Rothschild & Co
Wealth Management

MARKET PERSPECTIVE | NOVEMBER 2022

The old normal

Foreword

The UK, unusually, has been centre stage for global investors this last month. They – and we – have been transfixed by a richness of embarrassments, and by a gilt market rout that reportedly (we have our doubts) threatened global financial stability.

Things have moved on, and remarkably quickly. But for the record:

- The fiscal fiasco known as the "mini budget" was divisive, incoherent and inarticulate, and landed after another equivocal increase in UK interest rates. But it did not crash the economy, or render the UK's public finances unsustainable. Defined benefit pension schemes' solvency improved even as their liquidity fell.
- Natural gas prices were falling even as the outgoing administration unveiled its costing of the energy bill relief scheme – the main component of the fiscal event, accepted as necessary by almost everyone.
- Most of the contentious measures have been quickly shelved, gilts have rallied strongly, and the pound is above its five-year average against the euro. The new administration may be talking itself needlessly into an austerity mindset. The Office for Budgetary Responsibility had already cut its projected debt ratio in 2025 by almost 20 percentage points of GDP, though they may not be quick to point this out when the Autumn Statement is delivered on November 17th.
- The UK economy has not been materially underperforming its peers of late. It has not suddenly gone ex growth.

This doesn't mean the UK is one of our favourite stock markets, and while the 30-year gilt yield was briefly attractive at 5%, it is less compelling at 3.5%.

In other news… projected interest rates on both sides of the Atlantic have been back at what we used to think of as 'normal'. They might yet overshoot for a while, not least because inflation has yet to peak and economies are still slowing rather than collapsing, but global stock and (increasingly) government bond valuations suggest that long-term inflation-beating returns are available from today's levels. Tactically, however, cash still has its attractions. We doubt a slump lies ahead, but near-term earnings risk is clearly still high.

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Image sources: British banknote
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Threats to growth: turning a corner?

Two things are driving the widespread belief that we face a major economic downturn: the squeeze on real wages caused by energy and food costs, and the normalisation of interest rates as central banks repair their tattered monetary credibility. Other actors are playing supporting roles, but these are the two leads.

The surge in primary costs may have peaked, as we note below. European natural gas prices in particular have gone sharply into reverse since August, as even the UK's BBC has now reported. There is no guarantee food and gas prices will not rebound of course – but there is no long-term shortage of commodities and energy globally, and the more time that passes, the more likely it is that additional supply, substitution or adaptation will pull them back down again.

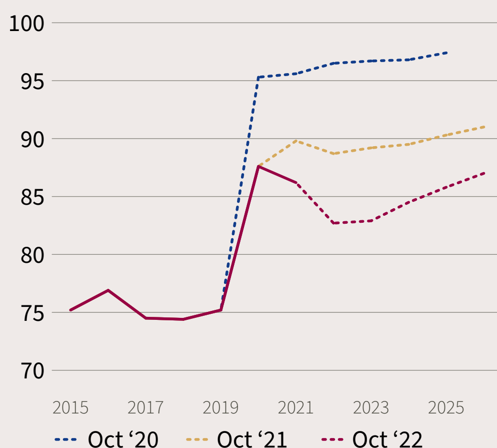
Meanwhile, support for hard-pressed households and businesses is being put in place by governments which can afford to borrow to do so. Talk of government finances being unsustainable is mistaken, whether in Italy, the US or even the UK, where the establishment response to the fiscal fiasco that was the "mini-budget" was almost as embarrassing as the event itself (figure 1).

Prospective interest rates – the rates embedded in current money market curves – have now risen a long way on both sides of the Atlantic, and have recently been at levels that are indeed what we used to think of as 'normal' (figure 2). They could easily overshoot these levels – after all, they have just undershot them for a decade or so – but if those price pressures do abate, they are unlikely to do so for long.

Wages have not responded as they could have – that's why we're facing that squeeze – and the routine addition of new capacity (and the existence of prematurely 'resigned' workers) may allow core inflation also to start to slow in 2023. If nominal rates do peak close to recent levels, in real terms they will have remained historically low. This is little comfort for people facing daunting increases in mortgage bills – but most US and UK households (for example) are not (and will not be) in that situation. And as we noted last time, there is a lot of short-term wiggle room in the economy: disposable income and spending do not move in lockstep or often even in the same direction, for example.

