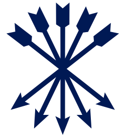


Market Perspective

Early warning signals?

Issue 102 | May 2018

Rothschild
Private Wealth

Foreword

"And then one day you find ten years have got behind you
No one told you when to run, you missed the starting gun"
Waters/Gilmour

The approaching 10th anniversary of Lehman Brothers' demise reminds us that this has indeed been another long cycle – and that it will end at some stage.

Will we be able to spot that ending in advance? We will certainly try our best: we are long-term investors, but we still want to avoid a bear market if we can. But market timing is not easy – even for the bigger moves.

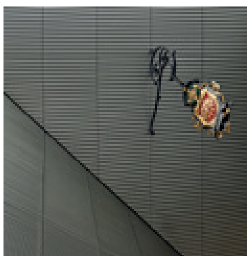
Recessions have a habit of sneaking up on you, and many of the things that matter to market dynamics – such as big investors' leverage, and dark/fast trading – are just not visible.

While geopolitics hasn't done much market damage in recent times – and the immediate situation is arguably less threatening than many feared – it may yet do so. Idiosyncratic political leaders are unpredictable.

If we do correctly call the next big downturn – and to be clear, we do not see one yet – it still may not be the most valuable thing we do for clients. Calling the last one was not so useful if you failed to spot the rebound, and subsequently missed one of the best investment periods in recent history.

Longer term, the most important thing is probably to be in the race – and if you're not going to be told when to run again, it can be better not to stop to begin with.

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.

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Publication date: May 2018.
Values: all data as at 30th April 2018.
Sources of charts and tables: Rothschild & Co or Bloomberg unless otherwise stated.

Early warning signals?

What might signal bad news ahead?

"This is the way the world ends
Not with a bang but a whimper"
TS Eliot

What sort of investment danger is out there – and what could be the financial canary in the coalmine?

What sort of bad news?

It's been a long time since the last bear market.

It's a loose label. For some, it means a decline in stock prices that grinds on for years. For others, it's about valuations, not prices – and on their view, we have been in one since 2000.

But usually, a bear market is declared when prices fall 20%. And for the MSCI All Countries Dollar Index, that last happened in 2008–09.

This ignores context. A 20% drop would have been a bigger real fall in the inflationary 1970s, for example. And two similar falls could have very different effects on other assets and the financial system.

Individual regions and sectors, and other asset classes, have had more recent bear markets. And spare a thought for Japanese equity strategists, who have yet to see local stock prices regain 1990s' levels.

But generally, a bear market is qualitatively different from short-term noise (coincidentally, 20% used to be seen as the "normal" level of the VIX, the widely watched measure of US stocks' implied volatility). Even long-term investors such as ourselves would try to avoid one if we thought we could see it coming – though market timing is never easy, even on this scale.

The record to date

There have been only seven such episodes in the post-1970 history of the MSCI index (figure 1), but this is still one every seven years or so.

The labels we've given them in figure 1 create a list of "usual suspects" – things to watch for now. They may not be the only possible drivers of bear markets, however.

Three of the episodes had largely economic drivers – the surging oil prices and inflation that contributed to the 1974–75 and 1981–82 falls, and the cyclical US endgame that played out in 1990 (perhaps the last "conventional" bear market in which a booming economy led to rising interest rates and eventual recession).

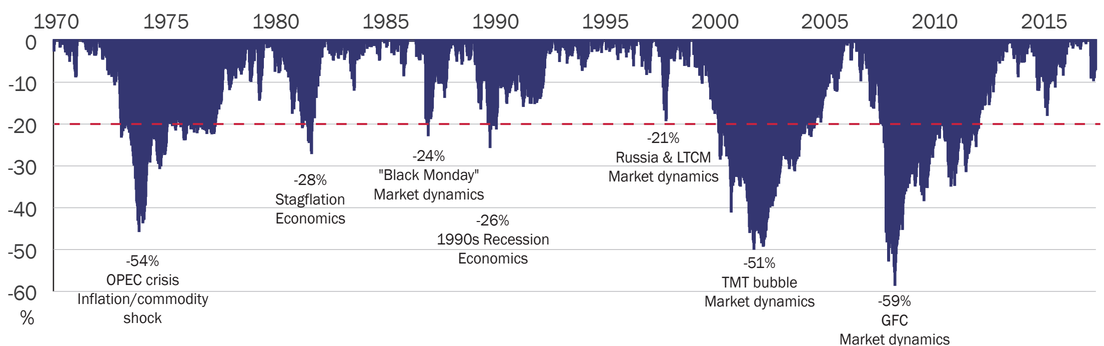
Four were driven more by the workings of markets themselves – the US-led market crash of 1987, the 1998 episode centred around the LTCM hedge fund, the "new economy" mania of 2000 and the credit-focused Global Financial Crisis itself in 2008.

