LOMBARD ODIER
INVESTMENT MANAGERS

Global Perspectives

Shocks – not age – kill cycles

Asset Management

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Introduction

The global economy is entering its ninth year of expansion since the global financial crisis. Beneath this global trend lie some stark regional disparities: the US economy has enjoyed solid growth for the full nine years, while the Eurozone's recovery is a more recent phenomenon with the economy now entering its fifth year of positive growth, and some countries – such as China or Australia – did not have an outright recession to recover from in the first place.

Despite this differing historical growth trajectory, global indicators are now pointing to continued growth that is both solid and synchronised across most regions. Coupled with low inflation, this situation that has proven to be positive for risky assets.

In this so-called 'goldilocks' environment, it would be easy for investors to become complacent, especially given the low level of market volatility. While we do not see an immediate threat (ie, over the next six months) to this favourable scenario, we are mindful that risks do exist and that they require close monitoring.

In this report we discuss the various top-line risks that might threaten the goldilocks environment before examining more closely the growth and inflation dynamics of key regions and discussing the shift in monetary policy that is finally taking place thanks to the improved health of the global economy. We then discuss what this all means for investors.

Risks to the status quo

In the short-term, we view a key and immediate risk to the current positive global backdrop to be geopolitical in nature. While tensions between the US and North Korea have subsided somewhat in recent months and are no longer at the forefront of investors' minds, the situation has not changed fundamentally; the risk of an escalation remains high and tensions could flare up at any time given the incentive of a first mover advantage when it comes to open confrontation. That said, we continue to believe that likelihood of an all-out conflict remains low given China and South Korea's stance/involvement in the issue.

The other key risk that we perceive to the global outlook is the continued protectionist bent of some countries, notably the US under the Trump administration. As such, the state of the current renegotiation of NAFTA between the US, Canada and Mexico is a cause for concern given the lack of concrete progress so far, with Canada's Foreign Affairs Minister warning against a "winner-take-all mindset." However, NAFTA, while important, is a regional trade deal; a more global challenge to free trade could arise if the US decides to confront China directly on the matter. The US is already looking into whether to launch an official complaint against China for systematic theft of intellectual property yet this issue is increasingly being linked to geopolitical developments and as long as the US needs China on-side for the North Korea situation, a trade dispute remains less likely.

Good times – for many

Regardless of their assessment of the probability of the above risks, cyclically, investors should be asking themselves how long the status quo is likely to remain and what will change first: will it be a growth slowdown or a rise in inflation? There is no crystal ball but there are some important regional dynamics that investors should be mindful of. Here is an assessment of global and regional trends.

Global backdrop: solid growth and low inflation

After posting a growth rate of 3.2% in 2016, global economic growth is expected to remain robust. Various indicators point to continued strength over coming months and quarters: global trade volumes have improved in recent months, rising to levels not seen since 2011; global manufacturing purchasing managers' indices (PMI) have continued to improve or to remain at levels that are consistent with solid growth; and business confidence indices are also in strong territory. The result: consensus growth expectations remain strong. As a consequence, global growth is expected to rise to 3.6% in 2017 and to remain strong at 3.7% in 2018, according to the latest forecast from the IMF. These are the fastest global growth rates since 2011. At the same time, global inflation is expected to remain subdued at 3.3% in 2018 – low by historical standards.

US: further room to grow; wage pressures to come?

The US economic expansion is mature but we do not believe that this should lead to the conclusion that a downturn is imminent. After all, as Chair of the Federal Reserve Janet Yellen once put it: "it's a myth that expansions die of old age" – a shock is generally needed to destabilise the system. Moreover, the US economy is likely to benefit from the tax reforms/cuts proposed by the Trump administration, reducing the probability of a downturn in the short run, in our view. However, given the political climate, the size of the stimulus may be limited and noise may remain high. We are more bullish than the consensus on the prospect of a tax cut as we believe Republicans are incentivised to push this through ahead of mid-term elections, especially given the lack of progress on other key issues.

