Market Perspective

The birthday party | Pessimism is not profundity

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Rothschild
Private Wealth

Foreword

Happy birthday to the US recovery, nine years old this month!

The birthday party will be a subdued affair. This must be one of the most unloved business cycles ever. Its meaning, its seemingly sinister characters, and its inevitable pauses, have been as critically dissected as a Pinter play.

Many pundits will not want to celebrate a recovery they said wouldn't happen, or would quickly lapse into a double dip, or would implode on the first rate rise at the Fed.

Potential festivities will be further overshadowed by renewed geopolitical concerns. These include an unorthodox new government in Italy, unscheduled elections in Spain, a seeming impasse on Brexit and of course the ongoing risks posed by an idiosyncratic US administration – not least the dangerous sparring over tariffs. Meanwhile, the stress points in an ever-tense Middle East seem to be shifting anew.

But as the US upswing enters its tenth year – just over a year away from perhaps becoming the longest ever – it shows few signs of overheating, and still has gas in the tank. Those geopolitical risks are neither new, nor as one-sided as many take them to be: they may prove manageable.

Commentators on current affairs often assume the worst. But secular stagnation, trade war, strife in the Korean peninsula and the death of democracy (the most recent addition to the wall of worry) are not inevitable. As Steven Pinker says, let's not confuse pessimism with profundity.

With the next US recession and/or financial crisis still not visible on the horizon, we continue to see the investment climate as a constructive one. We advocate ongoing portfolio protection, not a more significant defensive restructuring.

Kevin Gardiner
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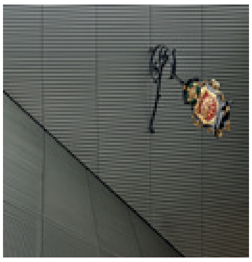

Cover:
A very public symbol of the heritage and values of the family business is the Rothschild shield positioned on the exterior wall of our New Court office in St Swithin's Lane, London. The five arrows combined with the family motto is the only advertisement for the business within.

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Values: all data as at 31st May 2018.
Sources of charts and tables: Rothschild & Co or Bloomberg unless otherwise stated.

The birthday party

“You know sir, you’re a bit depressed for a man on his birthday”
Harold Pinter, *The Birthday Party*

The NBER, official record-keeper of the US business cycle, dates the current upswing from June 2009. The longest-ever expansion was exactly 10 years (ending in March 2001). Another year, then, and this gets the record.

Ironically, the cycle in which the phrase “secular stagnation” was revived could yet prove the longest. Its arrival was greeted grudgingly. At the depths of the Great Recession, received wisdom was that any recovery would be fragile, overshadowed by debt and deflation risk. It was the biggest wall of worry in memory.

But there was little fundamentally wrong with the US and global economies. The Global Financial Crisis was the culmination of a richness of embarrassments for liberalised capital markets and their regulators, not a symptom of a broken economy.

The financial farce did a lot of damage – but as the excesses were corrected, and we caught up with where we should have been, there was always a good chance the cycle ahead would be reasonably lengthy.

Growth has not been spectacular – but neither has it been as weak as many think. Most recently, a soft start to 2018 looks (as we’d thought) to have been erratic.

US private spending has grown at an annualised pace of almost 3%, little different from the previous upswing. There is no sign of the investment shortfall proclaimed by many. The profits recovery has been the strongest ever (unsurprisingly: it followed the biggest fall).

The unemployment rate has not been lower since 1969 (when England were the football World Cup holders). Underemployment has also fallen markedly, and output and labour productivity may have been understated.

There are few signs of overheating. Inflation is still subdued, but this is less remarkable than we initially thought: inflation and growth have not always been linked. The “Phillips curve”, a negative correlation between pay inflation and unemployment, is relatively modern.

