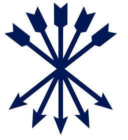
Market Perspective



Headroom reduced | A capitalist Japan?

Issue 98 | December 2017 / January 2018

Rothschild
Private Wealth

Foreword

It's Dickens' fault, apparently. All those seasonal trimmings – the cards, the tree, the spuriously detailed economic scenarios for the coming year. Bah, humbug.

We don't do those New Year forecasts. The calendar doesn't make the future any more predictable. Any adjustments to November's portfolios should reflect altered facts and views, not dates. Appropriate investment advice is not just for Christmas.

The investment backdrop still seems constructive – as we've argued it has been for the last eight years. Healthy growth with only modest inflation risk can continue for a while longer, and offers a friendly mix of rising operating earnings alongside only the most glacial rebound in interest rates. It suggests stocks remain the most likely source of inflation-beating returns.

This must, however, now be at least partly priced in. Even some traditional pessimists have noticed that the world has not ended, and the big markets have now risen a long way. Valuations are at above-trend levels.

But so too is corporate earnings growth – led by that operating income, not financial engineering. Talk of bubbles is understandable, but the major investment markets, while expensive, are not in that territory. We are braced for that overdue setback, but not a collapse (cryptocurrencies are another matter).

Plausible prospective long-term stock returns look lower than for some time, but are still above likely inflation. And we see risks as balanced.

If the calendar does not shape our investment advice, the passage of time certainly can. In the second essay we take a look at Japan, whose convergence with the Western business model is becoming more difficult to ignore.

Market Perspective will next be published in February. We wish readers everywhere a peaceful and prosperous New Year.

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.

© 2017 Rothschild Wealth Management
Publication date: December 2017.
Values: all data as at 30th November 2017.
Sources of charts and tables: Rothschild & Co or Bloomberg unless otherwise stated.

Headroom reduced

Prospective real returns are lower – but still positive

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

These are testing times for a constructive contrarian.

There has been a positive shift in mood in recent months. Even Scrooge would have to acknowledge that the global economy deserves a bit of credit for its recent performance. And if the surging price of bitcoin is not evidence of higher risk appetite, what is?

Uh-oh. Instinctively we'd side with Groucho.

But sometimes (often, in fact) the consensus is not wrong – or at least not for a while. And it's not that uniform or confident yet – look at the way in which the remarkably downbeat forecast in the recent UK budget was received. The Office for Budget Responsibility has bravely put its reputation on the line, and with it the credibility of the UK's fiscal framework.

This doesn't yet feel like "exuberance", irrational or otherwise. Big bears have not capitulated. Central banks remain diffident, even as the Fed raises rates. Cryptocurrencies are still far too small – and unleveraged? – to play the role of this cycle's collateralised sub-prime mortgage.

So if the mix of healthy growth with low inflation persists for a while longer, there is room for the mood to lift further. And on the growth front at least, some less-widely watched indicators testify perhaps to room for further upgrades.

World trade, for example, is growing at its fastest since the immediate rebound from the crisis. US operating earnings – before stock buybacks – will have grown by around 15% in 2017.

Political risk is still with us. Germany is without a government; the US probably wishes it was. British voters might be hoping to go short of two; Italians, several. But again, unless politics materially affects interest rates or profitability, markets are capable of ignoring it.

It still seems too early then to be anticipating anything other than the long-awaited setback. The available headroom, however, has been shrinking.