FIGURE 1: DEVELOPED GOVERNMENT DEBT RATIOS

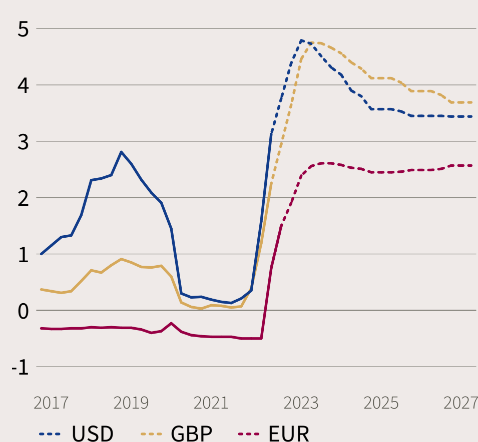
Net government debt as a % of GDP



Source: Rothschild & Co, IMF

FIGURE 2: MARKET-IMPLIED POLICY RATES

Overnight index swap (three-month tenor), %



Source: Rothschild & Co, Bloomberg

None of this means there isn't a downturn. But we still think a major setback is not inevitable. If today's global economy is not as intrinsically inflationary as it used to be, and if monetary policy, though inept, has not been as reckless as it could have been, then perhaps there doesn't need to be one.

Since we last published *Market Perspective*, the data have continued to point to a slowdown rather than collapse. Indeed, in China and the US, growth actually accelerated in the quarter just ended, though we doubt this will do much to improve deteriorating sentiment towards China's stock market. The IMF's updated forecasts seem to agree with us (though maybe we shouldn't be reassured by that). In 2009 and 2020, for example, the major economies shrank by 3.7% and 4.8% respectively, while it is quite possible that collective growth will have been positive in 2022, and may yet stay so in 2023.

INVESTMENT CONCLUSION

In investment terms, we think the main question now is when to buy, not when to sell. We have not advocated buying government bonds for many years, but yields more recently – particularly in the US, Italy and the UK – have been at levels that we think can beat even the more elevated inflation that may characterise the next decade or so, and we are less wary than we were. Stock market valuations have recently looked positively inexpensive, and we think offer more convincingly positive real long-term returns. But we doubt that interest rate and corporate earnings risk have quite peaked yet, and for the time being still think cash has most going for it tactically. As we have noted here often, cash is less volatile – even in real terms – than both stocks and bonds.

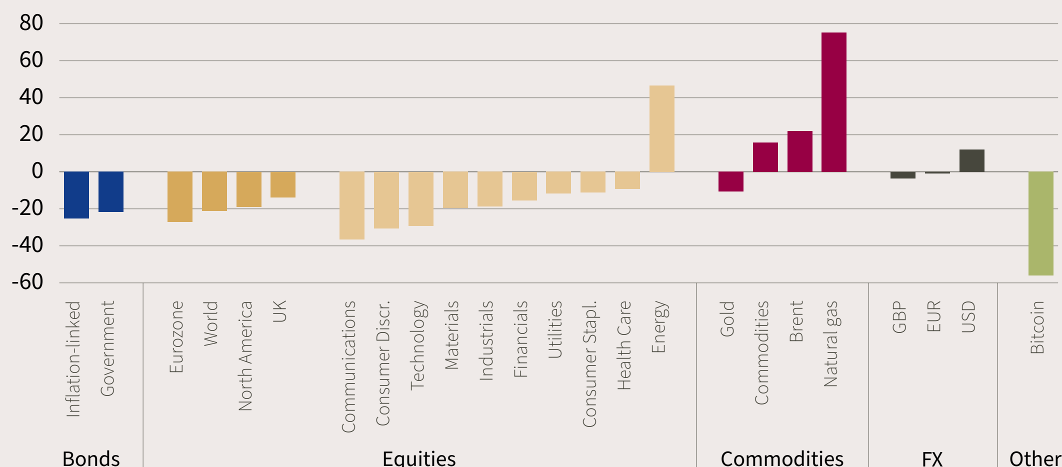
Interest rates and earnings are not the only sources of continuing tactical risk of course. This has been a torrid year (figure 3), and the declines in markets could themselves spill into a wider, cascading financial crisis. The risk surfaced visibly perhaps with the (literal) collateral damage suffered by UK pension funds as gilts sold off in September. We discuss systemic risk more carefully below: the key point here perhaps is simply to note that it is government and central bank balance sheets, not banks', that have been growing most of late.

