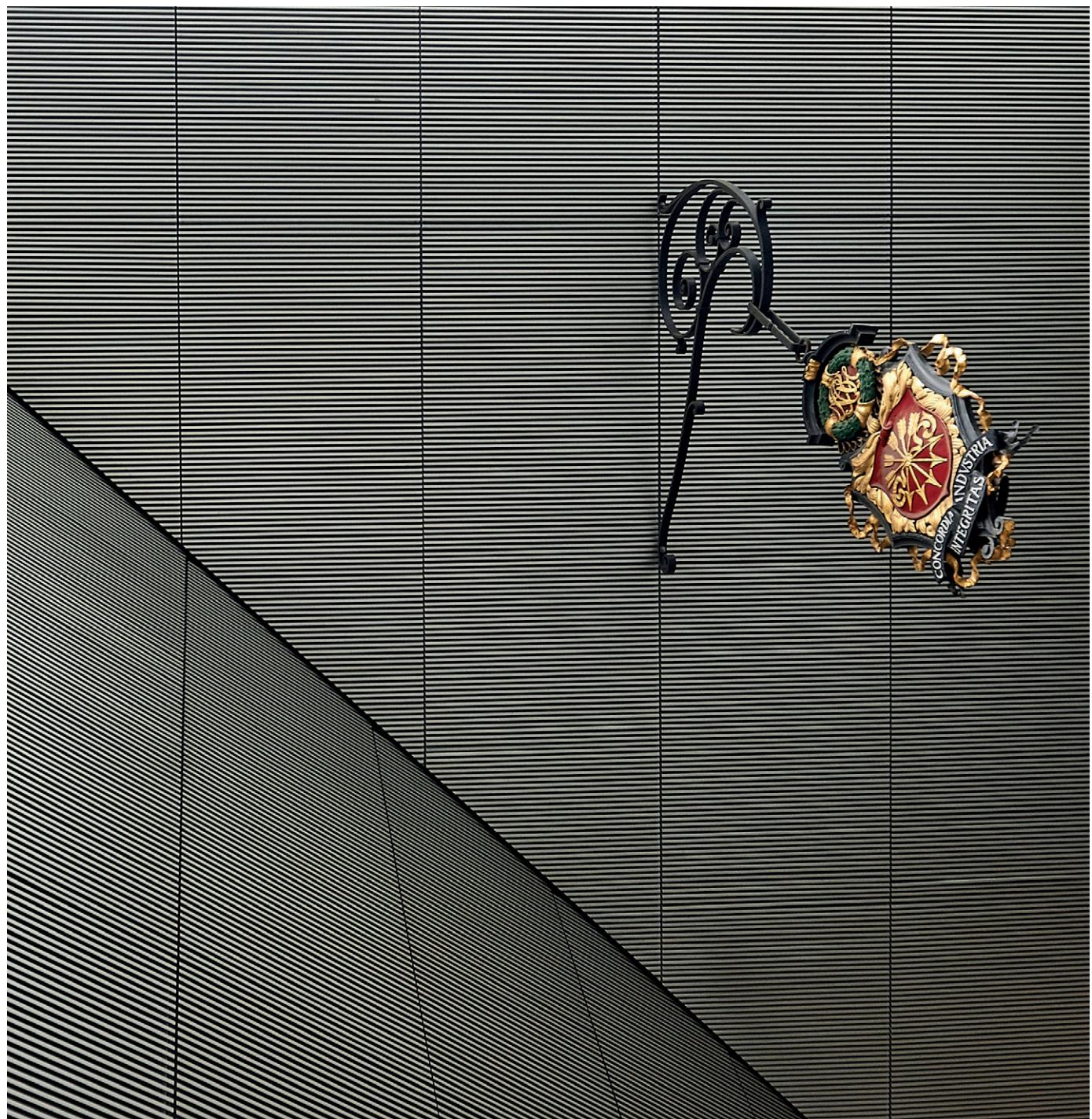




# Market Perspective

While we were away | US election brief

Issue 121 | September 2020



# Foreword

Disappointingly high contagion rates have not yet derailed economic recovery. Thankfully, fatality rates seem to be staying subdued, helping governments as they try to avoid renewed wholesale lockdowns: if they manage to do so, there are no obvious constraints on continuing growth.

