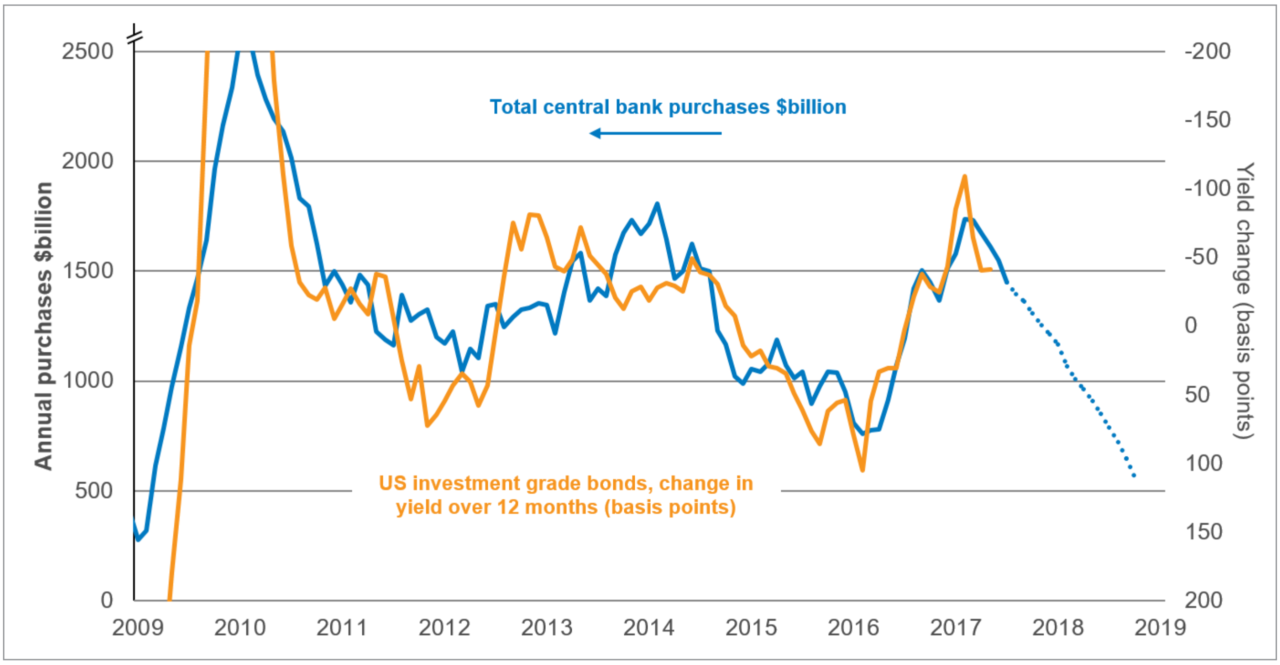
think-tank I 2018
Round Up

Throughout the post crisis period we have held the view that this is a long and sustainable cycle. The slow recovery from the recession has kept inflation subdued and enabled central banks to maintain ultra-loose policy. The environment has supported the corporate sector and risk assets. Our expectations a year ago was constructive on equites but cautious on fixed income, and this has largely played out. This can be seen by the 8% advancement in the MSCI World index, led by the 14% gain in the US market, while other developed markets have been relatively flat and emerging markets have fallen 8%. While in fixed income, bond yields in the US have risen significantly, especially in shorter maturities. An important message last year was that we were approaching a critical crossroads: where monetary policy, the key underpinning the near 10 year bull market, was approaching a major turning point. A year on and we are at that turning point.

Return to Cyclical Normality?

From the beginning of next month the Federal Reserve (Fed) will be shrinking its balance sheet by $50bn per month and the European Central Bank (ECB) will halve its asset purchase to €15bn per month after September and will end it completely at the end of the year. That leaves the Bank of Japan as the only Central Bank to continue with Quantitative Easing (QE), although the bank has been pursuing a stealth reduction in its programme. For the first time since the financial crisis we face a net reduction in global liquidity from Central Banks, with majority of that coming from the most important, the Fed. At the same time, the Fed is steadily lifting interest rates; the latest rate hike moved the target range to 2-2.25%, the move marks the eighth rate rise of this current cycle, and up from the low of 0.25%. The Fed is targeting one more rate rise this year and another three next year, which would take the Federal Fund rate to 3.25%.