Inflation in the US has remained weak despite the very low unemployment rate. We think this is in part the result of continued slack in the labour market as evidenced by the low participation rate and employment rate, even if one corrects for the impact of an ageing population. Moreover, as highlighted by the latest edition of the IMF's World Economic Outlook, a continued high level of underemployment is likely limiting wage pressures and high personal debt ratios are also blunting the labour market's bargaining power. That said, a continued reduction in the unemployment rate is gradually feeding into tentative wage pressures – a trend that we think will run into 2018 especially if tax cuts are approved in coming months.

Europe: gaining impetus

In Europe the expansion is at an earlier stage than in the US. Growth is the Eurozone is at its strongest since 2011. Moreover, growth hasn't been this broad-based since the birth of the single currency, as evidenced by the very low dispersion of growth rates and PMIs. We expect domestic demand to remain the main driver of growth in 2018. On the consumer side, a continued improvement in the labour market is likely to continue to support consumer spending, in our view. Furthermore, we expect the trends of continued growth, the need to replace capital and low funding costs to continue to support business investment. We believe that this positive backdrop will continue to lead to employment gains and a further gradual improvement in the unemployment rate. However, as the overcapacity in the labour market is expected to remain for some time, this will likely prevent an acceleration in wage growth and should not create a meaningful impact on underlying inflationary pressures. As a result, we believe the ECB will be compelled to continue to adopt a very gradual approach towards winding the down its quantitative easing program, which was confirmed at its latest meeting.

On the political side, there is a new wave of confidence since the election of French President Macron. As such, the renewed enthusiasm for the EU by the French government is generally welcomed by Germany. However, a weakening of Merkel's position in the recent elections is likely to have long-term implications. Regardless of Merkel's strength, both countries have opposing views on the sequencing of structural reforms and fiscal consolidation, the need for Euro bonds and a common deposit insurance – which means any development towards structural reform of the EU is likely to be very incremental, in our view.

The election of President Macron has also reduced the concerns posed by the rise of populism for now. Nevertheless, the recent German elections, which saw the entry into parliament of the anti-establishment AfD, suggests that the populist movement is not dead. The Italian elections next year are likely to remind investors that the populist wave is still alive. Currently, the democratic party (PD) and the 5-star movement (M5S) are neck-and-neck in the polls, followed by Forza Italia (Berlusconi's party) and the Lega Nord (another populist party). The result of the election is expected to be close and to include strong gains for the populists. That said, the new electoral law, which aims to align the voting system for the lower house with the Senate, will favour parties that are willing to run as an official coalition; given M5S has refused to enter any formal alliance, it is likely to be at a disadvantage in the upcoming election, explaining their sharp criticism of the new law.

UK: tricky situation

In the UK, growth has slowed but remained more resilient than most investors would have expected. We believe that this resilience should continue given the UK's relationship with the EU has yet to materially change until March 2019 and the probability of a transition period has risen. Nevertheless, we expect the uncertainty arising from the Brexit negotiations to continue to weigh on sentiment, weaken business investment and act as the main headwind to growth. The continued weakness in wage growth and the increase in inflation which, owing to Brexit, is now outpacing the sharp depreciation of GBP witnessed last year, have led to a decline in real wages. This should act as a break to consumer spending. However, households have taken advantage of low rates and the strong labour market to borrow to maintain their living standards, leading to an increase in household debt.

We view Brexit as remaining to be the key risk to the UK economy in the coming year, and the size of the shock will depend on the nature of the new economic relationship between the UK and the EU and whether there is a transition period. In the meantime, the Bank of England (BoE) has adopted a visibly hawkish stance by focusing on the supply-side shock in the pipeline due to Brexit, but it still managed to deliver a dovish hike by softening its stance on the future path of rate rises. While there is an argument that the recent hike is simply a reversal of the emergency hike carried out in the immediate aftermath of the shock Brexit results, we think that the thesis of supply side shock to the UK economy being articulated by the BoE implies that it may increase rates two more times before economic realities force it to pull back.