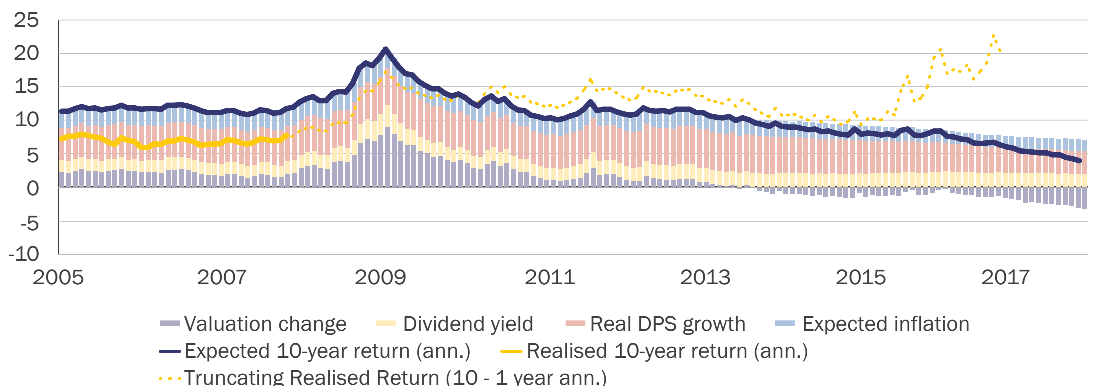
The major stock and bond indices are not in bubble territory or close, but having risen as they have, we have to anticipate some eventual reversion to (lower) valuations, and this will eat into prospective returns.

Combining (1) a normalisation in valuations with (2) plausible projections of dividend growth and (3) today's starting yield, we find that a reasonable expectation for 10-year returns from US stocks, for example, might now be just 4% per annum (before fees). We do not include any extra return ("alpha") created by portfolio managers.

This is still ahead of both likely inflation, and the likely returns on bonds and cash, but the lowest

Figure 1: Plausible 10-year expected returns from US stocks (% pa)

Likely returns have fallen as valuations have risen – but still exceed likely inflation



Source: Bloomberg, MSCI, Rothschild & Co

Note: Forecasts are not a reliable indicator of future performance. Past performance is not a reliable indicator of future performance. The 'Realised 10 year return' reflects the actual 10-year return realised from that point forward, with the most recent observation updated as of 30th November 2007. The 'Truncating' realised return reflects a shortening annualised return from a 10-year period to the most recent 1 year return.

estimate we've compiled yet using this approach (figure 1).

The US is admittedly one of the more expensive of the big stock markets. Emerging markets are cheaper, for example, and grow faster.

We see the risks as being more evenly balanced than does received wisdom: our probability distribution has a right- as well as a left-hand tail.

Potential disappointments can be found in every newspaper. But potential positive surprises include: stronger global growth, and demand-pull inflation; an improved US-China economic detente with more, not less, liberalisation; and US tax cuts becoming real.

Nonetheless, the next few years are unlikely to be as good as the last few. Despite all the cyclical and structural worries – steady sniping from the smart money and the clever columnists – the last eight years have been almost as good as it gets, investment-wise. We have to lower our sights now.

Investment conclusions

Stocks are not cheap, and some protection is warranted against an overdue setback. But restructuring long-term portfolios more substantially could leave us stranded if markets rally. Profits are growing, interest rate risk is modest, and geopolitical risk is manageable: stocks remain the most likely source of inflation-beating returns.

- 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 part of 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 cyclical upside in the US.
- We prefer stocks to bonds in most places, even the UK (where the big indices are in any case driven by global trends). We still favour a mix of cyclical and secular growth over more defensive bond-like sectors.
- Trading currencies does not systematically add value, and our conviction remains even lower than usual. Monetary policy favours the dollar, but it is expensive. The euro and yen are inexpensive, but have looser monetary policies. The pound is backed both by valuation – it may be pricing in too much bad news on Brexit – and monetary policy. The yuan has been dear relative to trend, but China's growth has been underpinning it, and capital controls may take longer to liberalise. The Swiss franc remains expensive, which is an issue again now that euro risk has stabilised. On a one-year view we still rank sterling highest; the dollar, euro, yen and now yuan are middle of the pack; and we now put the franc lowest.

A capitalist Japan?

The popular view of Japan may have things the wrong way round

"And there are some very interesting things going on in Japan… It seems like capitalism might actually be taking root, making progress there… the resources have been in place there for decades. But the focus of corporate management has often been on things that have nothing to do with return on equity and nothing to do with profits – scale, employment, you know, things that matter but aren't necessarily good for investors. And I think there's been a sea change." – David Swensen, CIO Yale University, November 2017.

