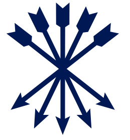

Market Perspective

Trading places | Inequality and investment

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Rothschild
Private Wealth

Foreword

Sometimes it seems to be one thing after another. No sooner have European electoral risks and Korean tensions subsided than worries about a trade war and diplomatic stresses with Russia have taken their place. Inflation risk has fallen back (again), but some technology business models are suddenly looking less sustainable.

This makes it all the more important to try to keep things in perspective. The background for these developments has been a combination of solid economic growth with subdued inflation – a lengthy business cycle with few of the traditional excesses.

This is delivering increasingly full employment and ongoing growth in corporate profits, but so far only modest interest rate risk. Average stock market valuations are not cheap, but neither are they irrationally exuberant – even in technology.

On the subject of trade, China, not the US, is the most protected big economy. China's awareness of this is likely colouring its so far measured response to higher US tariffs.

Overall, we see recent news as again contributing to an overdue revival in short-term volatility, but not yet heralding a significantly more testing investment climate.

In the second essay we try to answer a question we've been asked often of late, namely: how do we reconcile this constructive macro view with such an unequal society?

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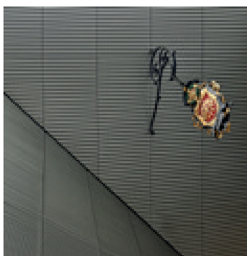

Cover:
A very public symbol of the heritage and values of the family business is the Rothschild shield positioned on the exterior wall of our New Court office in St Swithin's Lane, London. The five arrows combined with the family motto is the only advertisement for the business within.

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Trading places

Tariffs and tech move centre stage

It needn't escalate into a trade war, but the US-led skirmish is a gamble. Meanwhile, social media's business plan may be about to change, and EU indicators have rolled over further. But context, as ever, is key: the investment climate has been a friendly one.

Strategy or tactics?

Immediate losers from higher US tariffs are overseas suppliers, whose sales and/or net selling prices may suffer, and the US buyers facing higher costs. Immediate winners are the US government, which gets the tariff revenue, and US producers, who get a competitive boost.

The eventual impact on the US and global economy depends on several things, including:

- the response of consumers and businesses to lower purchasing power;
- what the government does with the proceeds;
- if the imports are essential, there will be no direct improvement in the US balance of payments – just higher domestic prices and a shift in spending power;
- retaliation might bring a vicious circle, a spiralling-downwards of private spending as the local tax becomes a global one (the unhappy precedent is the Smoot–Hawley tariff Act of 1930).

Any currency impact also depends on the circumstances. If an isolated US tariff increase cuts its trade deficit, it might help the dollar. But so too might a wider trade war, given the dollar's "safe-haven" status. Outcomes in between – partial retaliation, no improvement in US trade or a weaker case for investing in the US – might weaken the dollar.

Although tariffs push prices higher, they are ultimately more deflationary than inflationary because of the risks they pose to growth.

There is an alternative view, which is why we do not jump to a more negative conclusion.

If trade is distorted to begin with (by existing tariffs, subsidies, quotas and/or other forms of unfair competition), and the revenues are quickly spent, the new tariffs may do less damage. In the jargon, one "sub-optimal equilibrium" is replaced with another, and "welfare losses" may be smaller than they appear in the textbooks.

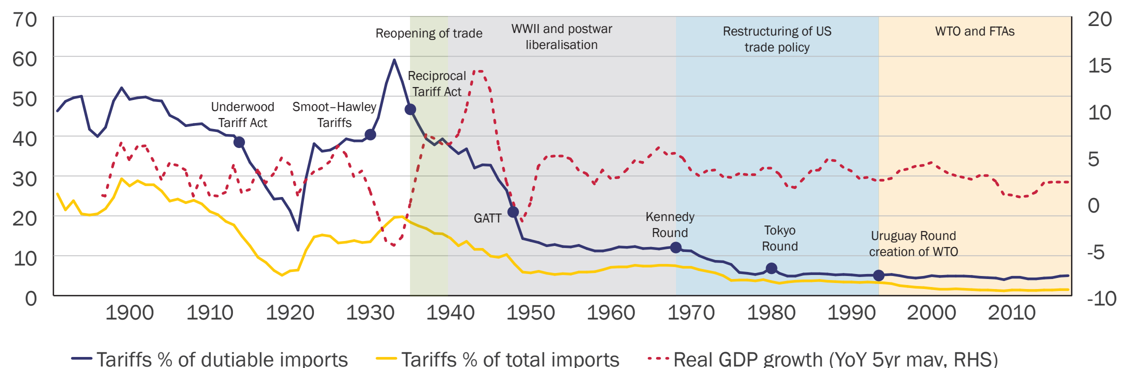
If the higher tariffs encourage constructive negotiations, the outcome might even be a net gain in global trading arrangements and welfare.