Figure 1.1 - Quantitative easing is going into reverse



Source: Citi as at September 2017

In the same way that ultra-loose policy has been a powerful tailwind, the reversal of policy is a significant headwind for asset prices. Perhaps more importantly it is a serious problem for any government, company or household that has borrowed too much in the good times.

Every Fed tightening cycle exposes vulnerabilities. In 2007/08 it was the exposure of households and under capitalised banks to the inflated housing market in the US. This time round there are clear pointers to where the problems lie: developing countries. Those with too much debt, particularly shorter term dollar debt, and running fiscal and current account deficits are already suffering. The problem is not insignificant as dollar liabilities globally have increased by $2tn since 2009.

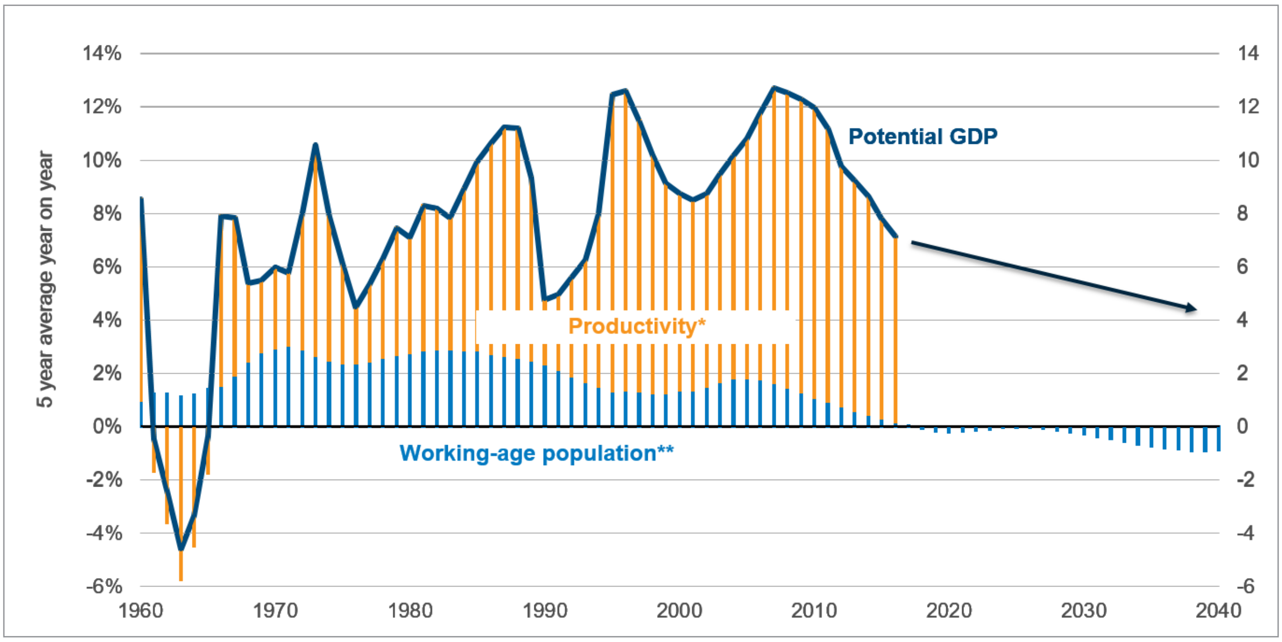
Investors have been voting with their feet: emerging market currencies are down 16% this year, led by the collapse in the Argentinian Peso and Turkish lira, both falling by over 40%. Other currencies including the Brazilian Real, South African Rand and the Russian Rouble all down by close to 20%. Emerging market equities entered bear market territory, with a decline of over 20% from the January peak. Unless the emerging market woes spread and contagion poses a threat to the US economy then it is unlikely the Fed will respond to these events. None of the countries affected to date are big enough to worry either the Fed or other advanced economy central banks.