A REINVESTMENT ROADMAP

What key developments might we see as we wait to advise reinvestment? If we are still not quite there yet, what might tell us when we are?

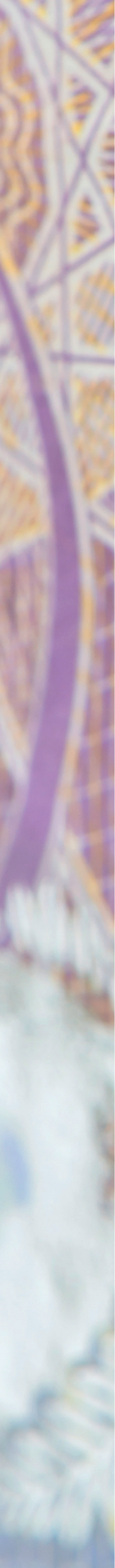
FIGURE 3: CROSS-ASSET RETURNS

Year-to-date, %



Source: Rothschild & Co, Bloomberg

Footnote: Bonds and equities are in US dollar, unhedged total return terms. Commodities are in US dollar terms, except natural gas which relates to eurozone (TTF) futures in EUR terms. FX relates to the JP Morgan Nominal Broad Effective Exchange Rates. Data as of 31st October.



Of course, a catalyst is not always needed: sometimes markets simply turn higher (or lower) for reasons which only become apparent after the event (if then). We get there when we get there, indeed. But the following would be on our list of events that could catalyse a rally (and in current positively correlated and more reasonably valued circumstances, that could mean a rally in both stocks and bonds).

Core inflation turns down

This seems most possible in the US, even with its tighter labour market. The strong dollar might help, as might the reversal of the post-pandemic surge in house prices. For stocks to fully benefit from this requires that the disinflation begins without that major economic setback.

Gas prices collapse (further)

With UK and Dutch front month natural gas futures both having halved since their August peaks, this has arguably happened already. As yet, investors clearly doubt prices will stay low. But if they were to fall materially further again – which is possible, even as winter approaches and attrition continues – one of the biggest threats to growth, and a major contributor to headline inflation, would reverse in direction.

Central banks "pivot"

Clumsy jargon, but a key point: if central banks feel able to signal that they can see the end of their tightening cycle – even if core inflation hasn't peaked when they do so, and even given their weakened credibility – markets will likely take heed. This could favour bonds more than stocks (if weak economic data drive their decision).

Economies start to shrink

Even with core inflation high and central banks quiet, this would likely trigger a big rally in bonds at least as it would suggest that lower core inflation and policy rates are only a matter of time. Government deficits would surge, but the cycle trumps issuance. This would obviously be bad news for corporate earnings, but the improvement in interest rates might be big enough to allow stocks to "look across the valley" as they often do.

Peace breaks out

This would signal reduced tension around energy prices and trade linkages. To the extent that it would mean a marked reduction in growth risk, it might be thought likely to trigger renewed worries about interest rates. However, the increase in risk appetite that would ensue would likely swamp other considerations. Government bonds would benefit from the reduction in headline inflation (and while they are less risky than stocks, of late they have been very volatile, and are more risky than cash).

Reduced tension around Taiwan

This could have the most profound impact: the risk of escalation from rhetoric to action is perhaps the biggest single risk facing the world today. The looming US mid-terms might have offered President Biden a motive for seizing the diplomatic initiative. But unfortunately it also feels the least likely event on our list: China will never give up on its claim, while the US president seems incapable of nuance in addressing it.

The dollar collapses

A turnround in the dollar is more likely to be effect than cause, and we think it may be losing steam now, as US interest rates may be nearing their peak (and global risk appetite approaches a trough). We are not however expecting a more dramatic reversal.

Such a turnround, and for reasons independent of the other considerations above, is possible. The dollar is expensive (it is perhaps 2.5 standard deviations above its 10-year trend in inflation-adjusted terms) and it might yet start to fall simply under its own weight. It would do little directly for European growth, but it would mute earnings risk in the more important US stock market, while reducing inflation and interest rate risk in the more exposed European economies (assuming it does not make the Federal Reserve (Fed) any more hawkish, that is). Emerging markets are not at the centre of this storm, but at the margin a weaker dollar would reduce some borrowing risks there, while boosting global risk appetite.

Inflation: encouraging signs

The inflation backdrop remains worrying at first glance.