The US focus is increasingly on China: the earlier steel and aluminium tariffs exempted Europe, Canada and Mexico at least temporarily, and the recent "Section 301" report deals with US–China technology transfer. Even before its 215 pages were published, China's practices in this respect have long been questioned.

Trade with China has accounted for most of the US current account deficit in recent years. The

Figure 1: US tariff history

The Smoot–Hawley Act likely contributed to the Depression



Source: US Department of Commerce, Peterson Institute for International Economics, Rothschild

fact that the US has had a deficit for most of our working lifetimes, that not all of China's trade practices are unfair, or that two wrongs might not make a right, is neither here nor there now.

So far, China's response has been measured. Since 2016 we've wondered whether consensus thinking overlooks the possibility that President Trump might stumble, Reagan-like, into improved (economic) detente with China.

China itself is by far the most protected big economy, and knows it. We are not surprised to see China helping stabilise Korea.

Meanwhile, a tariff of 25% (or "up to" 25%) on the $60bn of imports from China targeted recently would be equivalent to an impost of less than 0.1% of US GDP, and less than 0.2% of China's. Rounding upwards, they might increase the effective US import tariff by perhaps 1 percentage point, compared to the more dramatic impact in 1930 (figure 1).

Anti-social media?

The other driver of volatility in March has been the reappraisal of some social media business models: alleged misuse of personal data is amplifying earlier concern at tax avoidance. It feels as if a corner is being turned.

The wider US tech sector has not been especially expensive (Amazon these days is usually seen as a retailer). For us, the sector's attractions have had less to do with the advertising-heavy, networking companies and more with conventional content, whether software or hardware.

From a top-down perspective, the prospects for most of the sector are unchanged, and the hit to social media groups can be absorbed. If advertising losses are contained, a bigger regulatory burden might even strengthen some social media names by raising barriers to entry. This does not look like 2000 to us.

Economies peaking, not collapsing

The eurozone-led decline in business surveys (page 6) seems to confirm that the best readings in the current cycle are behind us. It is not surprising. We'd noted here that some (like Germany's Ifo survey) had been at levels at which they were more likely to fall than rise, and had run ahead of "hard" data such as GDP. It need not herald a significant downturn.

Investment conclusions

In anticipation of some (overdue) revival in volatility, our portfolio managers have been holding some protection. But we see the investment climate as remaining a constructive one, and view stocks as being fully priced but not outlandishly so: a more substantial portfolio restructuring might leave us stranded if markets rally. US tax cuts and growth have restored some headroom; interest rate risk remains modest, and as protectionism has moved centre stage, other geopolitical concerns have faded. Stocks can still deliver inflation-beating long-term returns.

- In their recent sell-off, government bonds didn't come close to the levels at which we thought they might offer long-term value. Most yields stayed firmly below likely inflation rates. High-quality corporate bonds (credit) shared in the setback, and are also unlikely to deliver positive real returns, but at this stage of the business cycle we still prefer them to government bonds. We view bonds and cash currently as portfolio insurance.
- In the eurozone and UK, we continue to favour relatively low-duration bonds. In the US we have been more neutral, and see some attraction in inflation-indexed bonds. Speculative-grade credit still has some cyclical and policy support, but has run out of longer-term headroom: net of likely default and loss, returns may struggle to match inflation.
- We continue to prefer stocks to bonds in most places, even the UK (where the big indices are in any case driven by global trends). We now have few regional preferences, but continue to favour a mix of cyclical and secular growth over more defensive, bond-like sectors.
- Trading currencies does not systematically add value, and we continue to have even fewer convictions than usual. US protectionism needn't boost the dollar, and higher US interest rates are largely baked in. The pound no longer looks as cheap as it did: the Bank of England may raise rates a little more quickly than markets previously expected, but domestic politics seem precarious. The euro is no longer cheap, and economic surprises have most likely peaked. The yuan is dear relative to trend, but the softest of landings for the Chinese economy – and slower liberalisation – has boosted it. The yen is cheap, but its monetary policy remains the loosest. We again single out only the still-expensive Swiss franc among the big currencies: its safe-haven appeal has fallen, and we expect it to continue to lag the others.