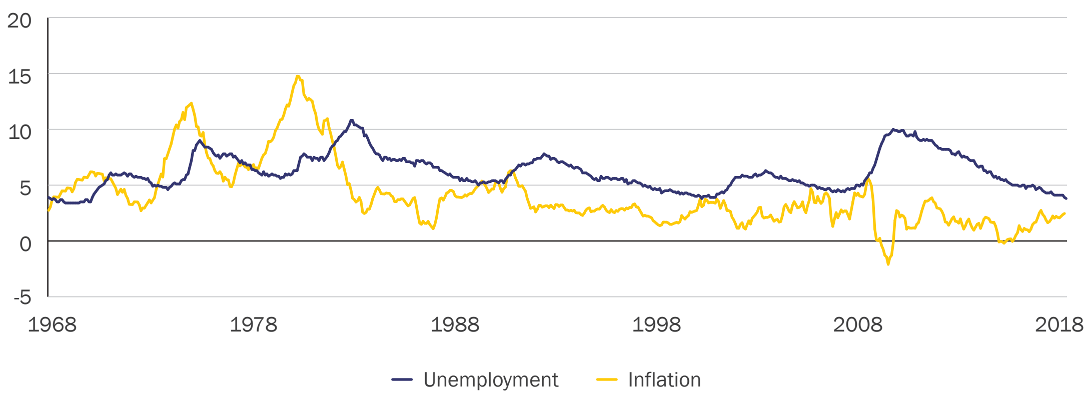
Intuitively, growth and inflation should be linked – if growth is largely driven by demand. But if we think supply is in the driving seat – whether because of new technology, new suppliers, or altered working practices – then the notion of “too much money chasing too few goods” is less compelling.

Meanwhile, sectoral imbalances are not troubling yet. The “twin deficits” are well behaved: the US current account and budget deficits are roughly 2% and 3% of GDP respectively, and the gap between the two hints at one of the best-kept secrets in this cycle – namely, a private sector surplus.

To be entering the tenth year of an upswing with US consumers and businesses not borrowing

Figure 1: US unemployment has not been lower since England were World Cup holders

US unemployment and inflation rates, %



Source: Datastream, Rothschild & Co

recklessly, but instead supplying liquidity to the wider economy, is little short of sensational.

This can change. And the government deficit will rise markedly as tax cuts and spending increases take effect. Tariffs will not prevent the US current account deficit from widening sharply (if they do, we'll have more pressing worries – see below). We may yet see too much demand for comfort.

We suggested last month that the cause of this cycle's eventual demise will likely be an old-fashioned one: rising inflation and interest rate risk. But we are clearly not there yet.

Pessimism is not profundity

"Keep some perspective. Not every problem is a Crisis, Plague, Epidemic or Existential Threat, and not every change is the End of This, the Death of That, or the Dawn of a Post-Something Era. Don't confuse pessimism with profundity..."
Steven Pinker, *Enlightenment Now*

Don't jump to gloomy conclusions
The response to the formation, fall and subsequent resurrection of a new Italian government, and to the collapse of Spain's government, shows pessimism still to be a common default setting.

Apparently we face the break-up of the euro and the wider EU, world trade is about to collapse, we've entered a new age of geopolitical insecurity and Western democracy is doomed.

We still haven't tackled that debt, or found new jobs for when the robots have taken over.

Really? Steven Pinker's latest book is not just an update on the factual reasons for questioning the "apocalypse now" view of current affairs, but sheds light on the news machine itself. Ex-teenage scribblers will recognise what he says about the allure of publicity-grabbing generalisations – or at least, we should.

For sure, another economic downturn and financial crisis will come along at some stage. Last month we reviewed some potential early warning signs: we saw a few amber lights, but few flashing red ones. That's still the case.

Italy: drama, not crisis
To adapt an old saying: things in Rome look hopeless, but not serious. Political instability is business as usual.

The Lega/Five Star Movement (M5S) coalition is reviving talk of a "Quitaly" to follow Brexit, but this feels premature. Markets' reaction has so far been more measured.

An alliance of left and right-wing populists is no surprise. Both see Italy's problems as someone else's fault, but they differ over who to blame. Lega was primarily a Northern separatist party, but more recently has been nationalist, and strongly anti-immigration. M5S is a newer, ecologically-aware and primarily anti-establishment party. Both are critical of the euro.

