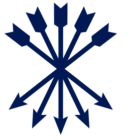
Market Perspective



Raising the roof | A logical digression

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Private Wealth

Foreword

An outright trade war is perhaps becoming the most immediate threat to the current business cycle. Emerging markets have been hit hardest so far. They contain some of the US' most targeted suppliers, and are also vulnerable to a stronger dollar and rising US interest rates.

How should we respond as investors? There are few winners: tariffs do no long-term favours even for the industries they are supposed to "protect".

The US administration's tactics and presentation are not reassuring. But economists' persistently mistaken diagnoses of European and Asian "savings gluts" and mercantilism have stoked US resentment. Nonetheless, it still feels premature to position portfolios for the worst.

We still think good sense will ultimately prevail. The elephant in the room is the uncomfortable but undeniable fact that the US administration has a point: America has been one of the most open economies on the planet, and the playing field is not level. Its trading partners and co-investors know this.

Overall, we continue to see trade and other geopolitical tensions (including the uncertainties associated with the new Italian government – which is a month old already) as manageable. Meanwhile, there are relatively few signs of macroeconomic excess – yet.

In two high-profile areas we can see some cyclical headroom. US consumers are not obviously maxed out, and UK fiscal policy has more room to ease than people – including the government – think.

We worry less about a shortfall in growth – or the allegedly-approaching Singularity in Artificial Intelligence – than about central bank complacency and some eventual revival in inflation. Meanwhile, we continue to advise that investors hold some portfolio protection, but refrain from a dramatic defensive restructuring.

Market Perspective will next be published in September.

Kevin Gardiner

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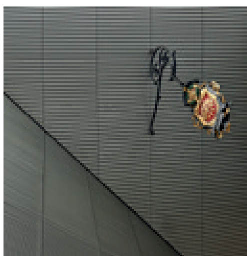

Cover:
A very public symbol of the heritage and values of the family business is the Rothschild shield positioned on the exterior wall of our New Court office in St Swithin's Lane, London. The five arrows combined with the family motto is the only advertisement for the business within.

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

Raising the roof

Trade worries – but some spending headroom

The trade risks are obvious, but remember the starting point is one in which tariffs generally have been historically low, not high – this is not the 1930s. The measures on the table do not yet add up to a game-changing amount (figure 1).

We cannot predict how things will play out, but as noted we think good sense will ultimately prevail. Meanwhile, we take a quick look here at two areas in which the prospects for cyclical growth may be brighter than people think.

Housing may fuel further US growth

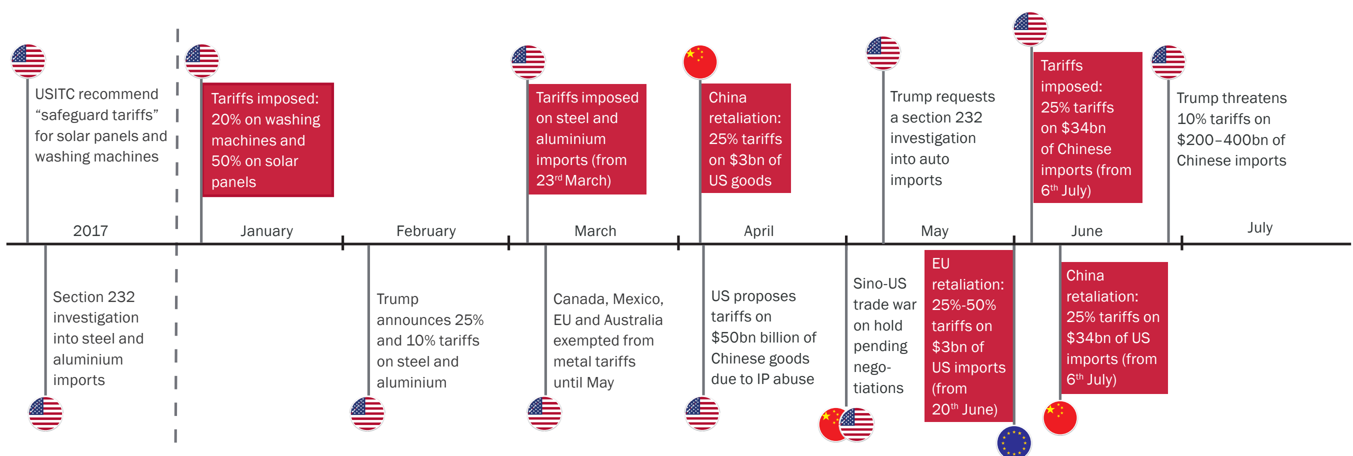
Can the much-maligned US consumer keep this US expansion on the road? Now into its tenth year, if it makes it into an eleventh it becomes the longest ever. Consumers account for the bulk of the US economy (as in most others), so if they still have fuel in the tank the odds are that the cycle does too.