It does, however, underscore the disappointing performance of eurozone stock markets. Despite the best economic indicators in a decade, and better-than-feared political news too, they have lagged global indices in both local and common currencies in the last six months.

US indicators have faded less. One of the oldest consumer confidence surveys recently hit an all-time high, doubtless fuelled by full employment and pending tax cuts – a reminder that not everything the administration has done has been harmful.

If anything, the main economic development for us this last month has been the continuing remarkable stability in most inflation indicators (page 6). Early February's US wage-driven flurry of excitement feels a long time ago now.

We still think interest rates will (and should) continue to drift higher in the US and UK, and that they will (and should) eventually do so in the eurozone and Japan too, but there is still little urgency to this call. We don't find bonds attractive, but nor do they deserve the "bubble" labels many attach to them.

Inequality and investment

Markets can seem indifferent

Humanitarian issues don't always affect markets in the ways expected.

An investible but unequal world?

We have been asked many times recently about inequality – usually along the lines of "how can you say the investment climate is benign when things have never been more unequal?"

Our response rarely seems to satisfy, but sadly it's true: like some other important issues, inequality may not directly affect markets.

As we've said often, those markets can seem callous. Unless something affects corporate profitability or interest rates, they may not respond to it – whether it be war in the Middle East, natural disasters, or the unequal distribution of incomes and/or wealth.

This does not mean we are indifferent. But our personal views may not be relevant to our day job, which is to offer objective advice about preserving and growing our clients' real assets.

We can certainly imagine a situation in which income inequality (for example) could affect total consumer spending or pay talks.

And a government determined to reduce inequality could hit investment returns hard. Indeed, that might be the aim: it might see investment portfolios as part of the problem.

But there are few signs of inequality affecting economic or investment performance directly.

Populism is not specifically anti-business. President Trump is no egalitarian. President Macron is progressive, but his reforms may bring more inequality (but faster growth and less poverty). Brexit is not driven primarily by economics. Disgruntled electorates have not yet jettisoned the economic consensus – best expressed many years ago by the German SPD as "markets where possible, government where necessary".

This could change, of course, notably in the UK.

Inequality of what, for whom, and why?

Our inner nerd feels compelled to note that there are measurement and definitional difficulties.

If we are sceptical of recent GDP statistics, how much more so should we be of data allegedly describing the distribution of income or assets decades – in some cases, centuries – ago?

Is this really the most unequal time ever? Feudal or even Victorian times seem to have been pretty unequal. Rockefeller and Morgan probably compare to today's billionaires. Is this a case of the "we live in special times" conceit?

Surging capital markets since the global financial crisis have far outpaced pay, and are viewed as the direct result of official monetary policy. Static or falling real wages partly reflect fiscal austerity. Inequality has seemed deliberate.

In reality, capital is more widely owned than many realise, through life assurance and pension funds for example. Nonetheless, many people have no assets at all (a recent survey suggested most US households had less than $1,000 in savings – but it didn't say if this was new).

In labour markets, our preoccupation with real (gross) pay per head ignores the newly employed, whose incomes before they found jobs may have

been a lot smaller. UK real average earnings have fallen by 6% in the last decade, but full-time employment is up 7% and unemployment is a percentage point lower.

It is widely reported that median US household real incomes have stagnated for a quarter of a century, which seems to show that economic growth is not shared widely. But when household size and qualitative gains ignored by the inflation indices are taken into account, the picture is less remarkable. And the unemployment rate is lower now.