On paper, the coalition is euro-sceptic, xenophobic and reckless, but not all its ideas are bad. It's not as if the status quo is wildly successful. Italy's GDP is growing again, but is below levels seen in 2005.

M5S's proposed "citizen's income" is a long-standing idea in public finance: it smoothes the complex interface between taxes and benefits that can deter people from taking a job. Lega's notion of "flat" tax rates too is credible: simpler tax codes are better.

If set at expensive levels, however, these policies could bring resurgent borrowing, a breach of euro guidelines, and a further rise in Italy's already-high government debt ratio.

Meanwhile, reversing pension reform might make it (even) easier for Italians to leave the workforce. Ending bank bail-ins and reducing some capital requirements could weaken the banking system.

But the coalition's policies, initially at least, might boost growth – as in the US, where anti-Trump pundits overlooked the potential impact of lower taxes.

This is not to be knocked: "kicking the can down the road" buys time, and time can be valuable (even when interest rates are low). That road could be lengthy. Italian government debt is mostly domestically-held, and its average maturity (seven years) is not short. Private debt is not a problem.

The most likely outcome, however, may be that nothing much changes. Governing is difficult: ask Mr Trump. Hard choices have to be made, work has to be done, and it is always easier to criticise than create. Big egos don't easily compromise – especially if they have to stay "popular".

There are also constitutional checks and balances – the president, the regions, the small majority, the fact that Italian voters are not as euro-sceptic as their new government.

If a depreciating currency led to economic prosperity, the UK would have been a post-war table-topper.

In reality, blaming Italy's poor economic performance on the euro – as so many commentators even outside Italy tend to do – just won't wash. If a depreciating currency led to economic prosperity, the UK would have been a post-war table-topper. Currencies can be scapegoats too.

If Italy's poor economic performance is chronic, not urgent, so too may be the threat its new government poses to the euro – if it makes it that far. Italian governments in recent decades have lasted on average little more than a year.

Meanwhile, the market focus will be on its planned budget, which will likely be unveiled and shared with the EU after the summer.

Political risk and the end of democracy

Spain's new government will not have a convincing mandate until a general election (2020 at the latest), and faces a difficult task in trying to hold together the various regional and national fissures. Its economy is in better cyclical shape than Italy's, its debt burden lower, and its electorate are keener on the euro. The most likely outcome is uncertainty and drift.

Overall, eurozone political risk has revived a little. At the margin, this makes a vigorous capital spending cycle, a hawkish ECB and a rampant euro look (even) less likely than before. But on a top-down view we still firmly prefer stocks to bonds, even here.

Western politics in general (Switzerland apart) seems febrile of late. True to form, we face an avalanche of analyses proclaiming the imminent end of democracy.

Some writers ignore the distinction between representation and delegation. It is easy to forget the practical limits of the latter (despite Switzerland's best efforts – the *Vollgeld* referendum being the latest). Equal rights make the political market less efficient than the commercial one. We have exactly one vote each. We can't all be involved in all decision making.

Democracy in practice is not about choosing "optimal" policies from a menu of options. It can't be, as writers as diverse as Kenneth Arrow and Jean-Jacques Rousseau have demonstrated (and this assumes that the options on the menu are at least internally consistent, as opposed to the "have cake and eat it" sort).

Instead, like capitalism, it may simply be the least bad system. This is not a criticism. Like capitalism again, reports of its demise are premature. We may not like what voters are doing, but the fact they are able to do it tells us democracy is alive and well.

When the newly-elected start changing the electoral rules, then we worry.

Trump tariffs

A full-blown trade war would fully deserve scary headlines.

Today's trading arrangements are not perfect (one of the reasons for thinking reason will ultimately prevail – see below). Winners (governments and domestic suppliers) can always compensate losers (consumers).