Consumers sound nervous but seem to be spending again. Labour market support is being withdrawn, but slowly, and at higher levels of employment than feared. Those confident predictions of sustained mass unemployment may have been premature.

Most other policy support is unlikely to be withdrawn soon – indeed, the Federal Reserve (Fed) is sounding even more doveish than it was, and where the Fed leads other central banks often follow.

If anything, we worry that central banks may be too lenient. Keynesian groupthink says low inflation must mean low growth, and so is a "Bad Thing". But the cycle that just ended saw both low inflation and full employment, and so might the next. Monetary populism risks killing the goose that laid the golden egg of non-inflationary growth: inflation cannot be fine-tuned in the way central bank models imply.

Market-wise, we suggested last month that it might be too soon to bet on a widespread rotation away from US and growth stocks. After August's further surges, the current setback is unsurprising, though its mechanics may tell us more about our industry's ongoing love affair with derivatives than about stock valuations generally.

A possible trigger for a lasting rotation would be a rethink on interest rates. A change at the White House might be another, though as we note in the second essay, Biden's policies might not have as big an impact as feared – and he may yet snatch defeat from the jaws of victory.



**Kevin Gardiner**

Global Investment Strategist  
Rothschild & Co Wealth Management



Cover:  
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# While we were away

Contagion, economic revival, tech reverse and monetary populism

*"The point is that the media likes to predict impending doom, preferably with a firm date attached. And there is something about human psychology that makes us want to believe it."*

**False Alarm, Bjorn Lomborg**

## COVID update

Contagion varies widely. China has recently been reporting fewer than 100 new cases a day (Wuhan held an eyebrow-raising mass musical pool party in mid-August), but India is reporting around 80,000.

The global picture shows new cases stabilising but not falling much since late July (figure 1 is adjusted for population). The developed world profile reflects a long first wave in the US added to a fading in Europe. More recently, US contagion seems to have turned down in August, as Europe's second wave emerged. However, developed world fatality rates have fallen materially since the spring, reflecting a younger age group being infected, better treatment and/or more testing.

Ongoing social distancing – which has not stopped economic recovery – may restrain contagion. Governments are understandably reluctant to reintroduce tougher measures: costs are more visible, voters less compliant and the virus a little less dangerous. Global reopening may continue even without a vaccine (which will take time to distribute anyway).

## Uneven but ongoing economic recovery

In August, some indicators suggested the recovery was weakening. However, growth rarely proceeds in a straight line even in normal times. More recent data have been firmer, despite that disappointing contagion picture.

The US has replaced half the jobs lost. Reduced unemployment pay has not yet hit US consumers' spending, and may even have spurred the return to work (many workers had been better off out of work). That said, as noted, the US rebound is very uneven. Retail spending has hit new highs, but some services continue to languish (figure 2).

Global indicators have risen further, and many estimates of the damage done to GDPs and corporate earnings in the second quarter turned out to be overly pessimistic. You wouldn't know it. Whatever you think the media's political bias might be, it is firmly tilted towards the sensational.

For example, in reporting the 20% fall in second-quarter UK GDP, the news factories quietly forgot their mid-April headlines in which the unlucky Office for Budgetary Responsibility predicted a 35% drop. To mislay almost a fifth of current-quarter GDP may be the biggest and gloomiest short-term forecasting mistake ever, but there were no headlines proclaiming "Economy was an order of magnitude less grim than we told you it was". Easy to miss too was the detail showing a sharp turnaround within the quarter (though as in the US, recovery is highly uneven).

Specific anecdotes can also mislead. If a firm makes 1,000 people redundant, it issues a press notice; but if 100 small companies hire (or re-hire) 10 people each, they don't.

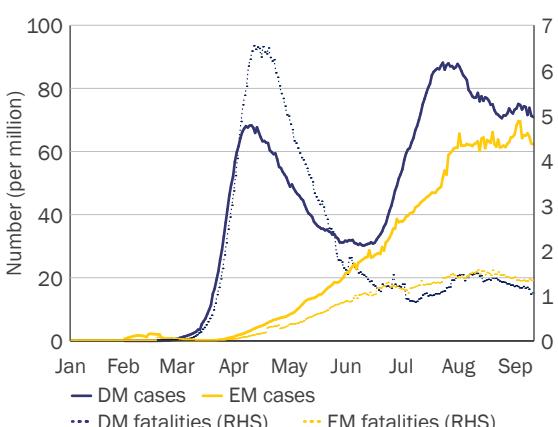
Overall, we still think this alarming downturn, already unusual in so many ways, may prove a relatively short one. As we suggested a month ago, things may be "moving on".