Headline inflation rates have only recently started to roll over in some advanced economies (such as the US) but have reached multi-decade highs in others (the UK and eurozone, for instance). Moreover, core inflation has accelerated further (figure 4). The pressure hasn't abated in emerging markets either: similar inflation rates were witnessed just before the financial crisis of 2007–08, and the picture looks more troubling again when China is excluded (figure 5).

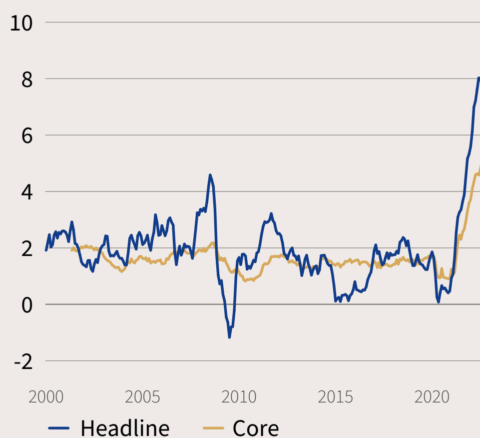
Nonetheless, several brighter spots have emerged.

First, supply chain stress has continued to moderate. One way to track this is by looking at container shipping freight rates, as this form of transport accounts for approximately 80% of global trade volumes. Both spot container rates and container ship charter rates have been declining (figure 6): they are still double the typical pre-pandemic rate, but are now well below last year's levels (which matters more for current inflation rates). Of course, China's Covid-related lockdowns remain a major risk, threatening resumed bottlenecks, but the squeeze on goods prices can continue to ease as transport costs fall and inventories rebuild.

Second, commodity prices have been broadly trending lower which should soften the contribution from food and energy components in consumer price baskets in coming months (core inflation rates may also indirectly benefit from falling production costs). The UN's FAO Food Price Index, for instance, has fallen for six consecutive months in level terms and is only 6% higher than last year's levels. Moreover, oil price benchmarks – Brent Crude and West Texas Intermediate – have rolled over: levels are still elevated in nominal terms, but looming base effects mean the year-on-year changes are approaching 0%. Even natural gas prices have moved sharply lower in recent weeks: several European governments are implementing energy

FIGURE 4: DEVELOPED MARKET INFLATION

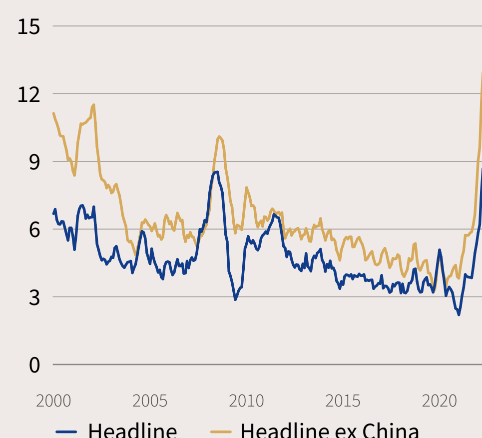
Annual change, %



Source: Rothschild & Co, Bloomberg, Refinitiv Datastream

FIGURE 5: EMERGING MARKET INFLATION

Annual change, %



Source: Rothschild & Co, Bloomberg, Refinitiv Datastream

Footnote: Developed market series is a GDP-weighted average of US, Canada, UK, Eurozone, Switzerland, Denmark, Norway, Australia, Japan, New Zealand and Singapore inflation data. Emerging market series is a GDP-weighted average of China, India, Indonesia, Korea, Malaysia, Philippines, Taiwan, Thailand, Vietnam, Czech Republic, Egypt, Greece, Hungary, Poland, Russia, South Africa, Turkey, Brazil, Chile, Colombia and Mexico inflation data

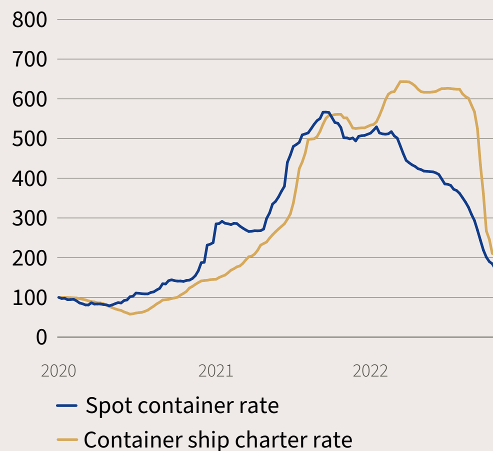
price caps for final users, but more importantly, prices in wholesale markets have themselves now fallen a long way. UK natural gas briefly fell below its pre-invasion price level, while the eurozone equivalent is very close to the same threshold (figure 7).