Emerging markets – better insulated and set to benefit from positive trends

For emerging markets, the question that investors have on their minds is: how much will these economies be affected by the tightening of global financial conditions, especially given the continued tightening of monetary policy in the US and the start of tapering by the ECB? To answer this question, it is important to take into account the improvement in emerging market economy fundamentals since the taper tantrum of 2013, and to consider how much interest rates are likely to increase.

Growth in emerging market economies is now driven more by domestically-sourced demand than by exports. This makes these economies less sensitive to external economic shocks, in our view. Nevertheless, in the current environment where global trade is accelerating, we believe global growth should contribute positively to growth in emerging markets. Another positive change over recent years is the improvement in the current account balances of emerging market countries since the taper tantrum, with an average current account deficit of 1.1% now, compared to 3.7% in 2013. This means that, on average, emerging market countries are less reliant on foreign financing.

The current monetary tightening cycle by the Federal Reserve is likely to be similar to the one in 2003-2006, in our view. By this, we mean that the Fed hikes will be very gradual and well-publicised/forewarned, meaning that yields are unlikely to increase rapidly in reaction to any hikes. We also believe that with the global economy growing robustly, albeit at a slower rate than in the mid-2000s, this should provide a positive growth backdrop for emerging market economies.

Inflation rates in most emerging market economies have also moderated in recent years. As a result, real yields are higher currently than they were at the time of taper tantrum in 2013, proving the attractiveness of emerging market assets which should also help provide resilience against reactions to rising rates in the more advanced economies.

The strength of the global economy may also benefit commodity-producing emerging countries, as it is leading to an increased demand for commodities, especially for base metals and oil. This would help support both export volumes and commodity prices, leading to a positive terms-of-trade gain for those countries.

That said, the recent consolidation of USD and rise in advanced economy bond yields has had a differentiated impact on emerging market assets, with fixed income segments – especially local-currency denominated – under heavier pressure than equities, as the stronger growth sensitivity coupled with gradual tightening of monetary policy has been more at play. We think this differentiated trend could last as we approach mid-cycle dynamics in emerging markets.

China: growth moderating as rebalancing continues

In China, growth has been more resilient than some investors had expected. This might be explained by the continued increase in leveraging by corporations and the authorities' actions to avoid an economic slowdown ahead of the Communist Party Congress. While there has been a slowdown in industrial production, other areas of domestic demand are picking up the slack. Growth is expected to moderate further in 2018, as the economy continues to rebalance from an investment-driven model to a domestic consumption-driven one. Moreover, we believe the Chinese authorities are likely to need to take further steps to slow credit growth, which would also lead to slower growth.

The 19th Chinese Communist Party Congress saw President Xi becoming the most powerful Chinese leader since Mao Zedong. With a more solid grip on power, we think President Xi will likely continue the economic reforms he has emphasised in the past: supply-side reforms, deleveraging of the economy, concerted drives against both poverty and pollution and a subtle move away from an explicit growth target. This would bring continuity to the current policy, reducing the risk of a sudden shift in policy.

Monetary policy enters a new era

With growth remaining strong, many central banks look set to begin to (or to continue to) reduce the amount of support they provide to economies by reining in their monetary policy accommodation – in other words, reducing the stimulus they have been providing to economies. The Federal Reserve has communicated that it will start to actively reduce the size of its balance sheet at the beginning of 2018 and is expected to continue to increase its policy rate gradually. We believe that the Fed will increase interest rates again before the end of 2017 and at least twice more in 2018. This is more than what is being priced in by the market.

US inflation remains modest despite the very low rate of unemployment, leading the Fed to question whether inflation is now structurally lower as reflected by a further flattening Phillips curve (which describes the inverse relationship between unemployment and inflation). However, one of the issues hampering the Phillips curve could be that the unemployment rate is a flawed indicator of the true amount of slack in the labour market. That said, we believe that the Fed is becoming more concerned by matters other than inflation, namely: that keeping interest rates too low for too long could create imbalances and vulnerabilities in the economy in the form of excess leverage, an excess appetite for risk and over-valued financial securities. Interestingly, we have found that while the Phillips curve has been flattening (signifying that the level of unemployment has lost its influence on inflation), an increasingly positive relationship between the unemployment rate and asset valuations appears to have gradually emerged.