## Sector rotation: are we there yet?

We suggested a month back that US technology and growth stocks overall were expensive, but not a bubble. They rose sharply further in August, and the market rally – led by the famous five (FAAAM) stocks – became even more concentrated. We

**Figure 1: COVID-19 update**

Reported new cases and fatalities (population-adjusted, 7-day moving average)



Sources: WHO, Rothschild & Co.

Past performance should not be taken as a guide to future performance.

DM (Developed Market) group includes US, Italy, Spain, UK, Sweden, Germany, Japan, South Korea and France.

EM (Emerging Market) group includes India, Brazil, Mexico, Russia, Venezuela, South Africa, Argentina and Turkey.

buy the idea of “looking across the valley”, but this was looking a long way rather quickly.

A setback unsurprisingly arrived. Is this the big rotation we discussed? The US market, growth stocks and the dollar have had multi-year runs, and no tree grows to the sky. Are other regions, sectors and currencies about to take the lead? Or is this just more short-term volatility and profit-taking of the sort seen several times already?

Safe-haven assets like bonds and gold have not responded much. The dollar has actually rallied: it often does when stocks fall, but doing so now argues against a wider rotation, for the time being at least.

Derivative trading (by big institutions, not just retail investors) seems to have been especially active. Implied volatility indices, which reflect the cost of traded options, rose alongside stocks, which doesn't happen often. Was the derivatives tail wagging the market dog, with option writers buying cash securities as hedges? Hardly edifying, but not suggestive of a bigger picture either.

A rotation is likely at some stage, and may not be as friendly as it sounds. If profits are taken before funds are reinvested, the overall market may be hit. But without crazy valuations, a trigger may be needed – such as a rethink on interest rates (as we said last month, good luck with that), a change at the White House (see below) or a vaccine. We get there when we get there.

### Monetary populism

Even with interest rates low and bond-buying high, central banks have been looking for new ways of stimulating demand. Now the Fed says it will target an average inflation rate, and worry about employment only when it is unusually low, not high.

This means that if inflation has been running below the 2% target for a while, the Fed will not tighten policy as soon as it returns to target, but wait for it to overshoot for a while too. And it will only be influenced by economic activity (that is, employment) if it has been weak.

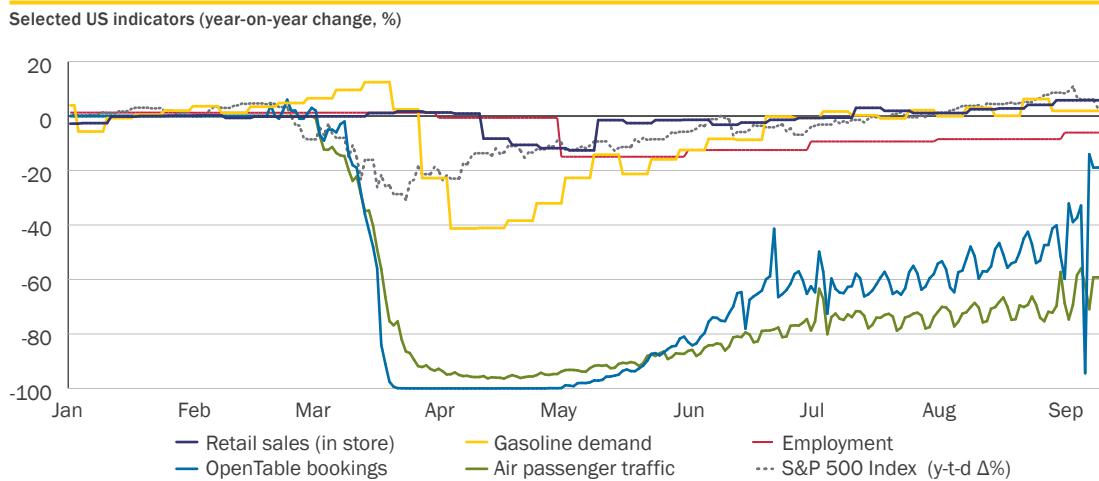
Arguably, the Fed has always targeted average inflation: the issue is over what period. Effectively, it will now aim to allow inflation, and the real economy, to run hotter for longer.