*"Japan's problems are rooted in **microeconomics**, in how the industry competes industry by industry… the government mistrusts competition and therefore is prone to intervene in ways that harm the nation's productivity and prosperity… Japanese corporate profit rates have long been chronically low by international standards… the low returns to capital persisted because Japan operated largely outside the international capital markets… Japan is a nation that reveres its traditions (and) prizes stability. But it is also a nation that has demonstrated an extraordinary capacity to transform itself when its well-being is at stake." – Michael E. Porter, Hirotaka Takeuchi, Mariko Sakakibara, "Can Japan Compete?", 2000.*

It has been popular in recent years to talk of the "Japanification" of the Western economy.

Popular, but mistaken. The likely convergence has been in the other direction – for Japan's

businesses to become more Western. This process is under way, and starting to become intriguing from an investment viewpoint.

Sluggish growth, deflation, an ageing population, a lengthy hangover from real estate and other financial excess, fiscal and monetary impotence, surging government debt ratios – Japan endured all these for many years after its own spectacular bubble burst in 1990.

In the wake of the global financial crisis, as Europe and even the US for a while struggled to get going again, the popular cry was that the Western economies were doomed to follow suit.

That analysis was superficial, and placed too much emphasis on perceived monetary and fiscal problems and remedies. These things can matter, but mostly in a cyclical, short-term sense – and even then, not in the mechanical and consistently predictable way imagined.

It was often patronising too. If Japanese living standards have been stagnating of late, they have been doing so at levels that much of the rest of the world still aspire to.

Japan's supposedly sensational deflation is statistically insignificant – an annualised decline in consumer prices of 0.6% per annum between 1998 and 2013 – and can't be the economic game changer of popular myth. And at a time when diagnoses of social and political bad temper are commonplace, Japanese society is characterised by relative stability – particularly after October's election, which saw Prime Minister Abe re-elected by a landslide – and, frankly, civility. The unemployment rate is at a post-1994 low.

Still, Japan has felt the need to do better – hence the policy initiatives, "Abenomics", launched after 2012. The first two "arrows" are fiscal and monetary policy, and have intermittently caused much excitement at macro funds (Japan has always been a popular hedge fund trade, if not always a profitable one).

Expansionary fiscal policies pushed that gross government debt ratio up above 200% – with little extra growth to show for it. (Not that we worry unduly about that debt: it's happily held by domestic investors content to shuffle their savings from private to public assets. Japan remains one of the largest creditor nations, thanks to an ongoing balance of payments surplus.)

More dramatically, monetary policy has seen the Bank of Japan pursuing quantitative easing policies more aggressively than even the Fed, the ECB and the Bank of England. Its cumulative purchases of $4.6tn (equivalent to 93% of GDP) have bravely extended to stocks as well as bonds, and are nominally open-ended – though recent comments and a stealthy tapering suggest a slightly less doveish stance.

Growth has now picked up – though reviving world trade and a cheap currency is likely playing a part too. But even if it lasts, GDP growth is not what matters most. As prospective long-term investors, we would not advise buying stocks anywhere just because a government has been borrowing a lot or a central bank has been buying bonds and stocks.

A key ingredient for a long-term investor is an efficient (and hopefully inexpensive) corporate sector – which is why the arrival of the third Abenomics arrow, aimed at structural reform, is what we've been waiting for.

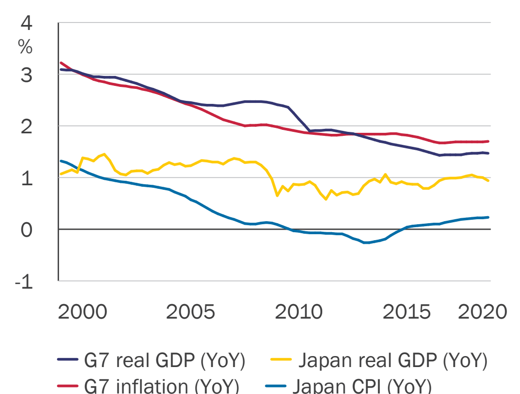
Traditionally, Japan's government has played a big role in shaping the economy, initially (in the sixties, seventies and eighties) with apparent success. (Some Western observers went so far as to suggest that Japan's economic model should be copied in the West. But a reduced emphasis on competitiveness and efficiency was probably not the best advice to offer a Western world unknowingly poised to greet an emerging China.)