The usual suspects

The current cycle – paced by the still-dominant US economy – is about to move into its 10th year. Recent business surveys have cooled – see page 6 – but this needn't herald its imminent demise. This is already one of the longest cycles, and may yet take the record (it needs to last another year to do so).

Figure 1: Bear markets in global stocks

MSCI all countries index ($): cumulative declines from latest peaks



Source: MSCI, Datastream, Rothschild & Co

Some of the cooling reflects unusually harsh weather. And the striking thing about the current cycle, as we've often noted, is that it has been accompanied by few obvious excesses.

US household cashflow remains positive. Its twin deficits are unremarkable (at least so far). Global inflation (page 6 again) is rising only slowly. Banks do not appear to have been lending recklessly – though they do have some exposure to the booming private equity sector. Capital spending needs are unlikely to have been sated. Manufacturers' inventories have not surged ahead of orders – if anything there are backlogs.

With inflation rising only slowly, a dramatic surge in interest rates seems unlikely. However, the difference between long- and short-term interest rates – the yield curve, shown in figure 2 as the spread between 10-year and 2-year US Treasury yields – has been trending lower.

Historically, a negative or 'inverted' curve has signalled a looming recession, often before conventional indicators have done so.

But correlation is not causation. Today's long-term yields may still reflect the lingering effects of QE, which have dampened the "term premium". An inversion now – and we are not there yet – may not be the usual guide. As figure 2 shows, there has sometimes been a lengthy gap between an inverted yield curve and the eventual recession.

Commodity markets do not seem threatening. Oil prices have rebounded sharply, but are well within their recent ranges – crude peaked at $150 per barrel in 2008, compared to today's $70. Economies are not as vulnerable as in the early 1970s: the oil age is slowly ending – and not because we're running out of oil (to paraphrase Sheikh Yamani).

Turning to market dynamics, stocks have risen less dramatically than before the 1987 crash, and earnings were not growing strongly then.

Another crazily geared investor may be out there, as in 1998. But in the post-GFC climate we doubt they can have taken on the systemic importance that LTCM did. Hedge funds overall do not seem to have been using much leverage of late – we believe if they were, they would not have lagged rising stock and bond markets these last five years.

There has certainly been some technology sector froth of late, but valuations are less stretched than in 2000 (a US sector price/book ratio of 5–6 compared to 11–12 then). Social media business models may be questionable, but thinking is not as wildly fanciful as it was then.

Merger and acquisition volume is close to all-time highs, but looks less remarkable as a proportion of stock market capitalisation. Bid premia are below average, and there is little stock-only financing (which can be a sign of a cresting stock market). The cross-industry indulgences that marked the empire building of the 2000s appear thankfully absent as yet.

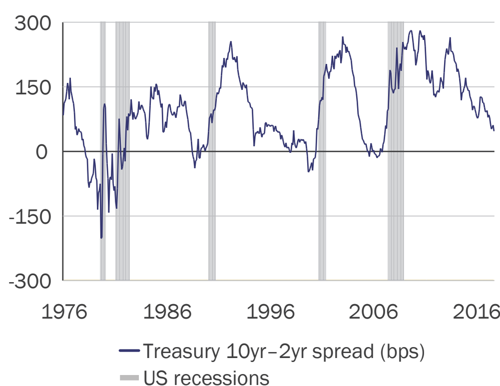
The credit markets of course were the epicentre of 2008's crisis, and now as then investors have been moving down the quality ladder in their "hunt for yield". Spreads have fallen almost back to the lows seen then, and yields are lower. Speculative grade yields in Europe briefly dipped below stock dividend yields for the first time.

"Covenant-lite" loans, without some of the usual protections granted to lenders, represented 75% of outstanding leveraged loan issues in 2017, a much higher proportion than in 2007.