Intent is not outcome. As (Lord) Mervyn King notes: “Above all, there’s the question of credibility. If the Fed has tried hard and failed to push inflation up to its 2% target, why would markets believe it would succeed in going further? Olympic high jumpers who fail to clear 2 metres on their first two attempts do not then ask for the bar to be raised to 2.5 metres.”

We have deeper misgivings. Nobody understands inflation very well, and monetary credibility is easier to lose than to gain. The risk may feel small right now, but central banks don’t need to take it. We might sympathise if economies were not reviving – though even then, what could any monetary policy achieve if consumers are not allowed out to work and spend? But recovery is underway.

We can *imagine* another non-inflationary cycle, like the last. We would relish a late-1800s mix of supply-led growth and deflation, which could boost both bonds and stocks. But for now we think longer-term inflation risks remain, and are positioned for them by holding few conventional bonds. Central banks are taking their targets – even as averages – too literally. Inflation cannot be fine-tuned in the way their models suggest, and it could be dangerous as well as unnecessary to try.

**Figure 2: An uneven rebound**



Sources: Bloomberg, Redbook Research, BLS, OpenTable  
Past performance should not be taken as a guide to future performance.

# US election brief

## Circumstances matter more than presidents

In September 2016 we suggested the presidential campaign then underway was the noisiest in recent memory. It seems 2020's campaign – the 59<sup>th</sup> – may have eclipsed it: the pandemic, renewed trade quarrels, civil unrest and strident personality politics are all playing a part in this heated race.

Joe Biden's near double-digit lead in the polls – sustained since early June (figure 3) – suggests he has a good chance of beating President Trump on 3<sup>rd</sup> November. The opinion polls are by no means decisive: Clinton's experience in 2016 exposed the shortcomings and biases in such data. But his national lead is bigger than hers at this stage, and he has been ahead in several swing states, boosting his chances in the electoral college, though his leads there have narrowed recently.

For investors, such a change at the White House could herald a significant change in US economic and financial policies, stock market leadership and the US's international investment appeal.

Of his more contentious election pledges, higher corporate taxes may be the biggest threat for investors, alongside a more intrusive stance on drug pricing, oil exploration and financial regulation – in some cases reintroducing regulation repealed by the Trump administration. His proposal to challenge technology stocks'

dominant market positions threatens the relatively narrow stock market recovery, though they are already facing scrutiny under the current administration.

### Four more years?

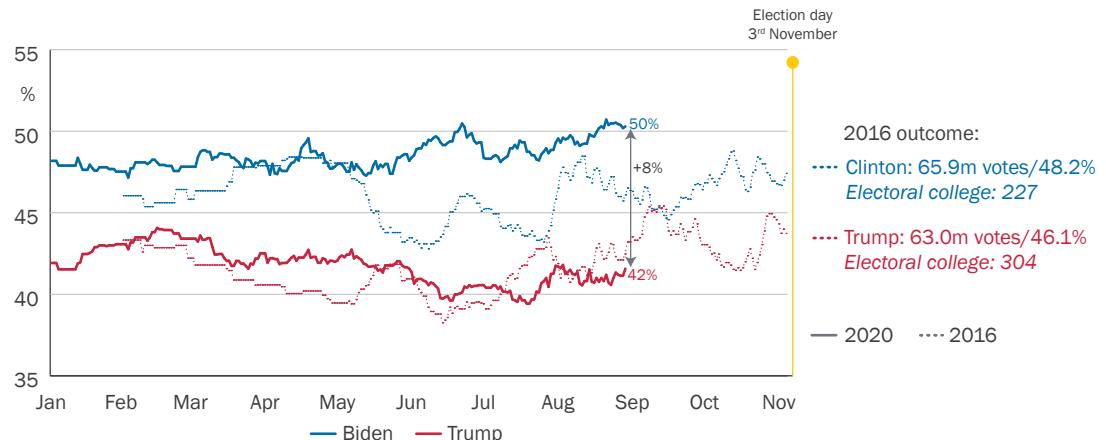
In narrow investment terms, President Trump has had a noisy but ultimately unremarkable four years in the Oval Office. US equities have returned a respectable 13% a year (after inflation), despite the COVID-19 crisis – a figure that compares favourably with the post-WWII average of 9% a year.