Whether that "government model" was as successful as it could have been – Michael E. Porter, the doyen of national competitiveness studies, quoted above, has questioned that – it was certainly hugely influential. Japan's business leaders, under the auspices of the old Ministry for International Trade and Investment, valued market share and stability highly, and efficient asset allocation less so.

Japan had – still has – some world-class businesses: consumer electronics, transport equipment and capital goods. But it had some uncompetitive ones too, including its financial

Figure 2: Japan's economy

GDP growth and CPI inflation, 5-yr mav, % pa



Source: Bloomberg, IMF, Rothschild & Co

sector, and it wasted a lot of resources (including much of its potential female labour supply).

The market for corporate control in Japan has been underdeveloped – hostile bids are extremely rare, and have faced significant obstacles. Minority shareholders do not always seem to receive protection, and accounting can be opaque.

Overall, profitability historically has not been a priority, and has disappointed. Return on equity, for example, has in the last quarter century lagged behind that in the US or Europe, even when allowance is made for Japan's lower inflation.

One of the reasons why lower interest rates seemed to do little for growth is probably that the efficiency of capital is not a major driver of business decisions: tweaking interest rates just doesn't move the decision dial.

Japanese business was more profitable in the more distant past, before 1990 in particular. But that was a by-product of growth under the government model, not the major objective.

Investors were tolerated rather than courted, and capital was something to be used rather than rewarded. As recently as the noughties, shareholders were the subject of some famously disparaging comments made by bureaucrats. At the bottom of this disdain was probably a dislike of markets' short-termism, perceived or real.

Shareholder value can be pushed too far. The single-minded pursuit of profitability can be socially damaging and counter-productive. The wilder claims made for unfettered capitalism have long since been quietly shelved in pursuit of a middle way. But Japan's corporate governance often placed owners' interests at the very bottom of the pile.

There is nothing necessarily wrong with this: why shouldn't Japan do things its own way? If it wants to grow faster in a more integrated global economy, however, there may be a limit to the extent to which its business can operate differently. And it looks like Japan is now becoming more conventionally capitalist.

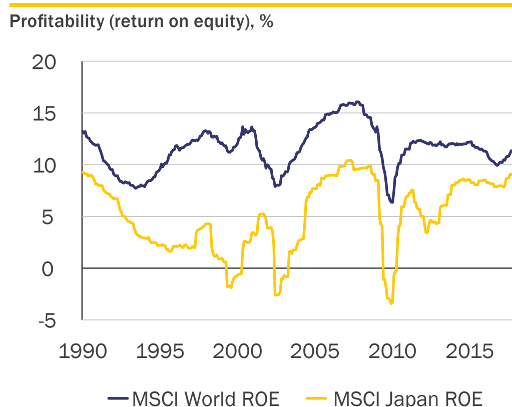
Improved profitability is being delivered without any associated increase in leverage, and starting to look more sustainable – and deliberate.

We are less convinced by the more obviously cosmetic changes, such as the introduction of the "400" stock index. However, improved profitability is being delivered without any associated increase in leverage, and starting to look more sustainable – and deliberate.

In particular, it has continued to improve even without the yen falling further, and we are viewing Japan more positively – because while many valuations have risen and converged, Japan is still trading at a discount not just to its own history, but to the rest of the developed world. The months ahead (not the calendar!) will tell us if the trend is persisting.