The rehabilitation of securitisation and its alphabet soup – MBS, CMBS, CDO, CLO and

Figure 2: The US yield curve as a recession signal

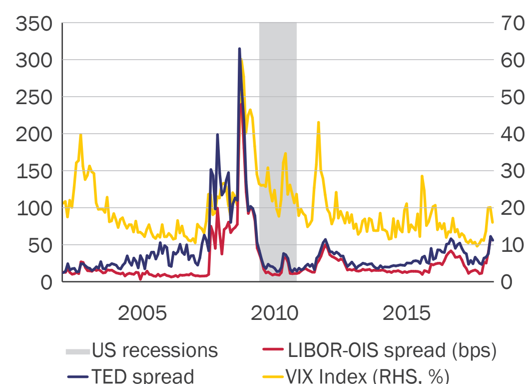
US recessions and 10yr–2yr Treasury yields



Source: Datastream, Rothschild & Co

Figure 3: Market risk indicators

Money market spreads and the VIX



Source: Bloomberg, Rothschild & Co

their synthetic counterparts – is a bit unsettling. So too is the return of more exotic Payment-in-Kind (PIK) loans, giving issuers the option to pay interest with further debt rather than cash.

However, while securitised issuance has been rising, it remains below pre-crisis levels. The mix is a little different too, with less reliance on houses. Corporate defaults remain low (3.3% in the US in the last 12 months). Aggregate net leverage does not look outlandish, and is relatively long-dated and more bond-financed than usual. Surges usually happen after a slump in profits, however, not before. Within the aggregate, private equity is likely more vulnerable, but poses less of a systemic threat (though banks' exposure is equivalent in the US to perhaps 5% of total commercial bank credit).

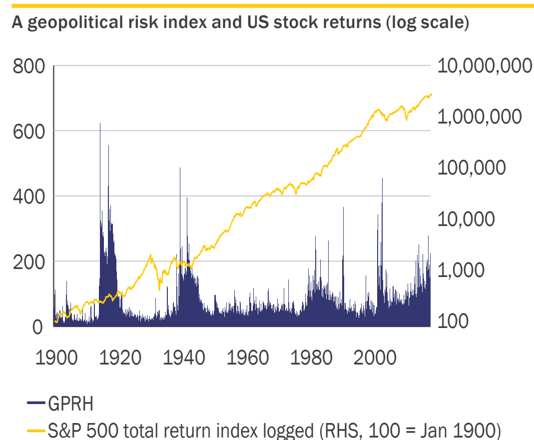
A recent widening in the so-called TED spread (between the rate at which banks lend to each other and the lower rate which the US government pays for short-term funds), and the LIBOR-OIS spread did ring a few alarm bells: these can signal banking stress (figure 3). The spreads can widen because investors flock to safe-haven assets, or because LIBOR rises as banks are wary of lending to each other.

This widening seems relatively benign, however, reflecting distortions associated with tax reform, the unwinding of QE, and US government funding. Banks are better capitalised on both sides of the Atlantic than in 2007.

Some large institution somewhere may be about to suffer a horrible loss. Some high-profile investors have already managed to sink their boats in a flat sea. High-frequency and off-exchange (dark) trading is still largely untested in a crisis, and may yet help cause one. Synthetic ETFs and (as we saw in February)

Figure 4: Measuring geopolitical risk

A geopolitical risk index and US stock returns (log scale)



Source: Dario Caldara and Matteo Iacoviello, Bloomberg, Rothschild & Co

Note: This geopolitical risk index (GPRH) counts the monthly occurrence of words related to geopolitical tensions across three US newspapers since 1899.

volatility-trading structures have the potential to disappoint. The cryptocurrency bubble will hurt someone when it bursts.

But as yet, neither the business cycle nor market dispositions seem to be especially vulnerable.

Potential new offenders?

Despite all the hot air, **aggregate debt** has not caused any of the crises seen to date.

Could it cause one? "Analysis" usually tots up all identified financial liabilities, notes that there are a lot of them, and concludes that we must therefore be doomed.

Reality is much more nuanced. A prosperous world has more assets: balance sheets balance, so it must have more liabilities too.

The IMF, McKinsey and others like to remind us that there is even more debt now than in 2008. The global economy however is one-third bigger than it was then. That big balance sheet has not stopped growth, nor need it suddenly do so.