Emerging markets have been under pressure since the peak in late January and there was a marked deterioration during August, led by the most vulnerable countries, Turkey and Argentina. A toxic combination of factors in the current macroeconomic environment resulted in contagion spreading. While some of the problems were self-inflicted a common theme as contagion spread was the high levels of offshore debt, built up in the era of very low interest rates and the majority being in US Dollar. Countries exposure to global trade has made them vulnerable to trade wars, and having high fiscal and current account deficits has raised uncertainty over their economic sustainability.

Other emerging countries face problems but these are more in the nature of normal cyclical patterns rather than systemic structural issues. Most emerging countries, especially in Asia post the late 1990s crisis, have reformed and restructured so that they are financially stronger today and less vulnerable during a tightening cycle. That is not to say there will be no further bouts of nervousness as the cycle progresses but the risks of meaningful contagion seem limited while valuations across emerging markets appear attractive.

In the case of the biggest emerging market of all, and the one that has a major impact on the global economy, China, the longer term structural rebalancing of the economy and demographic headwinds will lead to lower growth, as has the deleveraging policy in place since late 2016, focused on the corporate sector, where debt increased from 100% of GDP in 2008 to 160% in 2017.

Figure 1.2 - China's potential growth, productivity and population



Source: Minack Advisors as at September 2018. * 5year average change in GDP/worker ** 5 year change in 15-65 year-olds. With UN forecasts GDP = Gross Domestic Product.

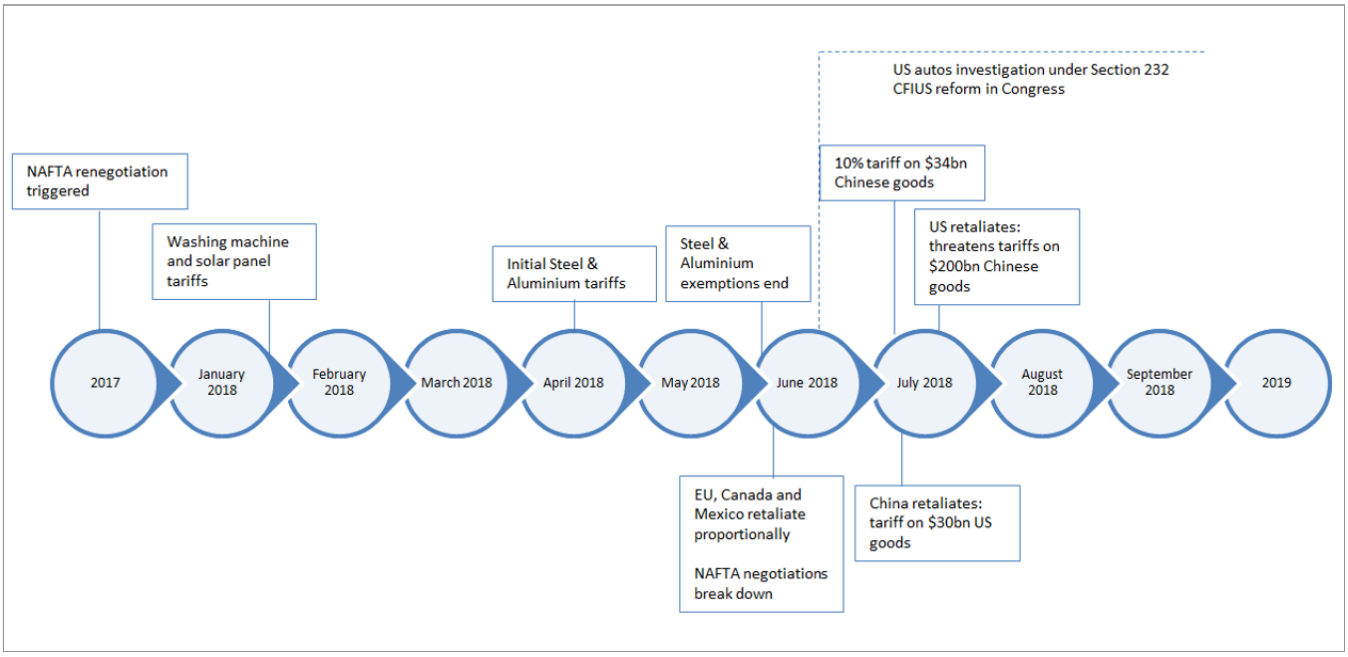
However, it is instructive to consider how China has reacted in recent months to evidence that deleveraging has begun to bite too hard, with credit expansion falling rapidly from a peak of 25% per annum to below 10%. The ensuing slowdown in the economy quickly led to an easing of monetary policy: interbank rates have almost halved, from 5% to 2.7% in recent months. China is determined to deliver on its target growth rate of 6.5% per annum.