Figure 3: Japan turns capitalist

Profitability (return on equity), %



Source: Bloomberg, MSCI, Rothschild & Co

Figure 4: Performance and valuation

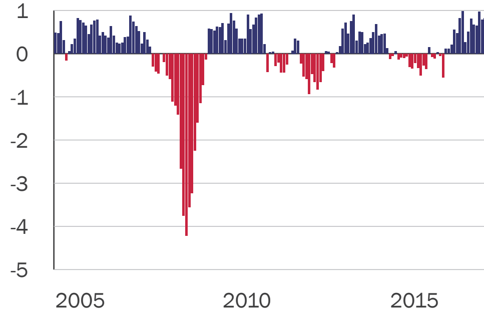
Relative stock market returns (index) and relative price/book ratio

Source: Bloomberg, MSCI, Rothschild & Co

Economy and markets: background

Growth: major economies

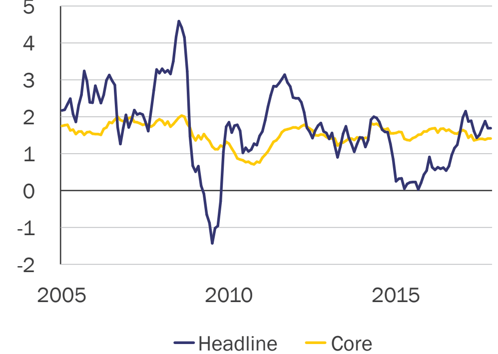
Business optimism: standard deviations from trend



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

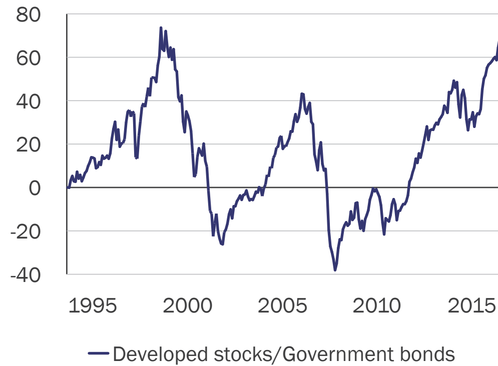
G7 inflation

%, year-on-year



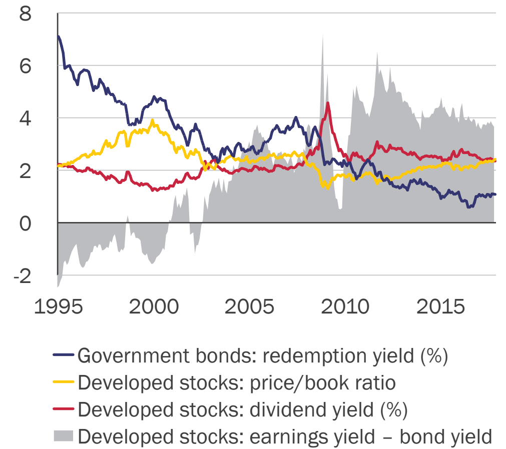
Source: OECD, Bloomberg, Rothschild & Co

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	2.4	2.2	4.9
10-yr UK Gilt	1.3	2.2	10.6
10-yr German bund	0.4	0.4	6.1
10-yr Swiss Govt. bond	-0.1	0.4	5.0
10-yr Japanese Govt. bond	0.0	0.3	4.2
Global credit: investment grade (USD)	1.6	3.1	8.5
Global credit: high yield (USD)	5.3	10.0	21.7
Emerging (USD)	4.6	9.0	16.9

Source: Bloomberg, Rothschild & Co

Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

	Yield (%)	1yr (%)	3yr (%)
World: all countries	2.3	21.2	29.3
Developed	2.3	20.4	29.4
Emerging	2.3	27.5	28.3
US	1.9	22.1	33.4
Eurozone	2.9	21.5	27.2
UK	3.9	12.0	21.1
Switzerland	3.1	21.4	12.2
Japan	1.9	22.1	28.4

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (1980 = 100)

	Level	1yr (%)	3yr (%)
US dollar (USD)	104	-6.1	9.8
Euro (EUR)	125	6.4	3.6
Yen (JPY)	87	-3.5	11.7
Pound sterling (GBP)	78	0.4	-8.4
Swiss franc (CHF)	152	-4.4	4.0
Chinese yuan (CNY)	131	-1.4	-3.4