But making imports more expensive will probably make the average person worse off. Unless the tariffs are immediately returned to them – in which case why bother? – spending power is smaller and choices less attractive.

If homemade goods are close substitutes for imports, consumers might switch completely. No tariff revenue would be raised, and domestic suppliers would gain from higher sales (and possibly prices). But consumers would still be less happy: they could have bought locally to begin with, but chose not to. In addition, domestic alternatives do not always exist.

Several skirmishes are underway, including new and proposed US tariffs on solar panels, steel, aluminium and cars; US action on intellectual property rights and technology transfer; and the responses of the US' main partners – notably the EU, Canada, Mexico and of course China.

Trade imbalances are not always the result of "unfair" practices. They usually reflect divergent business cycles, or structural issues.

The US has had a current account deficit almost continuously in recent decades, and now has roughly $8 trillion of net international liabilities. But the latter can also be shaped by the relative performance of US markets, and are usually viewed with equanimity by the markets. By way of perspective, US consumers' tangible assets and equity investments are roughly $64 trillion.

The US actions thus seem to be a high stakes gamble taken for little obvious need. But the playing field is not level. As we've noted before, China, not the US, is the most protected big economy. The US has a point, even if we disagree with the way in which they make it.

Sloppy economist talk of "savings gluts" in Germany, Japan, China and/or Saudi Arabia has not helped. We have made it sound as if imbalances are the deliberate result of national strategies. Mr Trump has been listening.

The measures taken to date are containable – they amount to small fractions of a percentage point of US GDP – and we have seen signs of compromise even from the US (most visibly, perhaps, some thawing towards China's ZTE). China has seemed relatively constructive – as we've suggested it might – acknowledging the need to push on with opening up its own economy (its capital account is largely closed, for example). Its acceptance of more global responsibility perhaps helps explain its behind-the-scenes leaning on North Korea.

Conclusion?

EU uncertainty and trade tensions in our view warrant the use of portfolio protection, not a more defensive restructuring.

In terms of Steven Pinker's remarks quoted above: if we expect anything to end, it might be scepticism towards Francis Fukuyama's persuasive 1989 diagnosis that the world is in reality steadily turning more liberal, not less ("The End of History and the Last Man").

An individualist, market-oriented, rational worldview – what Pinker reminds us to call "progress" – may still be in the ascendancy. And yes, that does mean we take seriously the possible end of the end of "The End of History".

Investment conclusions

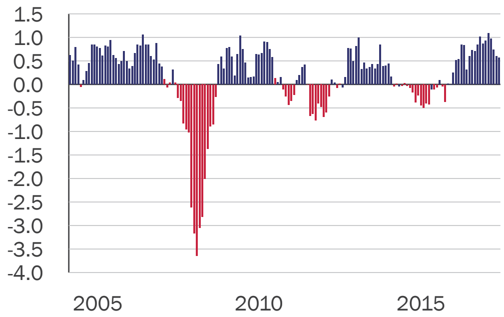
Our portfolio managers have been holding some protection in anticipation of some revival in volatility. But we still see the investment climate as a constructive one, and stock valuations as full but not overblown: a more defensive portfolio restructuring might leave us stranded if markets rally. US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

- Even in their recent wobble, most government bond yields remained firmly below likely inflation rates. High-quality corporate bonds seem 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 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 even fewer strong views than usual: few big misalignments have emerged of late. Cyclical momentum has shifted back towards the US, but the dollar was not cheap to start with and rising USD interest rates may be priced in. The pound has been undermined by ongoing Brexit tensions and yet another shift in forward guidance on UK rates, but on a long-term view it looks competitive. Current risks seem focused on the euro, which has softened only a little on Italian uncertainty. Higher interest rates are some way off and local economic data still disappoint. But we are sceptical of the disaster scenario, and it is inexpensive. The yuan is dear relative to trend, but supported by firmer data and slower liberalisation. The yen is cheap, but its monetary policy remains the loosest. We still single out only the Swiss franc among the big currencies: it has rallied, but we doubt its safe-haven appeal will be attractive for long. On a long-term view it remains expensive, and we expect it eventually to resume its downward drift.