In reality, consumers – individuals and households – don't only "consume", that is, buy things that satisfy immediate needs and wants (such as food, clothing, rent and transport). They invest in capital assets too, mainly new houses. This can be an important part of the business cycle.

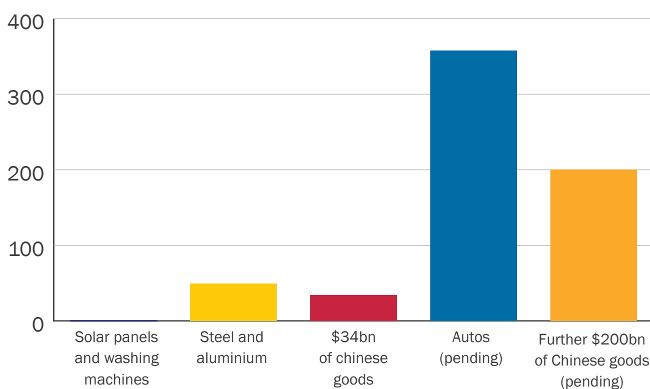
We tend to think of "investment" as superior to "consumption". Deferred pleasure is seen as better than instant gratification. But as we learned in the noughties, however, home buyers are not always as patient as we'd like to think.

Figure 1: Protectionism timeline

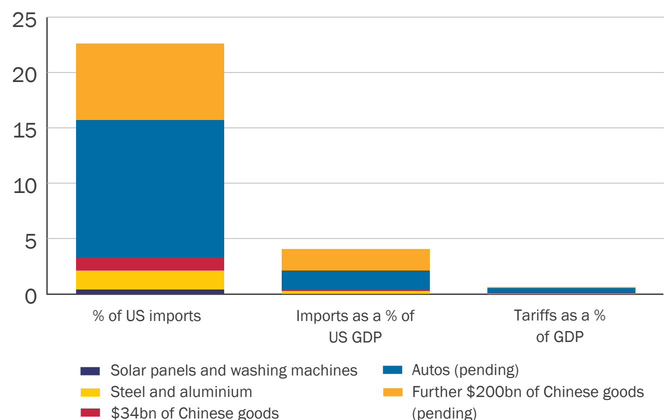
Key events in the current skirmish



US imports subject to new tariffs by value (USD bn)



US imports subject to new tariffs on a relative basis (%)



Source: Bloomberg, Capital Economics, FT, Rothschild & Co. Notes: 1. Past performance is not a reliable indicator of future performance. 2. Tariff rates for 'Autos' are assumed to be applied multilaterally at a rate of 25%. A 10% tariff rate has been assumed on the additional $200bn of Chinese imports.

Housing can be as prone to binge spending as high street sales. Capital outlays are smaller than consumption, but more volatile.

So if US households are to keep this cycle on the road we need to see how much room they might have left for further spending – on both consumption and investment.

It is not easy. Consumers' fuel tanks are more flexible than cars'.

Admittedly, their real incomes usually don't vary much, and most of its growth is driven by a few key variables.

Currently, taxes are falling, employment growth looks steady and pay is broadly matching inflation. The risks posed by higher oil prices (to real pay) and by rising interest rates (to net investment income) look manageable: oil prices are less important than they used to be and interest charges are still at low levels (figure 2).

Real disposable household incomes have been growing recently at a solid if unexciting pace of just under 2%. This picture could change, but perhaps not dramatically – or soon.

The real flexibility comes from the room consumers have to vary how much of their income they spend. The more confident they feel, the higher their spending rates (and the lower their savings rates).

Confidence reflects all sorts of things – a tightening labour market, for example, and/or changes in interest rates (which affect both disposable income and the relative attraction of spending now as opposed to later).

It can also reflect US consumers' aggregate balance sheet. They can collectively run down assets (spend saved cash and investments) and/or add to liabilities (borrow). The US banking system once again has loanable funds, giving them room to do the latter.

Alongside growing real incomes, US consumer confidence is currently high (figure 3). Unemployment is low, and consumer net worth is strong (at five times US GDP – despite all that debt – and up from 4.7 times at the pre-crisis peak). The stage has been set for spending rates to rise (and saving rates to fall).

This has indeed been happening. So how much of the potential flexibility in consumer spending behaviour has been used up?