The combination of low inflation and interest rates, respectable growth and low unemployment (the suppression of COVID-19 aside) and business tax cuts all helped the market. The Tax and Job Cuts Act of 2017 – the first major change to US taxes since an almost-as-idiomatic Ronald Reagan's first term – is arguably Trump's major legislative success.

On other pledges, his 'Contract with the American Voter' has been less successful. Grand infrastructure proposals, educational reform, Obamacare repeal and revised immigration policies failed to pass muster with Congress. There has been ongoing brinkmanship, including the longest ever US government shutdown at the start of 2019. The Wall wasn't built and Mexico didn't pay for anything.

**Figure 3: US voting intentions**

National opinion polls in 2016 and 2020 campaigns



Sources: Bloomberg, Rothschild & Co.  
Past performance should not be taken as a guide to future performance.

Meanwhile, Trump's focus on realpolitik and a mercantilist 'America First' policy has accelerated the US's retreat from the international stage and prompted a departure from key supranational organisations and environmental accords.

In this context, the possible shift to a more collectivist, but internationalist, outlook may not seem threatening (figure 4), particularly when you remember that a Democrat in the White House does not necessarily translate into poor economic and investment performance.

#### Biden: Less economic nationalism?

Biden's pro-regulatory stance should be seen alongside pledges to promote social equality, green initiatives (including \$2 trillion spending on clean energy by 2035), new infrastructure spending and a less hawkish stance on China. It may also revive the US's role on the international stage – a possible resumption of global leadership, and a return to economic integration and multilateralism generally.

There may well be some market unease – higher taxes would hit corporate profits hard: increasing the corporate tax rate might hit full-year earnings by ~10%. But other developments might offset the hit for investors, as has happened in the past. On the half dozen occasions that corporate income tax rates were increased in the post-war period, the S&P 500 was up, on average, in the 12 months that followed.

The chances of this happening may be helped if, as seems likely, the proceeds of higher taxes were largely recycled into higher government

and consumer spending, supporting business revenues. In the longer term, infrastructure and environmental initiatives could foster more sustainable growth.

The starting point is a marginal US corporate tax rate toward the lower end of the OECD range (figure 5). Effective US tax rates are even lower.

As we've noted often, context matters as much as any president's political complexion. There are many moving parts in the US and global economy, and domestic politics are not the only driver of investment returns, as this year has very visibly shown. Moreover, election manifestos are rarely fully implemented, and a Democratic clean sweep of Congress – far from certain – will be required for some of the more contentious policies.

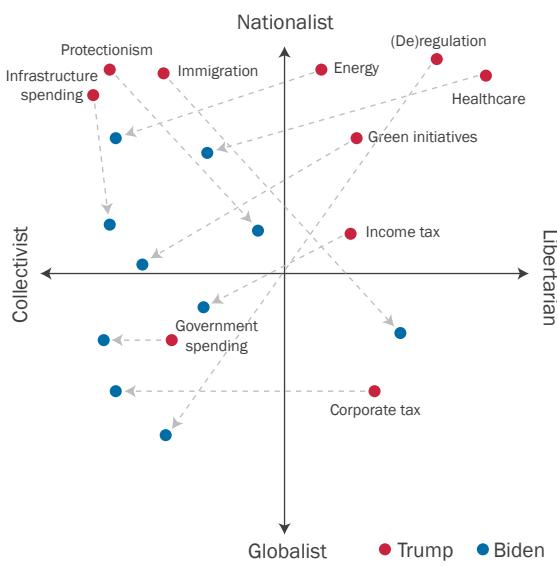
Our investment advice, then, would be to recognise the potential changes in policy; ensure that portfolio insurance is in place; but wait for more clarity, and stay open-minded about the evolving wider context.

After all, there is no such thing as a safe bet in politics, as in investing. With almost two months to go, ongoing economic recovery and vaccine-related developments could shift sentiment and those unwavering opinion polls.

So too could a Democratic party that may have forgotten Politics 101. If your opponent is at one end of the political spectrum, you don't beat them by going in the opposite direction, but by moving closer to the middle.