It is not just the end of the ultra-loose monetary policy environment that puts at risk the benign conditions of recent years, but also US President Trump's reflationary agenda. Notably, the President has delivered on his promised economic plans of implementing big tax cuts and increased infrastructure spending, adding around 0.5% to GDP this year and next year when the economy is already operating close to full employment. For the first time since the crisis the risks have moved from deflation to an inflationary surprise, and a risk of over-heating. The big increases in spare capacity following the financial crisis are disappearing. The danger is that the Fed is forced into raising rates more rapidly than currently planned, to get real rates to a level which would cool the economy.

Risks of a downturn are further heightened by the prospect of protectionism and escalating trade wars between the US and its trading partners. Although the tariffs introduced to date have had a very small impact on economic activity, they have reduced confidence and investment spending somewhat. An all-out trade war would be far more damaging; however, alone it is unlikely to be the sole reason for tipping the global economy into recession. Although combined with tighter monetary policy could prove a real threat.

While the trade concerns with NAFTA and the EU remain apparent, it is here compromise will be made, and we are seeing evidence of that; with Canada agreeing to the new United-State-Mexico-Canada Agreement, and the US and EU announcing they would work towards zero tariffs on non-auto industrial goods. It is the US-China relationship which is critical: the recent implementation of 10% tariffs on another $200bn of US imports from China and China subsequently retaliating, imposing tariffs on $60bn of goods from the US. However, China is now left with limited bargaining power if it was to retaliate in the future as the majority of imports from the US have now been covered. President Trump has threatened another round of tariffs which would then cover almost all Chinese exports to the US, over $500bn. With the inclusion of impact on neighbouring countries via supply chains and on the US through price increases then the impact becomes worrying, with some market commentators stating it could reduce GDP by 0.5%. With two leaders entrenched in their positions and the issue seen as a trial of strength the risk of serious escalation should not be under estimated.