But if the world can never be insolvent, it can certainly become illiquid – triggered perhaps by the default of individual consumers, companies or even small countries, which takes us back to our credit watch as discussed above.

Emerging economies can be at risk from rising US interest rates and a strong dollar. The Asian crisis in 1997 certainly had a wider impact for a while. But again, there have been few visible excesses in this cycle. Argentina's recent difficulties appear largely home grown, and are sadly not unusual. Neither it nor Venezuela seem likely to trigger global stress.

China is often seen as likely to cause the next global crisis from a crash landing for its economy, and/or an implosion in its rapidly growing debt. But it is hard enough to call the cyclical pace of the US and Europe: for China's opaque economy, conviction should be in even shorter supply. The government still controls much of the economy. China has a trade surplus, its capital account is largely closed, and it is a big international creditor (with more than $3 trillion of currency reserves still – despite all that talk of their dwindling).

The impact on the rest of the world of slower growth and/or surging domestic defaults in China might not be big. We doubt either will happen, and for now focus instead on the long-term attractions of investing in an economy which has taken more people out of absolute poverty than any other to date.

Geopolitical risk takes many forms. To an even greater extent than with economic issues, perceptions here can diverge markedly from

reality – the world may not be more dangerous, but it can seem so. Measuring geopolitical risk overall – as opposed to, say, the number of armed conflicts under way – is difficult, but some analysts track media comments, producing the time series shown in figure 4.

As we have noted often, geopolitical events have not always influenced markets, which can be callously focused on profitability and interest rates, not humanitarian issues. We are not surprised to see little link. But this does not mean that they may not do so in the future.

For the time being, however, and notwithstanding the ongoing flashpoints in the Middle East, we see risks being more balanced.

The world needn't end because there is an unorthodox occupant of the White House. China knows that it, not the US, has the most protected big economy, and it has so far responded to US provocations in a measured way – and not just in trade: China has surely pulled some strings in the cooling of tension in Korea.

A **rejection of capitalism** by the world's electorates is another potential risk. Whether inequality really has risen, or is as troubling as poverty, is a moot point – see last month's essay. But again, perceptions may be the key here, and there is no doubt that profits' share of the economic cake has been trending at historically high levels.

But while populists tell voters that their unhappiness is someone else's fault, they don't all blame capitalism. The backlash that boosted Brexit and Corbyn has also given us Trump – and Macron. As we've noted before, "sticking it to the man" needn't mean sticking it to business.

Conclusion?

If we had to stick our necks out, we'd suggest an old-fashioned cyclical demise for this upswing – inflation and interest rate risk in a fully-employed US economy – but perhaps not soon. We continue to focus on portfolio protection, not a wider, defensive restructuring.

It is always possible that this positive – though unsurprising – episode might yet simply peter out, and end with a whimper, not a bang.

Now that would be a first.

Investment conclusions

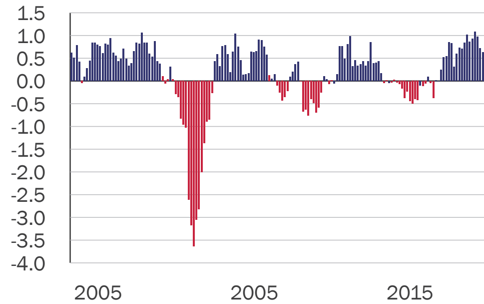
In anticipation of some (overdue) revival in volatility from last year's remarkably low levels our portfolio managers have been holding some protection. But we still see the investment climate as a constructive one, and stock valuations as full but not overblown: a more substantial portfolio restructuring might leave us stranded if markets rally. US tax cuts and growth have restored some headroom; interest rate risk remains modest; and both trade war and wider geopolitical crisis can be avoided. Stocks can still deliver inflation-beating long-term returns.

- Government bonds have still not reached levels at which they might offer long-term value. Most yields remain firmly below likely inflation rates. High-quality corporate bonds are also unlikely to deliver positive real returns, but their yields have risen a little further and 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 still prefer stocks to bonds in most places, even the UK (where indices are in any case driven by global trends). We have few regional convictions, 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 have even fewer strong views than usual. Growth indicators have cooled less in the US, but the dollar is not cheap and rising US interest rates are likely priced in. The pound has been undermined by softer data, renewed Brexit tensions and yet another shift in forward guidance on UK rates, but looks very competitive. There is once again room for a less doveish ECB to underpin the euro. The yuan is dear relative to trend, but supported by the softest of landings for the Chinese economy. The yen is cheap, but its monetary policy remains the loosest. We again single out only the Swiss franc, whose safe-haven appeal has faded: it has finally fallen back to its old ceiling against the euro, but remains expensive, and we expect it to continue to lag the other big currencies.

