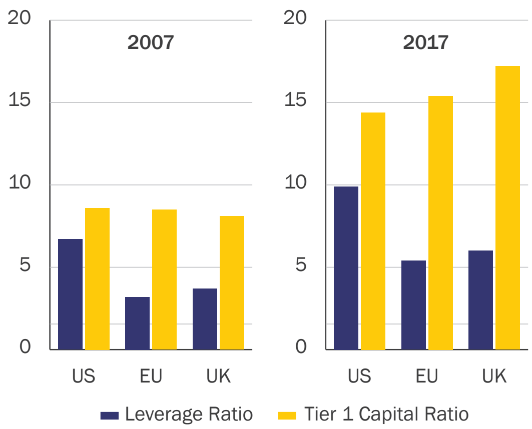
Monetary policy can be an important influence on investment returns – especially when badly designed, as it often was in pre-independence days. Then, interest rates were set directly by the Chancellor of the Exchequer, an elected politician, and the UK suffered for many years from stubbornly high rates of inflation.

Independence seemed a neat way for the incoming Labour government quickly to gain monetary credibility, and so it proved.

The current UK monetary regime may be the most credible in modern times. That said, much of the decline in inflation (figure 4), and the associated fall in borrowing costs (both nominal and real), might have happened anyway: inflation

Figure 3: Bank balance sheets

Estimated ratios for a sample of large banks (%)



Source: Bloomberg, Rothschild & Co

and interest rates fell across most of the world, and had started to do so before 1997.

Inflation targeting by an operationally independent central bank has become more widely popular (the UK was not the first to adopt it), and as investors we'd sooner have it than not. That said, we need to guard against complacency.

Inflation targets were not introduced because it was felt that inflation is a good thing – and that we'd like a specified amount of it – but because they were seen as a way of tackling entrenched expectations. Inflation is a bad thing. To occasionally fall a percentage point or two short of the target is not a meaningful policy failure. But in the current low-number context some economists and central bankers are talking as if it is.

Success is encouraging us to think that we have solved an "optimal control" problem, that we understand how the economy works, and can fine-tune the outcome. But the shifting trade-off between growth and price stability, and the ongoing discussion about the way in which QE has worked, serves notice that we don't.

Trying to engineer a little more inflation when the economy seems to be functioning well is to risk letting the genie out of the bottle all over again. Received central banking wisdom – on both sides of the Atlantic – has started to see inflation risks as symmetric, when (as noted) they are not.

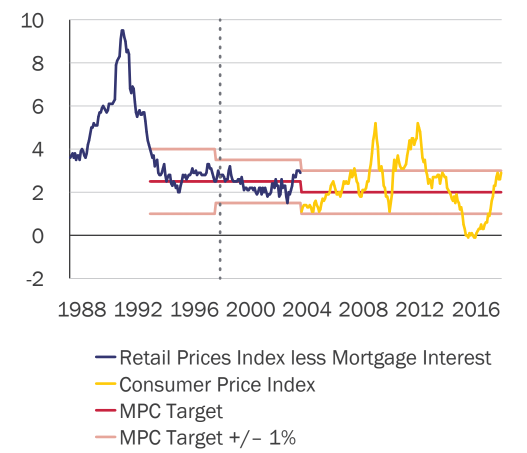
30 years since the crash

The 20% fall in the US stock market on 19th October 1987 remains the biggest one-day fall ever. It was a sensational, unsettling event, and an ominous one: it was widely believed that the market was "telling us something".

In fact, stocks had simply risen far too quickly – up by almost a half between late September 1986 and July 1987 – and the market correction was dramatically amplified by a form of automated trading. The episode had little long-term significance (figure 5), and in retrospect is best seen as a reminder of how bandwagons can develop, of the looseness of the links between stock markets and economies – and of how brutal stock market volatility can be.

Figure 4: UK inflation targeting experience

UK inflation and the Bank of England's target



Source: Datastream, Bank of England, Rothschild & Co
Note: a short period of inflation targeting preceded Bank independence

100 years since Lenin took control

There were two revolutions in Russia in 1917. The second, in October, saw the Bolshevik party seize power. It is difficult to overstate the significance of what followed.

Economics is not science. But a few empirical regularities are sufficiently well established to command acceptance, and perhaps the most important of these is the observation that centrally planned economies make people poorer.

Much of the rest of the twentieth century was devoted to demonstrating this, at great human, as well as financial, cost.

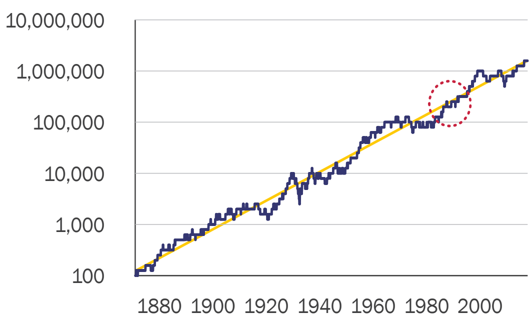
Central planning seems attractive in theory, but in practice is rigid and clumsy, constraining initiative, ingenuity and improvisation. It assumes everyone is motivated by the same things, and to the same extent – but they often aren't, as anyone who's tried to get the team tent pitched after a long day's hike knows. When it becomes apparent that you can't make people want to do the "right" thing, collectivism falls back on coercion.