Third, US house prices have started to reverse their post-pandemic surge amid rising mortgage rates (figure 8). The shelter component in the US consumer price basket is linked to house prices to some degree, as it aims to capture the rental price of "the service that a housing unit provides its occupants". Importantly, shelter CPI accounts for almost one-third of the US inflation basket and it has historically trailed house prices by a year or so (renters often change accommodation on an annual schedule). As a result, we could start to see a meaningful decline in shelter's contribution to US CPI from the second half of next year.

Fourth, and perhaps most importantly, there is still little evidence of a wage-price spiral brewing – in which wages and prices chase each other to ever-higher levels – as nominal pay growth has not been accelerating sharply, and real wage growth has remained firmly in negative territory.

FIGURE 6: SUPPLY CHAIN METRICS

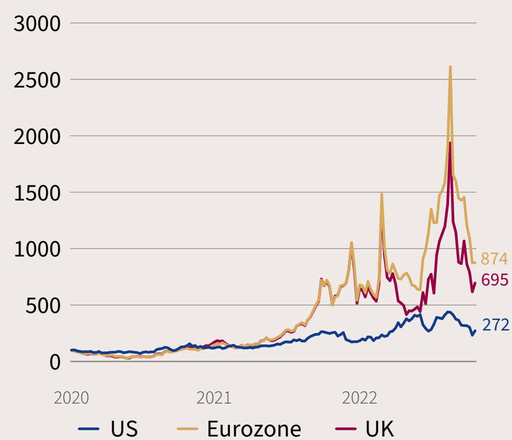
Rebased indices, Jan 2020 = 100



Source: Rothschild & Co, Bloomberg, Refinitiv Datastream, Drewry Research, Harper Peterson

FIGURE 7: NATURAL GAS PRICES

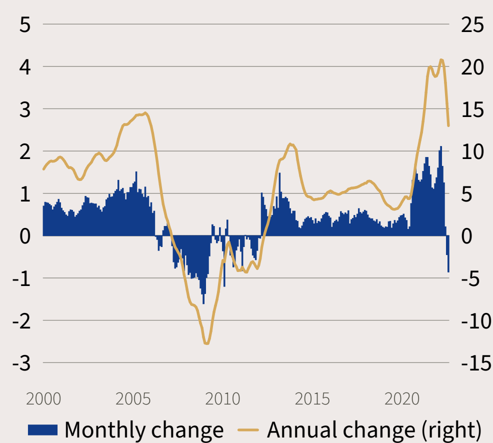
Rebased indices, Jan 2020 = 100



Source: Rothschild & Co, Bloomberg

FIGURE 8: US HOUSE PRICES

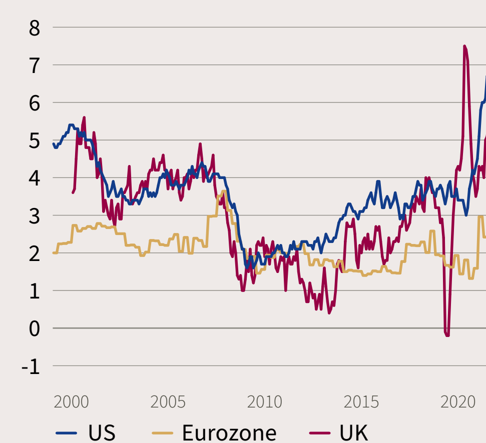
S&P Case-Shiller index



Source: Rothschild & Co, Bloomberg, S&P/Case-Shiller

FIGURE 9: NOMINAL WAGE GROWTH

Annual change, %



Source: Rothschild & Co, Bloomberg, Refinitiv Datastream, Federal Reserve Bank of Atlanta, European Central Bank, Office for National Statistics

There is a possibility that real wage growth turns positive again when headline inflation rates start to fall, but as noted, *nominal* wage growth seems somewhat unremarkable: it has already rolled over in the US, while eurozone wage growth looks little different to the pre-pandemic period (figure 9). The UK data is perhaps the most eye-catching: wage growth has recently reaccelerated, but is still at relatively modest levels, remarkable perhaps given this year's talk (and partial reality) of spreading industrial action.