The rate of consumption spending has risen back to levels on a par with the highest seen in recent years (figure 4). But new housing spending has not (perhaps because of the long shadow cast by the housing-related crisis breaking exactly 10 years ago).

This helps explain why the US private sector is still running a cashflow surplus (regular readers will remember us charting it often in these pages). And it leaves the housing market's recovery incomplete. New housing starts per capita remain far below not just the sub-prime-fuelled 2005 peak, but also below longer-term trends (figure 5).

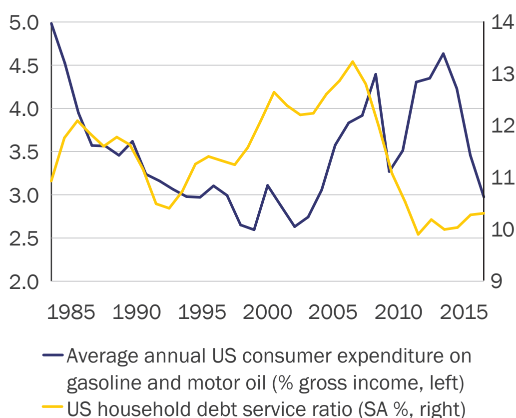
With real interest and mortgage rates still low – even after the Fed's seven rate hikes to date – and confidence high, we think spending on housing investment has room to rise further.

In portfolio terms, we favour growth-related assets over safe havens. We think US financial stocks in particular still have headroom. They benefit from rising interest rates – but also from the mortgage lending that will occur if/when confident US consumers invest more in new homes.

Closing the book on UK austerity?

The UK has plenty on its collective mind at the moment, and so can perhaps be excused for overlooking the increasingly favourable trend in its government's borrowing.

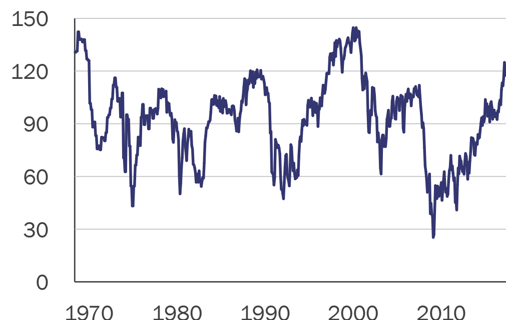
Figure 2: Oil and interest in perspective



Source: Bloomberg, Federal Reserve, BLS, Rothschild & Co

Figure 3: US consumer confidence is high

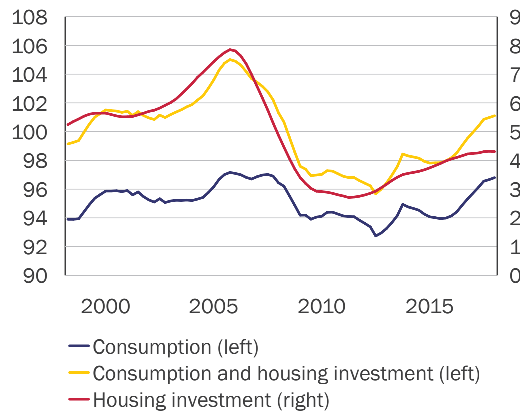
Conference Board index of consumer confidence (survey)



Source: Datastream, Rothschild & Co

Figure 4: US households' spending rates

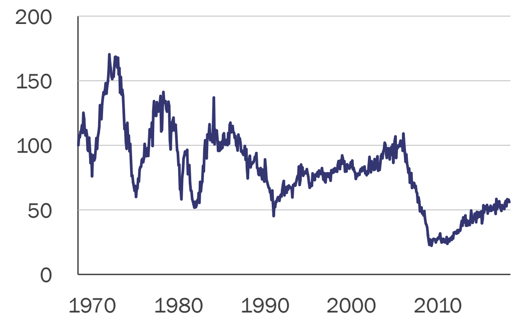
Consumer spending and housing investment (% disposable income, 4Q mav)



Source: Datastream, Rothschild & Co

Figure 5: US housing recovery incomplete

US housing starts per capita



Source: Datastream, Rothschild & Co

The deficit is falling steadily, and faster than the latest official forecasts suggested. As a proportion of GDP, it is back below 2%, its lowest since the early noughties. The public debt ratio is peaking (at last) at a manageable 86%.

This trend can continue. The Office for Budget Responsibility's projections are based on a very downbeat forecast for the UK to grow at less than 1.5% from 2018 to 2022.