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	189	-0.1	-25.6
Brent crude oil ($/b)	63.6	26.0	-9.4
Gold ($/oz.)	1,275	8.7	9.2
Industrial metals (1991 = 100)	259	12.5	-0.6
Implied stock volatility (VIX, %)	11.3	-15.4	-15.4
Implied bond volatility (MOVE, bp)	46.8	-42.2	-29.7

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data correct as of 30th November 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 40 80 260

Geneva
Rue de la Corraterie 6
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 705194

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 Milan
Italy
+39 02 7244 31

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

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

Zurich
Zollikerstrasse 181
8034 Zurich
Switzerland
+41 44 384 7111

Important information

This document is strictly confidential and produced by Rothschild & Co for information purposes only and for the sole use of the recipient. Save as specifically agreed in writing by Rothschild & Co, this document must not be copied, reproduced, distributed or passed, in whole or part, to any other person. This document does not constitute a personal recommendation or an offer or invitation to buy or sell securities or any other banking or investment product. Nothing in this document constitutes legal, accounting or tax advice.

The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment. Past performance should not be taken as a guide to future performance. Investing for return involves the acceptance of risk: performance aspirations are not and cannot be guaranteed. Should you change your outlook concerning your investment objectives and/or your risk and return tolerance(s), please contact your client adviser. Where an investment involves exposure to a foreign currency, changes in rates of exchange may cause the value of the investment, and the income from it, to go up or down. Income may be produced at the expense of capital returns. Portfolio returns will be considered on a "total return" basis meaning returns are derived from both capital appreciation or depreciation as reflected in the prices of your portfolio's investments and from income received from them by way of dividends and coupons. Holdings in example or real discretionary portfolios shown herein are detailed for illustrative purposes only and are subject to change without notice. As with the rest of this document, they must not be considered as a solicitation or recommendation for separate investment.

Although the information and data herein are obtained from sources believed to be reliable, no representation or warranty, expressed or implied, is or will be made and, save in the case of fraud, no responsibility or liability is or will be accepted by Rothschild & Co as to or in relation to the fairness, accuracy or completeness of this document or the information forming the basis of this document or for any reliance placed on this document by any person whatsoever. In particular, no representation or warranty is given as to the achievement or reasonableness of any future projections, targets, estimates or forecasts contained in this document. Furthermore, all opinions and data used in this document are subject to change without prior notice.

This document is distributed in the UK by Rothschild Wealth Management (UK) Limited. Law or other regulation may restrict the distribution of this document in certain jurisdictions. Accordingly, recipients of this document should inform themselves about and observe all applicable legal and regulatory requirements. For the avoidance of doubt, neither this document nor any copy thereof may be sent to or taken into the United States or distributed in the United States or to a US person. References in this document to Rothschild or Rothschild & Co are to any of the various companies in the Rothschilds Continuation Holdings AG Group operating/trading under the name "Rothschild & Co" and not necessarily to any specific Rothschild & Co company. None of the Rothschild & Co companies outside the UK, nor companies within the Rothschild Trust Group are authorised under the UK Financial Services and Markets Act 2000 and accordingly, in the event that services are provided by any of these companies, the protections provided by the UK regulatory system for private customers will not apply, nor will compensation be available under the UK Financial Services Compensation Scheme. If you have any questions on this document, your portfolio or any elements of our services, please contact your client adviser.

The Rothschild & Co Group includes the following wealth management and trust businesses (amongst others): Rothschild Wealth Management (UK) Limited. Registered in England No 4416252. Registered office: New Court, St Swithin's Lane, London, EC4N 8AL. Authorised and regulated by the Financial Conduct Authority. Rothschild Bank International Limited. Registered office: St Julian's Court, St Julian's Avenue, St Peter Port, Guernsey, GY1 3BP. Licensed and regulated by the Guernsey Financial Services Commission for the provision of Banking and Investment Services. Rothschild Bank AG. Registered office: Zollikerstrasse 181, 8034 Zurich, Switzerland. Authorised and regulated by Eidgenössischen Finanzmarktaufsicht FINMA.