Overall, 1970s-style wage-price dynamics have not yet taken hold (we've doubted they would, or will). This may partly be explained by structural differences: unionisation rates are much lower nowadays; management practices are better; labour supply has been augmented by China's workforce; the product range is less tangible; the workplace is more atomised.

This does not mean we are out of the woods yet. Even if we are, the trajectory back to 2% inflation is unlikely to be a smooth or rapid one. Nonetheless, the signs are encouraging. We continue to think that inflation is likely to settle in the above-target 2–4% range in the medium term. This would be uncomfortable for central banks, but manageable for businesses – and a lot lower than today.

Canaries in the coalmine: looking for systemic risk

"We are prone to overestimate how much we understand about the world and to underestimate the role of chance in events. Overconfidence is fed by the illusory certainty of hindsight."
Daniel Kahneman (*Thinking, Fast and Slow*)

With markets recently in turmoil, systemic risks may be mounting, raising the possibility that this economic event might yet turn into a financial crisis. UK pension funds have faced margin calls; money markets face funding stress; and there may be emerging risks within the 'shadow banking' system (and in one high profile case, within the formal European banking system too). The IMF's latest Global Financial Stability report warned of a "series of cascading shocks" that could erode financial stability.

In the past, the most damaging economic downturns have emerged from banking crises and the failure of large systemically important institutions, through to less visible threats, such as the improper functioning markets or the collapse of infrastructure. Collective euphoria, policy missteps, lax regulation and financial innovation have all played their part. The Global Financial Crisis (GFC) was a case in point - borne of excessive leverage within the real estate sector and poor collateral oversight, a liquidity crisis quickly became a solvency issue precipitating the collapse of Bear Stearns and Lehman Brothers.

So how worried should we be?

The last month's turbulence within the UK government bond (gilt) market and pensions sector has been perhaps the most visible risk to date. Reckless fiscal policy may have not been the sole cause of gilt market volatility – we think that a hesitant Bank of England (BoE) may bear some responsibility - but this catalyst was sufficient to expose excessively leveraged "Liability-Driven Investment" pension funds with inadequate liquidity. The risk of more vicious feedback loops – as pension funds sold more bonds to satisfy margin calls, precipitating even higher gilt yields – led to temporarily renewed bond purchases by the BoE as it sought to contain such risks.

While the UK's credibility has been tarnished, a doom-loop in gilts has been avoided. The ripple effects to other asset classes - including real estate holdings (some open-ended property funds have been gated – again), as well as corporate bonds and securitised debt (including the CLO market and even Australian Residential Mortgage-Backed Securities, apparently) – has been modest. These and other leveraged and illiquid funds may have been coming under pressure from normalising interest rates anyway, independently of the pension fund issue: discount rates and funding costs feature prominently in property and private market funds more widely, and the surge in rates and yields will have caught many offside.

Liquidity issues have also emerged within the much more important US treasury market. They seem largely technical, and may rank lowly amongst the big systemic crises of the past, but the most recent Treasury market dislocation – in March 2020 – led to a temporary seizure in interbank funding markets and a shortage of dollar liquidity, and could yet be repeated.

The normalisation of monetary policy and the withdrawal of liquidity currently is more difficult than usual as massive amounts of Quantitative Easing (QE) are unwound – the Fed is slowly shrinking its huge balance sheet through asset sales (Quantitative Tightening). Less obvious is a change in the market structure in recent years: fewer banks (or 'market makers') are willing to intermediate such transactions – a legacy of the GFC's tighter capital requirements.

Measures of liquidity stress have risen, but not yet a scale that roiled markets back in the first wave of the pandemic, let alone the GFC. The Treasury eurodollar (TED) spread, a measure of tension in interbank funding markets, or the FRA-OIS spread, a measure of money market liquidity, have moved by less than 30bps during this latest episode (figure 10).

Initiatives to improve the depth of this market are afoot: the US Treasury (rather than the Fed) is exploring repurchasing its own bonds – an unusual move that might involve buying where liquidity is thin and issuing new bonds where it is more plentiful (perhaps at shorter dated tenors). At the same time, the Federal Reserve is set to retain its major (repo) liquidity facilities, providing an alternative temporary source of cash for holders of treasuries, who otherwise would have to sell those holdings on the open market. The existence of such a backstop suggests these are not yet systemically critical concerns.