And here we are in London in October 2017 reminding ourselves of what we'd come to take for granted. Free enterprise is flawed – but the alternatives are worse. Perhaps the lesson has to be relearned every few generations.

A secondary lesson is the narrow investment message: not all stock markets have delivered the long-term growth illustrated in figure 5 above, and we need to be aware of survivor bias. The St Petersburg market closed in 1917, and didn't reopen for a very long time.

Figure 5: US stock market long-term performance: 1987 lost in the wash

Index: inflation-adjusted, dividends reinvested, log scale

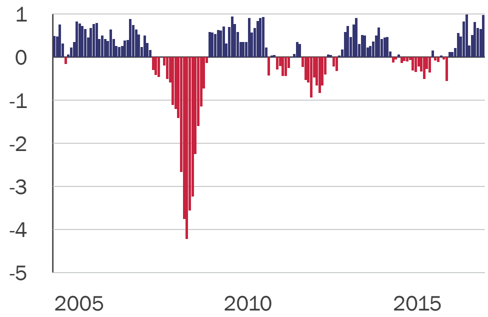


Source: Robert Shiller's homepage, Datastream, Rothschild & Co

Economy and markets: background

Growth: major economies

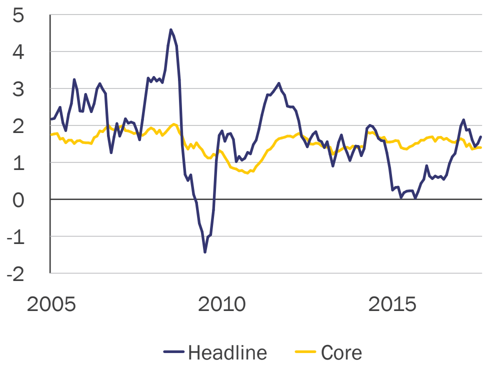
Business optimism: standard deviations from trend



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

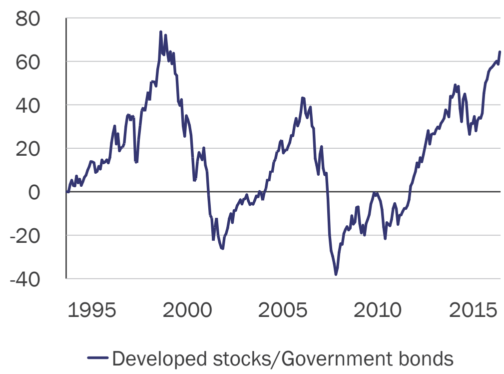
G7 inflation

%, year-on-year



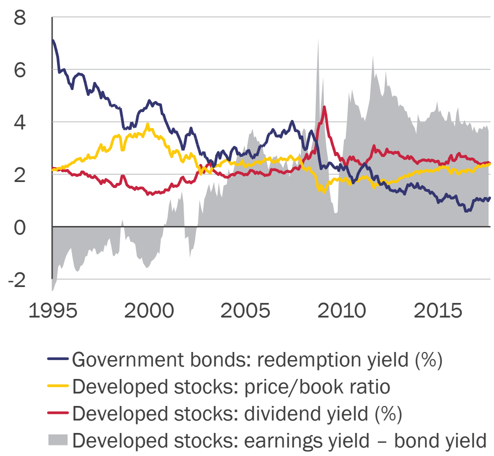
Source: OECD, Bloomberg, Rothschild & Co

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	-3.0	8.5
10-yr UK Gilt	1.4	-2.7	14.8
10-yr German bund	0.5	-3.2	7.3
10-yr Swiss Govt. bond	-0.0	-3.5	5.6
10-yr Japanese Govt. bond	0.1	-1.2	4.9
Global credit: investment grade (USD)	1.6	-0.2	9.7
Global credit: high yield (USD)	5.1	8.7	21.6
Emerging (USD)	4.5	4.7	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	18.3	29.2
Developed	2.4	17.9	29.3
Emerging	2.4	21.8	27.7
US	1.9	17.8	33.1
Eurozone	3.0	22.2	29.5
UK	3.9	11.0	23.6
Switzerland	3.1	15.5	13.9
Japan	2.0	26.8	28.4

Source: DataStream, Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (2000 = 100)

	Level	1yr (%)	3yr (%)
US dollar (USD)	104	-1.5	12.2
Euro (EUR)	124	4.6	3.8
Yen (JPY)	88	-10.9	5.2
Pound sterling (GBP)	78	0.9	-10.9
Swiss franc (CHF)	155	-2.3	6.9
Chinese yuan (CNY)	131	0.5	-0.6

Source: J.P.Morgan, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	183	-1.7	-34.3
Brent crude oil ($/b)	57.5	17.3	-39.2
Gold ($/oz.)	1,280	-2.7	6.0
Industrial metals (1991 = 100)	255	24.0	-3.9
Implied stock volatility (VIX, %)	9.5%	-28.4	-41.7
Implied bond volatility (MOVE, bp)	5.3%	-12.7	-17.6

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data as of 30th September 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