Economy and markets: background

Growth: major economies

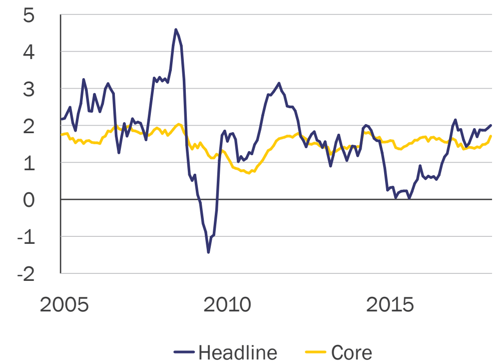
Business optimism: standard deviations from trend



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

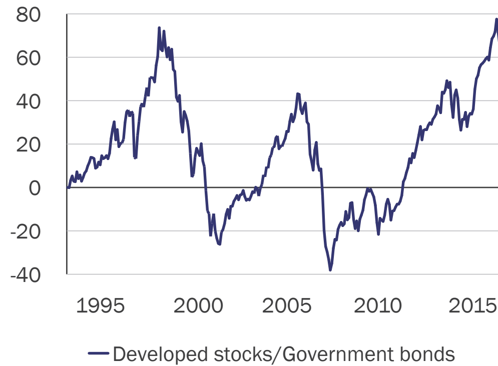
G7 inflation

%, year-on-year



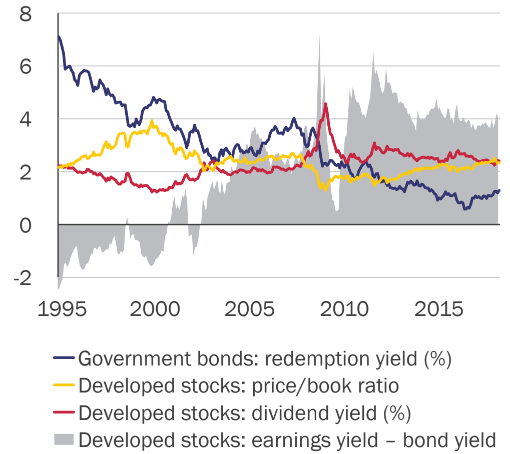
Source: OECD, Bloomberg, Rothschild & Co

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	3.0	-2.7	-0.0
10-yr UK Gilt	1.4	-1.6	9.2
10-yr German bund	0.6	-1.0	2.5
10-yr Swiss Govt. bond	0.1	-0.8	1.1
10-yr Japanese Govt. bond	0.1	-0.1	3.3
Global credit: investment grade (USD)	1.9	1.4	6.3
Global credit: high yield (USD)	5.8	3.2	18.3
Emerging (USD)	5.3	0.9	12.7

Source: Bloomberg, Rothschild & Co

Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

	Yield (%)	1yr (%)	3yr (%)
World: all countries	2.4	11.8	24.2
Developed	2.4	10.8	24.0
Emerging	2.4	20.6	24.0
US	1.9	12.6	32.0
Eurozone	2.9	4.8	12.5
UK	4.1	8.0	19.9
Switzerland	3.3	3.6	8.2
Japan	2.0	17.0	13.1

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (1980 = 100)

	Level	1yr (%)	3yr (%)
US Dollar (USD)	103	-5.4	3.0
Euro (EUR)	126	6.5	11.8
Yen (JPY)	88	-3.2	11.1
Pound Sterling (GBP)	78	-0.4	-12.1
Swiss Franc (CHF)	149	-6.2	-7.1
Chinese Yuan (CNY)	136	4.8	-2.2

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	202	11.1	-12.0
Brent crude oil ($/b)	75.2	45.3	12.6
Gold ($/oz.)	1,315	3.7	11.1
Industrial metals (1991 = 100)	274	20.8	7.9
Implied stock volatility: VIX (%)	15.9	47.2	9.5
Implied bond volatility: MOVE (bps)	50.4	-16.3	-33.1

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data correct as of 30th April 2018.

Notes

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