Figure 1.3 - US-led trade tensions have risen through the year



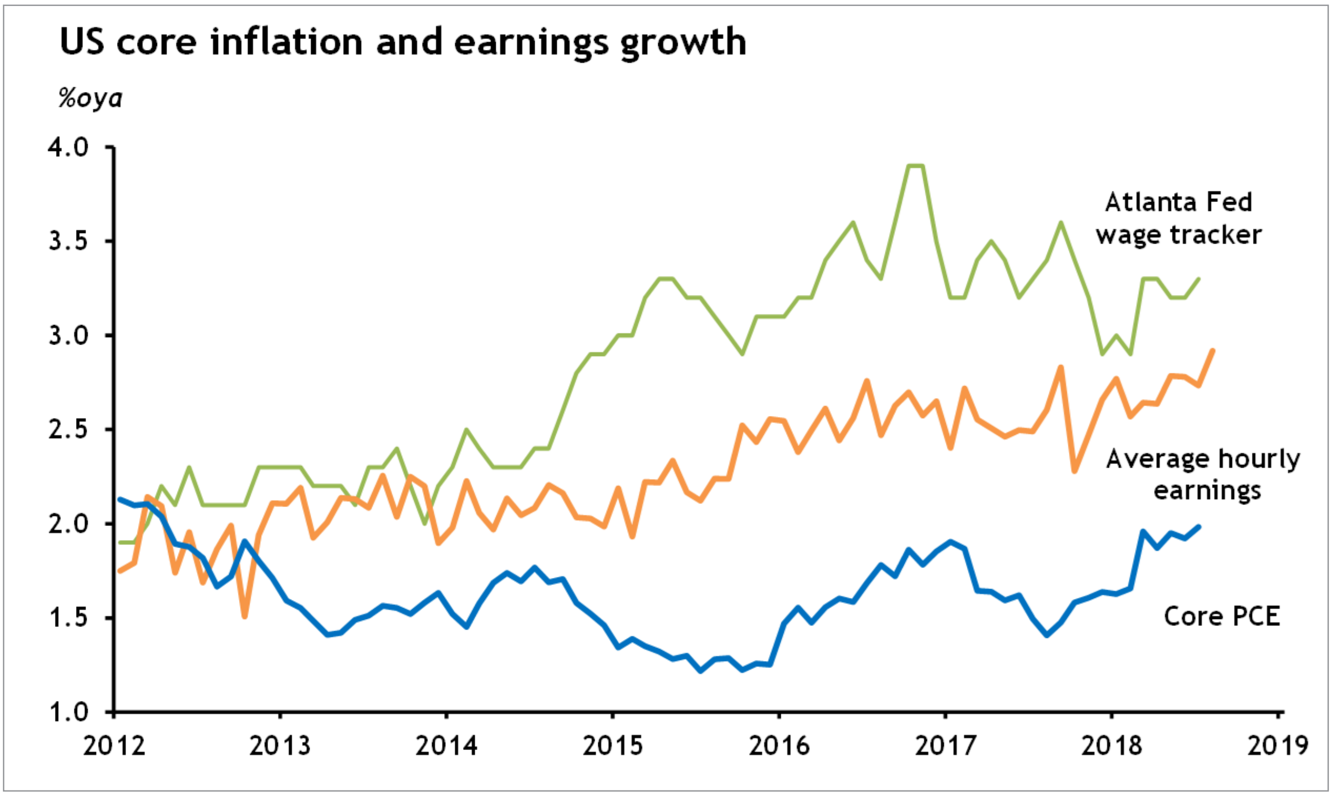
Source: Aberdeen Standard Investments, September 2018

The number of risks has intensified this year following the discussions of a no-deal Brexit, Italy falling into financial difficulties as a result of irresponsible fiscal policies, geopolitical threats to stability and rising populism across Europe. These risks combined with the above factors have contributed to holding markets back. Therefore, it is no surprise that consensus thinking is that there will be a US recession in 2020/21.

However, the factors holding back growth and restraining inflation could well do some of the Fed's tightening job for it and prevent the overheating that would trigger a sudden and unexpected hike in rates. The Fed's own expectations point to a peak in the Federal Funds rate at around 3.5% in the next couple of years, 2-3% lower than the peak in the last 2 cycles, and a long term neutral rate of around 3%. If that proves to be the case we are already two thirds of the way through the rate tightening cycle.

Outside of the US it is almost impossible to find an economy that is facing a late cycle growth and inflation surge. Even in the US the inflation which markets are concerned with is mostly confined to the labour market; given the intensely competitive environment there is no certainty that higher wages will flow through to higher consumer price inflation while productivity, which has languished since the crisis, could well pick up as investment spending rises and absorbs some of the rise in real wages.

Figure 1.4 - A very gradual rise in US wage growth, the US has returned to price stability due to lacklustre productivity growth



Source: Atlanta Fed, BEA, BLS, J.P. Morgan

Globally inflation has persistently surprised on the downside since the financial crisis, held back by ample spare capacity, lack of pricing power, the deflationary impact of globalisation and the rise of the digital economy. As we have seen, there are plenty of negative impulses to restrain confidence and spending, thereby limiting the risk of a more normal cyclical overheating. Furthermore, there are no widespread asset bubbles that would trigger a systemic dislocation when they deflate. There are a few pockets of real estate at extreme valuations, but some of these such as London prime residential property are already falling back, and 2017's bitcoin craze has well and truly unwound. None of these are anyway large enough to cause any serious ripples. In the UK, uncertainty regarding Brexit has been a recurring theme since the Referendum in June 2016 and it continues to hold back confidence. With only 6 months from the exit from the European Union, negotiations are entering the business end. The real negotiations is now not between the UK and EU, but within the Conservative Party. Any exit deal agreed with the EU must be approved by Parliament and there is a risk that Prime Minister May will not be able to carry her party with her. Even more, Jeremy Corbyn and his Labour Party will almost certainly vote against any deal in the hope to bring down the government.
As we come through this immensely difficult period for the UK, asset markets have underperformed markedly and offer good opportunities.