**Figure 4: Stylised policy compass**

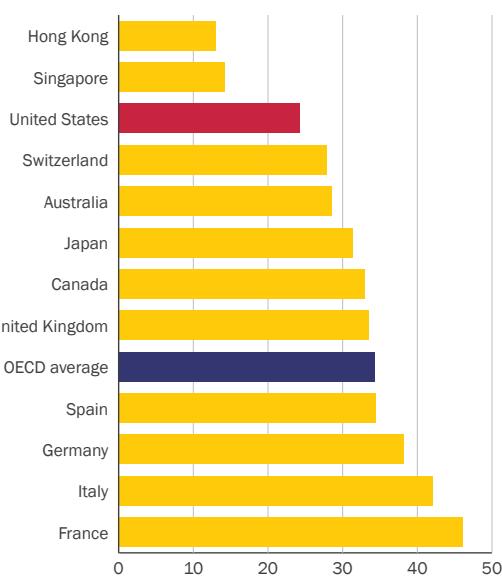
A stylised qualitative interpretation of the direction of travel in which selected policies would move under a Biden presidency



Source: Rothschild & Co.  
Past performance should not be taken as a guide to future performance.

**Figure 5: US tax rates are low**

2018 tax revenues as a proportion of GDP (%)



Source: OECD, IMF, Rothschild & Co.  
Past performance should not be taken as a guide to future performance.

# 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

## Stocks/bonds – relative return index (%)



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	0.7	9.0	19.3
10-yr UK Gilt	0.2	2.9	10.7
10-yr German bund	-0.5	-1.3	7.4
10-yr Swiss Govt. bond	-0.5	-3.6	2.5
10-yr Japanese Govt. bond	0.0	-2.2	0.4
Global credit: investment grade (USD)	0.9	3.8	15.3
Global credit: high yield (USD)	5.8	3.5	11.9
Emerging (USD)	4.1	5.1	14.3

Source: Bloomberg, Rothschild & Co

## Selected exchange rates

Trade-weighted indices, nominal (2000 = 100)

	Level	1yr (%)	3yr (%)
US Dollar (USD)	110	-0.5	8.0
Euro (EUR)	132	5.9	5.7
Yen (JPY)	96	-1.1	6.3
Pound Sterling (GBP)	78	2.8	4.0
Swiss Franc (CHF)	168	4.1	7.9
Chinese Yuan (CNY)	131	3.0	-1.2

Source: Bloomberg, Rothschild & Co

Data correct as of  
31<sup>st</sup> August 2020.

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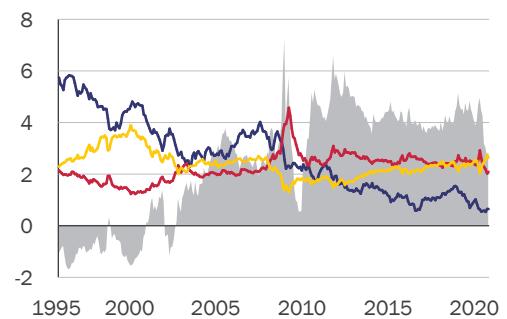
## G7 inflation

%, year-on-year



Source: OECD, Bloomberg, Rothschild & Co

## Stocks/bonds – relative valuations



Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

## Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

	Yield (%)	1yr (%)	3yr (%)
World: all countries	2.1	8.8	26.5
Developed	2.1	8.3	27.8
Emerging	2.3	12.6	16.3
US	1.7	14.6	42.5
Eurozone	2.3	-4.9	0.7
UK	4.2	-17.4	-11.7
Switzerland	2.8	2.2	23.5
Japan	2.4	7.9	10.7

Source: Bloomberg, Rothschild & Co

## Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	146	-15.4	-19.4
Brent crude oil (\$/b)	39.8	-35.4	-26.0
Gold (\$/oz.)	1,939	28.7	44.0
Industrial metals (1991 = 100)	250	0.7	-3.9
Implied stock volatility: VIX (%)	31.5	109.7	159.6
Implied bond volatility: MOVE (bps)	50.7	-35.7	-7.6

Source: Thomson Reuters, Bloomberg, Rothschild & Co

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**Dusseldorf**  
Heinrich-Heine-Allee 12  
40213 Dusseldorf  
Germany  
+49 211 8632 17-0

**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

**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**  
Passaggio Centrale, 3  
Milan 20123  
Italy  
+39 02 7244 31

**Zurich**  
Zollikerstrasse 181  
8034 Zurich  
Switzerland  
+41 44 384 7111

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