THE SHADOW BANKING SYSTEM

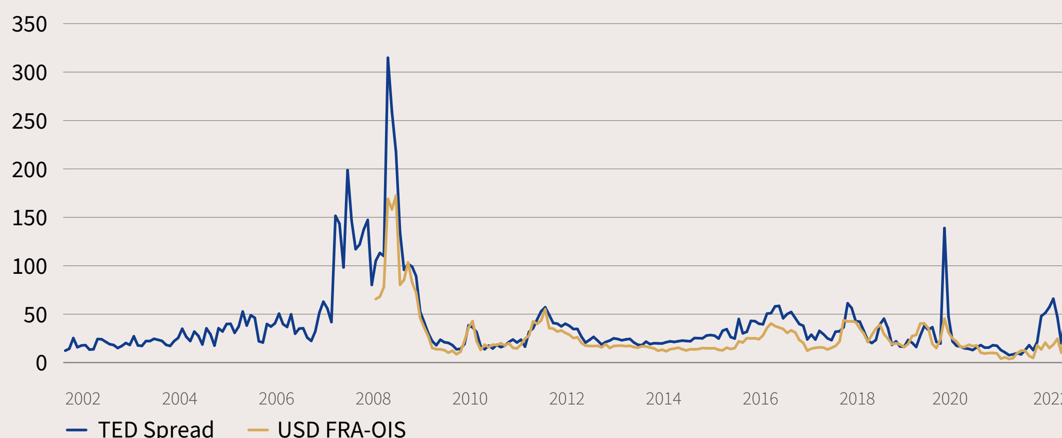
One area that has long been a source of concern to regulatory bodies – a 'known unknown' – is the growing non-banking financial sector. These institutions – which are subject to little oversight from regulators (unlike banks) – typically undertake some sort of financial intermediation role, perhaps extending credit or facilitating securitisation. The BIS estimate that they now represent half of all financial assets globally (and a majority in Europe), and this growing interconnectedness, alongside their opacity and complexity, is a plausible threat to financial stability.

Indeed, pension funds may not strictly form part of the catch-all definition of 'shadow banks', but the vulnerability of leveraged liability-driven investment strategies (which are not limited to the UK market) highlights these less visible risks in the financial sector. Life assurance groups across Europe may face similar pressures where they have issued guaranteed-return products. Such risks are not easily quantifiable: data is patchy. The increasing emphasis on understanding the various counterparty links and introducing more robust regulation may however mute such risks.

Elsewhere in the 'shadow banking' system, hedge funds are often posited as a source of potential contagion. We think this is unlikely: collectively, leverage in the sector is likely low, inasmuch as its poor overall returns would have been much higher had it been investing borrowed money during the last decade.

FIGURE 10: LIQUIDITY STRESS

Treasury-eurodollar and FRA-OIS spreads



Source: Rothschild & Co, Bloomberg

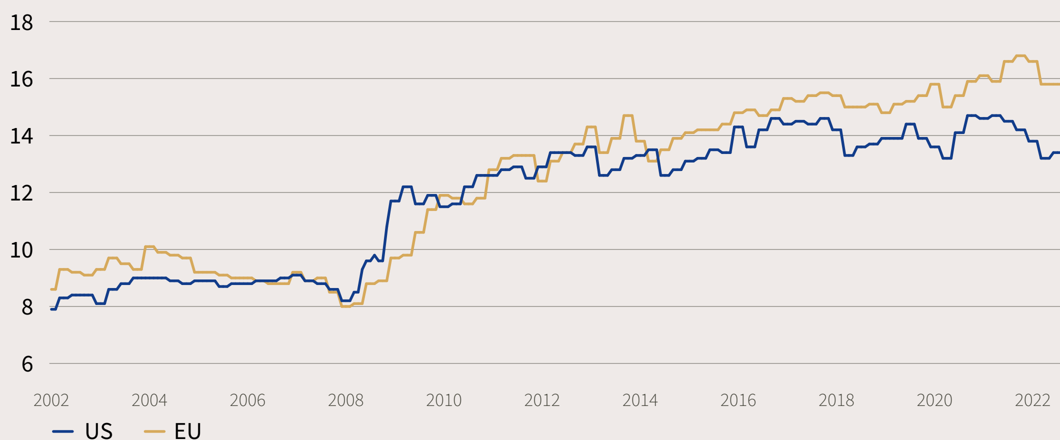
More optimistically, the risk of a collapse in the conventional banking system – the most dangerous form of contagion – seems relatively low. Bank balance sheets are stronger and more liquid than they were at the time of the last financial crisis in 2008 – for example, European bank's Tier 1 Core capital ratio is twice its GFC level (figure 11). Bank lending has simply not been that big in the last decade.