For what it's worth, the inequality data itself suggests pre-tax income inequality was markedly higher in a number of countries in the early twentieth century, and fell until the 1970s before starting to rebound.

In the last decade, UK household income inequality may have declined slightly after taxes, benefits and housing costs. But the UK – like the US – is one of the more unequal developed economies (figures 2 and 3).

As this discussion already illustrates, it is not clear whether we should focus on income or wealth inequality (they can move differently); on global or local issues (emerging countries' growth is compressing many inequalities); or on population percentiles or wider Gini coefficients.

If we were to engage in the debate more carefully – outside the day job – we might ask whether (relative) inequality matters more than (absolute) poverty. Relativities are important, but so too are basic living standards. Of course, in practice, a degree of relativism is hard to avoid: socially acceptable living standards change over time.

Is it inequality of outcome, or inequality of opportunity, that needs to be reduced? If the latter, are there to be no limits on "meritocracy"? An unequal outcome arrived at meritocratically might still be socially damaging.

Do our answers depend on whether we're talking about the arts and sports rather than business? What role should luck be permitted to play?

The late Professor A. B. Atkinson led the way in the careful, objective discussion of many of these issues: interested readers might try his "Inequality: what can be done?" (2015).

Other things matter too

Policies designed to reduce inequality may do damage.

The nearest thing to a socioeconomic law, yet to be refuted after many experiments conducted at great human cost, suggests that if we try only to make the economic cake grow, it will be shared out very unequally – but if we aim only for equal shares, the cake will be much smaller.

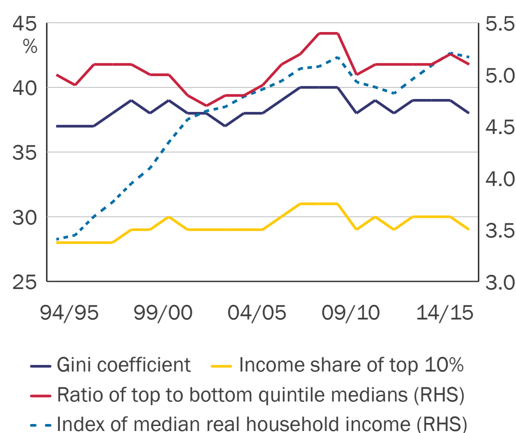
In practice, policy doesn't have to aim at either extreme. And it can be valid, when asked "how much inequality should we tolerate?", simply to answer "less".

Finally, while the news that society is unequal may have recently piqued central bank and hedge fund interest, it has perhaps not astonished us all.

We shouldn't yet alter investment portfolios – or monetary policy – on this account. But we can always alter our behaviour elsewhere.

Figure 2: UK inequality data

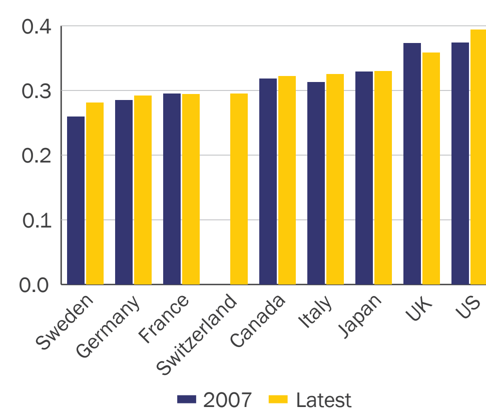
Based on household net incomes, after housing costs



Source: ONS, Rothschild
Note: a higher Gini coefficient implies greater inequality

Figure 3: Selected countries: Gini coefficients

OECD data, net incomes, latest year 2014 in most cases

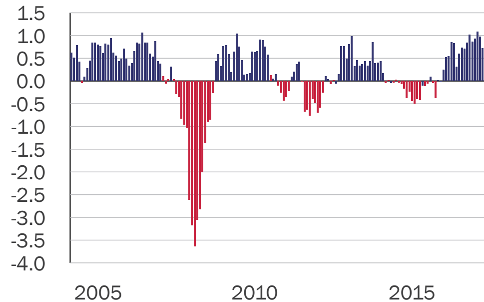


Source: OECD, Rothschild
Note: a higher Gini coefficient implies greater inequality. The theoretical range is 0–1; in practice, it is more like 0.2–0.7