A serious potential risk for the UK is the possibility of a Labour government under the complete control of a core of unreformed authoritarian Marxists. The Conservative Party are unlikely to run the risk of voting against Prime Minister May's deal, only to let in a Marxist government, therefore a compromise is likely to be reached. Due to this uncertainty the coming weeks and months ahead will be a nervous period for the UK.

Importantly for the stability of the global financial system as we enter a more difficult phase of the cycle, banks, with the exception of some in Continental Europe, are very much better capitalised now than in 2008, so are much better equipped to withstand of a slowdown the impact or recession.

Portfolio positioning for this environment

Complacency is undoubtedly dangerous at this stage of the cycle. Wages and inflation are rising in the US, albeit from low levels, and the risks of overheating are higher than at any time in the post crisis decade. As tighter monetary policy takes effect, the fiscal impulse injected early this year fades and trade wars begin to have an impact, growth could slow materially next year. Engineering a soft landing is a feat achieved by no previous Fed Chairman so we should not underestimate either the challenges or risks.

However, it seems quite possible that these balancing forces extend rather than curtail the cycle, which could well be sustainable for some time ahead. Growth in the US is likely to revert to a lower but still reasonable level; the rest of the advanced world is much earlier in the cycle and in none of the big economies are there signs pointing to recession any time soon. Under these circumstances inflation should remain relatively subdued and the risks of a sharp and unexpected tightening of policy are low.

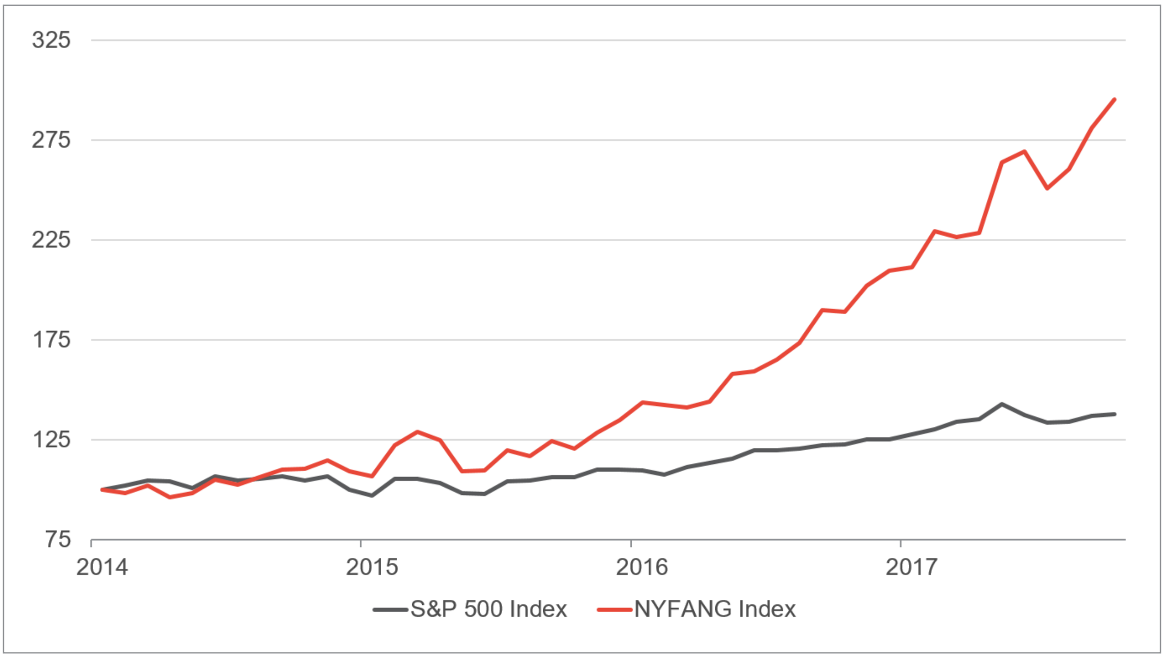
It is too early to be substantially de-risking portfolios in anticipation of a sharp global slowdown or recession. Predicting a recession is a hazardous exercise, just as Paul Samuelson's famously said 50 years ago: 'the stock market has predicted 9 of the last 5 recessions'. However, it is appropriate in constructing portfolios to recognise the heightened risk especially in the US where the cycle is much further advanced.