Economy and markets: background

Growth: major economies

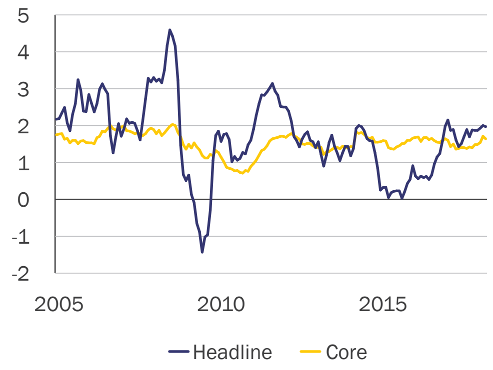
Business optimism: standard deviations from trend



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

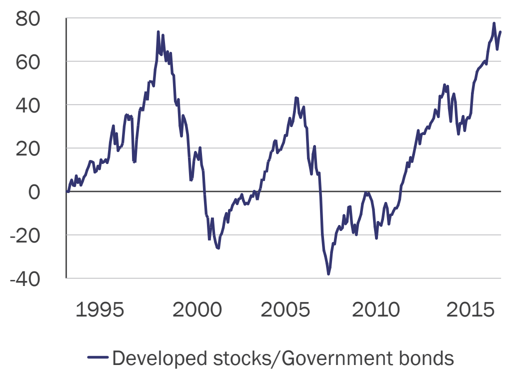
G7 inflation

%, year-on-year



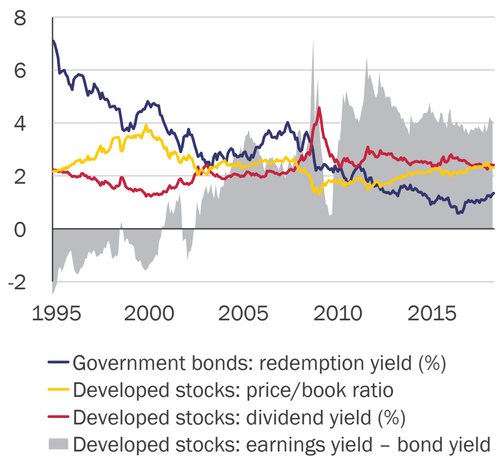
Source: OECD, Bloomberg, Rothschild & Co

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	2.8	-1.7	1.9
10-yr UK Gilt	1.2	-0.7	10.5
10-yr German bund	0.3	1.2	5.6
10-yr Swiss Govt. bond	-0.1	0.4	1.9
10-yr Japanese Govt. bond	0.0	0.3	3.8
Global credit: investment grade (USD)	1.9	1.4	7.2
Global credit: high yield (USD)	6.2	1.7	17.1
Emerging (USD)	5.4	-0.0	12.3

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	23.9
Developed	2.4	10.1	23.7
Emerging	2.5	14.6	25.0
US	1.9	13.0	32.6
Eurozone	3.1	1.4	10.5
UK	4.1	4.6	21.5
Switzerland	3.3	-1.2	4.0
Japan	2.1	13.2	6.7

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (1980 = 100)

	Level	1yr (%)	3yr (%)
US Dollar (USD)	105	-1.6	4.5
Euro (EUR)	123	2.6	10.1
Yen (JPY)	90	-0.3	16.6
Pound Sterling (GBP)	78	1.6	-13.5
Swiss Franc (CHF)	153	-3.9	-5.4
Chinese Yuan (CNY)	137	5.9	-3.2

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	202	10.9	-9.6
Brent crude oil ($/b)	75.4	44.2	15.0
Gold ($/oz.)	1,299	2.3	9.1
Industrial metals (1991 = 100)	279	23.5	18.9
Implied stock volatility: VIX (%)	17.0	73.5	23.0
Implied bond volatility: MOVE (bps)	63.0	16.5	-23.8

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data correct as of 31st May 2018.

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

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