An individual insolvency may yet trigger a widespread contraction in credit and liquidity, but the most visible case in point currently is well-known and likely largely provided-for on its creditors' and remaining counterparties' balance sheets.

Of course, banks themselves might decide autonomously to stop lending, but for the time being money market spreads – as well as credit spreads and credit default swaps (CDS) (figure 12) – which measure the cost of insuring against default have widened only modestly. Famous last words, perhaps, but we think the banking system is far safer now than in 2007.

FIGURE 11: LEVERAGE

Tier 1 Capital Ratio (Capital to RWA), %



Source: Rothschild & Co, Bloomberg

FIGURE 12: CDS

5-year senior CDS, average of big banks

Source: Rothschild & Co, Bloomberg

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, %

— Headline — Core

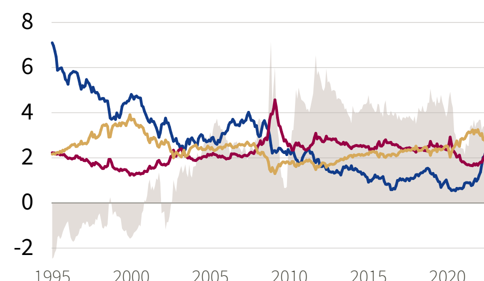
Source: OECD, Bloomberg, Rothschild & Co

STOCKS/BONDS — RELATIVE RETURN INDEX (%)

— Developed stocks/Government bonds

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

STOCKS/BONDS — RELATIVE VALUATIONS



— Government bonds: redemption yield (%)
— Developed stocks: price/book ratio
— Developed stocks: dividend yield (%)
Developed stocks: earnings yield – bond yield

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	4.0	-15.9	-11.2
10-yr UK Gilt	3.5	-16.1	-16.8
10-yr German bund	2.1	-15.7	-17.0
10-yr Swiss Govt. bond	1.1	-7.9	-10.7
10-yr Japanese Govt. bond	0.2	-1.3	-2.6
Global credit: investment grade (USD)	3.8	-12.0	-8.3
Global credit: high yield (USD)	10.0	-14.4	-5.1
Emerging (USD)	8.5	-21.1	-15.7

Source: Bloomberg, Rothschild & Co

SELECTED STOCK MARKETS

Dividend yields, recent local currency returns (MSCI indices)

	YIELD (%)	1YR (%)	3YR (%)
World: all countries	2.3	-15.2	21.3
Developed	2.2	-13.9	24.8
Emerging	3.5	-25.2	-2.8
US	1.7	-16.1	32.6
Eurozone	3.4	-15.1	4.5
UK	4.1	3.4	8.0
Switzerland	3.0	-12.0	8.3
Japan	2.5	-3.3	23.9

Source: Bloomberg, Rothschild & Co

SELECTED EXCHANGE RATES

Trade-weighted indices, nominal (2000 = 100)

	LEVEL	1YR (%)	3YR (%)
US Dollar (USD)	121.1	13.1	10.5
Euro (EUR)	126.2	-2.0	1.9
Yen (JPY)	74.1	-15.1	-21.3
Pound Sterling (GBP)	80.0	-3.2	1.5
Swiss Franc (CHF)	178.4	5.8	12.1
Chinese Yuan (CNY)	142.9	1.0	11.8

Source: Bloomberg, Rothschild & Co

COMMODITIES AND VOLATILITY

	LEVEL	1YR (%)	3YR (%)
CRB spot index (1994 = 100)	273	14.3	52.9
Brent crude oil ($/b)	95.8	13.6	55.5
Gold ($/oz.)	1,645	-8.6	10.2
Industrial metals (1991 = 100)	312.7	-12.8	24.8
Implied stock volatility: VIX (%)	25.8	55.8	96.4
Implied bond volatility: MOVE (bps)	144.6	100.9	114.5

Source: Bloomberg, Rothschild & Co

Data correct as of 31 October 2022.

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

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