Equities remain the preferred core of our portfolios to generate significant real returns but we see better returns outside the US given the valuation differential heavily in favour of non US markets, the different stage of the cycle in the US and the extent to which the US market has outperformed the rest of the world: over the past 5 years the US is up 90%, the rest of the world by 20%, a differential rarely seen in the past.

Many investors worry about valuations in equity markets but the growth in corporate earnings in the past year has far exceeded the rise in share prices, so valuations are lower today than a year ago. The highest rated market, the US, is on a forward PE of 18x, while other major markets, Europe, Japan and the UK, are on 13-14x. These are not bargain basement levels but neither are they expensive, bearing in mind that outside the US interest rates are expected to remain very low for some years ahead. Even in the US the Fed has been and no doubt will remain cautious in its monetary tightening and highly sensitive to the risk of curtailing the expansion.

Repositioning of equity style exposure is also appropriate, reducing the growth and momentum stocks which have so dominated markets since 2010, and have the most stretched valuations, and adding to value stocks.

Figure 1.5 - The Macro background has been supportive of 'growth' investing



Source: Bloomberg as at 29 June 2018

Bond markets generally remain at high valuations after a decade of ultra-loose policy, but in the US there has been a big change over the past 12 months. As the Fed has tightened, yields have increased substantially, especially at shorter maturities. This is all due to a rise in real yields; the break-even inflation rate has remained around 2.1% this year. Today the 2-year US Treasury offers a yield of 2.8%, the highest for a decade, up from 1.3% a year ago and from a low of 0.2%. For the first time since the crisis short dated bonds in the safest haven of all offer a reasonable real yield and can be considered again for the defensive part of multi asset portfolios.

Yields have moved up much less in longer dated bonds, reflecting the anchoring of inflation expectations, and caution is warranted here, not least because of the avalanche of bonds that will be issued to fund Trump's fiscal agenda and the withdrawal of the Fed as the major buyer. However, we have recently bought small positions in short dated Treasuries to build up the resilience in our portfolios, and we will buy more if rates rise further.
On the other hand, Credit and High Yield bonds remain at very low yield spreads against government bonds and here we have been reducing both credit and duration risk. The cycle has further to run but the balance of risk and reward has shifted from credit to Treasuries over the past year. We are seeing opportunities however in the private debt markets, especially in floating rate debt; where we find the appropriate structure for this sector we intend to use it as part of our defensive mix of assets.
As part of that more defensive shift we will maintain the position we built up over the past year in non-correlated strategies among liquid alternatives, which typically aim to exploit style premia without taking on market risk.

Finally some insurance is valuable against the risk of a sharp rise in inflation: inflation protected bonds issued by the US Treasury, and gold, disappointing so far this year, both have strong credentials in this respect and offer perhaps the ultimate safe haven status.

To conclude, last year I finished off by saying that we are acutely aware of the danger of mis-calculating both portfolio and liquidity risk, and we seek broad and true diversification as we navigate the inflection point in the monetary cycle. That statement is even more valid today; during the course of the past year we have reflected this thinking progressively in our portfolios so that we can continue to benefit from the opportunities in markets while building greater defensive positions and resilience to withstand the inevitable bumps on the way through this extraordinary cycle.

Stay invested, be prepared to ride out the bumps and avoid the temptation to time the next recession.

Glyn Owen - 27th September 2018