Economy and markets: background

Growth: major economies

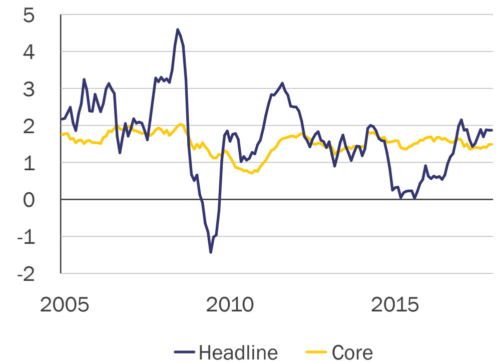
Business optimism: standard deviations from trend



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

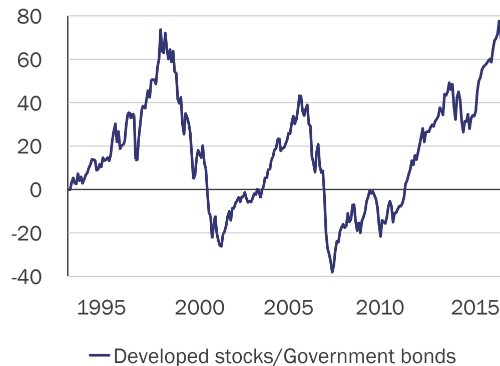
G7 inflation

%, year-on-year



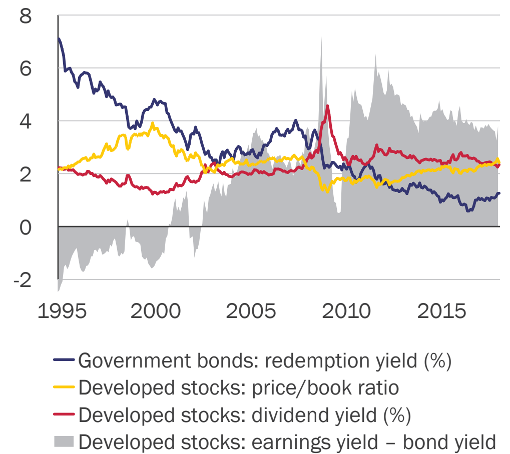
Source: OECD, Bloomberg, Rothschild & Co

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	2.8	-0.4	0.8
10-yr UK Gilt	1.4	-0.5	7.4
10-yr German bund	0.5	-0.0	1.8
10-yr Swiss Govt. bond	0.0	-0.1	1.1
10-yr Japanese Govt. bond	0.0	0.4	3.8
Global credit: investment grade (USD)	1.8	2.5	6.1
Global credit: high yield (USD)	5.8	4.8	20.1
Emerging (USD)	5.0	2.9	15.8

Source: Bloomberg, Rothschild & Co

Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

	Yield (%)	1yr (%)	3yr (%)
World: all countries	2.4	10.2	22.9
Developed	2.4	9.0	21.8
Emerging	2.4	20.3	31.1
US	2.0	12.1	31.3
Eurozone	3.0	2.6	5.6
UK	4.2	-0.7	14.3
Switzerland	3.3	4.6	6.0
Japan	2.0	11.9	10.9

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (1980 = 100)

	Level	1yr (%)	3yr (%)
US dollar (USD)	101	-6.4	0.3
Euro (EUR)	126	7.1	13.4
Yen (JPY)	90	-2.3	11.1
Pound sterling (GBP)	79	3.8	-10.1
Swiss franc (CHF)	152	-5.5	-5.1
Chinese yuan (CNY)	135	4.0	-4.2

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	194	5.6	-9.7
Brent crude oil ($/b)	69.5	35.5	23.3
Gold ($/oz.)	1,325	5.8	10.5
Industrial metals (1991 = 100)	265	12.0	10.8
Implied stock volatility (VIX, %)	22.9	98.4	51.8
Implied bond volatility (MOVE, bp)	58.3	-5.8	-32.3

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data correct as of 31st March 2018

Notes

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