If the deficit continues to shrink faster than the chancellor's current plans imply, the brakes on departmental spending will loosen. The proposed extra spending for the NHS may turn out to be more financeable than even the government seems to think.

Of course, even before any fiscal easing, the Bank of England is likely to tighten monetary policy (with forward guidance implicitly shifting yet again recently). The post-crisis policy mix – tight fiscal policy, loose monetary policy – is thus set to reverse.

This might eventually support the pound, which is competitive. Our instinct is to see public spending as more reliably expansionary than monetary policy. It may yet make itself felt in the political arena too.

A logical digression

"And pray that there's intelligent life somewhere out in space…"
Eric Idle

Let's set the business cycle aside for a moment and take a quick look at an aspect of another theme that has many investors worried – the proximity of Artificial Intelligence and its impact on the economy.

As robots learn to walk, fears are growing that the Singularity – when artificial intelligence moves beyond human intelligence – may be at hand. Not content with doing all our jobs, robots supposedly may decide to take over the world.

We're not convinced, and still see most technology as overwhelmingly good for people and business – something to be embraced, not feared.

Processing and dexterity are certainly moving ahead briskly – literally, of late, in leaps and bounds. Robots have long since been able to compete with humans at chess, for example, and are increasingly able to approximate physical human actions too (running and jumping are no mean feats). Much of what you read online is written by a robot (we promise this isn't).

But isn't there a distinction between computation and intelligence? Computers are surely capable of processing information faster and in a more focused way than we are, but does this give them the capacity to think?

The so-called "paperclip maximizer" threat – in which robots, programmed solely to make as many paperclips as possible, devote more and more of the world's resources to doing so, doing all sort of damage in the process – may one day become real. But will the paperclip maximisers be thinking, and capable of anticipating the human response to their actions?

Much of the literature on the topic is beyond us. But occasionally something seems to lift a bit of the veil. Douglas Hofstadter's book *Godel, Escher, Bach* was a case in point. A recent Brexit-related blog thread (of all things) was another.

The blog's author – who played a prominent role in precipitating the UK's current embarrassment – clearly takes the history of ideas, and the development of logical analysis, seriously. They posted a helpful summary of number theory.

We can't comment on the maths, but we are interested in the uses to which maths can be put in finance and economics. (The blog writer is perhaps mistaken in thinking it has a bigger role to play there, but that's another matter.)

The paper contained two intriguing quotes. They weren't directed specifically at AI, but they reinforced an instinctive scepticism about some claims being made for it.

The first is a bit dry:

"A complete epistemological description of a language A cannot be given in the same language A, because the truth of sentences in A cannot be defined in A." – Kurt Godel

The second seems more immediately digestible:

"The general problem of software verification is not solvable by computer." – Michael Sipser

Both relate to the impossibility of a complete and consistent logical system being contained within a single language (whether English or set theory). No language is free from paradox (Godel's "Incompleteness Theorem" proved as much for the axioms that comprise number theory).

If you, a robot, are going to break free from somebody else's programming, perhaps you need to be aware of those paradoxes – which requires the use of another language defined independently of the system wiring your brain.

But the ability to establish a motive, to acknowledge paradox, and to move from one frame of reference to another, has evolved in our own softer wiring over many centuries – and we don't know how it did so. So what are the chances of something that we ourselves program being able quickly to do the same?

Let's get back to worrying about trade war: the robots can't look after themselves.

Investment conclusions

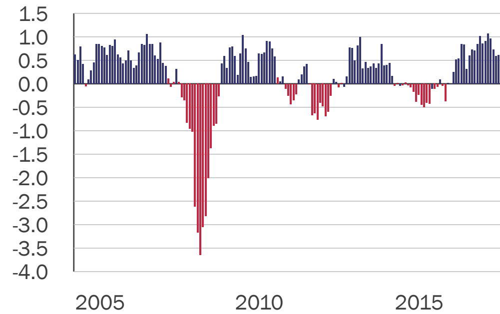
Our portfolio managers continue to hold some protection in anticipation of volatility. But we still see the investment climate as constructive, and stock valuations as full but not prohibitive: a more defensive portfolio restructuring might leave us stranded if markets rally. US tax cuts and growth have restored some headroom, interest rate risk remains modest, and geopolitical risks may be manageable. Stocks can still deliver inflation-beating long-term returns.