This all means that US yields, both long and short maturities, should continue to be pressured on the upside, in our view. However, while the changes to monetary policy are being well communicated by the Fed, we believe the market has yet to price in enough policy rate hikes in the rates curve, as we noted above. Some investors have been worried by the flatness of the yield curve, as longer-term rates remain low because of low inflation expectations, and the risk that the yield curve could end up inverted. We believe these worries to be overblown. The Fed holds a little over 20% of the US treasuries in circulation, it can easily manage the shape of the yield curve by reinvesting mostly on the short end of the curve to lift long term yields (something that could be viewed as a reversal of operation twist).

Recent reports indicate that Jerome Powell has been nominated as the next Fed chair, which is a vote for continuity in the Fed, though this is likely to have implications on the financial regulations landscape, given Mr. Powell's somewhat more lenient views on the issue compared to Ms Yellen. That said, a number of board positions still need to be filled and that will have an impact on Fed's policy-making direction.

Over in Europe, with strengthening economic growth the ECB has announced that it will start reducing its support by slowing the pace of its asset purchases. However, it is clear from the ECB forward guidance that rates hikes are very unlikely in 2018 since the ECB said that the asset purchase program needs to come to an end first. We believe that the ECB will end the APP program at the end of 2018 and keep reinvesting maturing bonds afterwards. In our view, the first rate hike is likely to take place in second half of 2019, while the end of reinvestment (in other words, balance sheet reduction) is unlikely to happen until 2021. While continued economic strength could put into question whether a faster unwind of stimulus measures might be necessary, we believe the focus of the ECB remains firmly on inflation developments rather than growth; as long as inflation rates remain modest which is still the case, we expect the ECB to stick to its current policy plan. For this reason, we think the ECB will also remain sensitive to any EUR appreciation given its strong influence on financial conditions for the Eurozone.

Investment considerations

In terms of our views, we maintain our pro-risk stance with a clear preference for European and emerging market equities, and local currency debt, but we remain watchful for any sign of peaking growth momentum.

Although short-term risks to global yields are now somewhat biased to the upside given the strong growth upswing and the ongoing gradual shift in key central banks' policy stance, from a business cycle perspective, the current low level of yields could pose a problem for investors in the event of an economic downturn. In an average downturn, nominal short-term yields have fallen by about 400bp on average and by about 520bp in real terms during the post-World War II era. This decline in yields has a positive impact on portfolios given the capital gains on the bond holdings (bond prices are inversely-related to yields), mitigating somewhat the losses on equity holdings. However, with the Fed fund rate currently at 1.25% and US Treasury yields at 2.400% (0.5% in real terms using TIPS), there is little buffer to compensate for the loss coming from the equity holding – ie not much lower for rates to go (unless the entire financial system is rewired) and thus not much potential for bond price rises, in our view. This suggests that investors need to think about managing the systemic draw-down in the case of a downturn as we traverse the current "goldilocks" period.

Another risk we are currently monitoring is the increase in investment herding behaviour (investors holding similar positions) and rise in passive ETF investment, and the impact such developments could have on markets. Our concerns are mainly focused on bond markets, where the majority of investments follow a market capitalisation-based benchmark, leading to many investors holding mainly the most indebted parts of the market rather than the segments with the strongest fundamentals. And with primary dealers now holding much lower levels of bond inventories, we believe that both the herding of investors and fractured liquidity in the fixed income market could exacerbate shocks, potentially leading to nasty surprises for bond investors. Hence, we continue to believe that investors should rely on quality-based, low-turnover portfolio construction approaches that have a lower reliance on trading and comprise robust portfolio construction that is designed to withstand periods of liquidity-induced volatility.

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