- Most government bond yields remain firmly below likely inflation rates. High-quality corporate bonds seem 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 are 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 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 little conviction currently: few big misalignments have emerged of late. Cyclical momentum has shifted back towards the US, and interest rate carry is wider than for many years, but much of this may be priced in. The pound has been undermined by ongoing Brexit tensions, but the domestic policy mix is shifting in its favour and on a long-term view it looks competitive. Current risks remain focused on the euro, where higher interest rates remain some way off, local economic data are more sluggish and political faultlines are visible. But we are sceptical of the disaster scenario, and it is inexpensive. The yuan has been dear relative to trend, and monetary policy is loosening, but (as Mr Trump is reminding us) it is still very competitive on a long-term PPP basis. The yen is cheap, but its monetary policy remains the loosest. We still single out only the Swiss franc among the big currencies. We doubt its revived safe haven appeal will be attractive for long. It remains expensive, and we expect it eventually to resume its downward drift.

Economy and markets: background

Growth: major economies

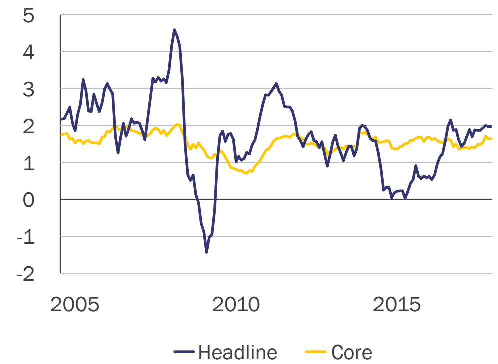
Business optimism: standard deviations from trend



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

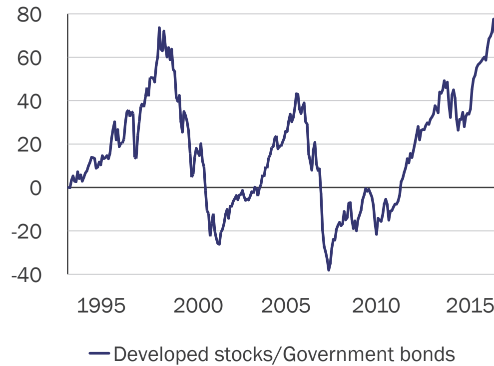
G7 inflation

%, year-on-year



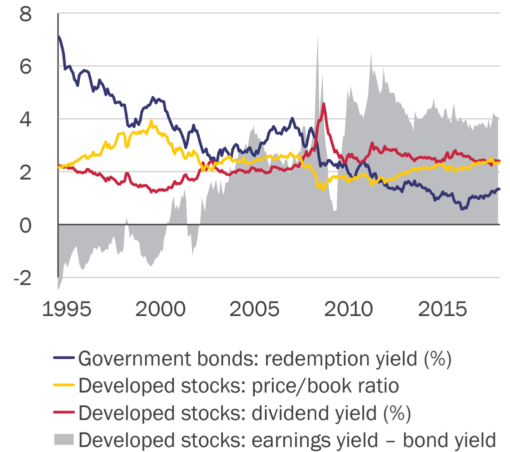
Source: OECD, Bloomberg, Rothschild & Co

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	2.9	-2.0	2.9
10-yr UK Gilt	1.3	0.6	12.1
10-yr German bund	0.3	2.4	7.5
10-yr Swiss Govt. bond	-0.1	0.8	2.9
10-yr Japanese Govt. bond	0.0	0.5	4.1
Global credit: investment grade (USD)	2.0	1.5	8.8
Global credit: high yield (USD)	6.5	1.1	18.3
Emerging (USD)	5.8	-1.2	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	10.6	27.9
Developed	2.4	10.7	28.1
Emerging	2.6	10.4	25.4
US	1.9	14.1	37.3
Eurozone	3.2	2.7	12.5
UK	4.1	7.7	28.6
Switzerland	3.3	-0.2	8.3
Japan	2.1	8.1	8.8

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (1980 = 100)

	Level	1yr (%)	3yr (%)
US Dollar (USD)	107	0.8	6.0
Euro (EUR)	125	3.1	10.8
Yen (JPY)	90	1.0	14.9
Pound Sterling (GBP)	77	1.0	-15.9
Swiss Franc (CHF)	154	-4.2	-5.6
Chinese Yuan (CNY)	134	2.8	-4.8

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	200	16.6	-10.4
Brent crude oil ($/b)	79.4	67.5	28.1
Gold ($/oz.)	1,253	0.6	6.2
Industrial metals (1991 = 100)	268	15.7	19.2
Implied stock volatility: VIX (%)	16.1	40.6	-14.6
Implied bond volatility: MOVE (bps)	51.2	-6.4	-43.0

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data correct as of 30th June 2018.

Notes

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