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Our view of the world

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The US cycle is not over, but...

By Gianluca Tarolli,
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Since the current US economic cycle has already lasted much longer than normal (7 years, vs. around 5.5 years for the 11 cycles recorded since 1945), it is now more than legitimate to wonder about its longevity and inevitable end.

Conclusions and convictions

It must be borne in mind that a cyclical downturn historically comes after the excesses of the expansionary phase: full employment leads to pay growth, higher consumer prices and subsequently higher interest rates, company margins contract, profits decline, default rates rise, etc. Today, most of these excesses are not visible: inflation remains low and 10-year yields are currently lower than they were at the start of the cycle in March 2009 (1.5% vs. 2.08%). One explanation lies in the severity and nature of the last recession: since it was caused by a credit crisis, the strength of the recovery is logically more modest. In fact, the level of real GDP at this stage is around 12-14% lower than it ought to have been had the recovery been as strong as it usually is following a recession. This lack of momentum therefore goes some way towards explaining why, in spite of the time that has elapsed, end-of-cycle excesses have yet to appear.

However, some variables appear to have peaked. This is undoubtedly the case for corporate margins, which have benefited greatly not only from lower labour costs (due to the plentiful supply of labour) but also from the fall in the price of most commodities and, finally, from low interest rates, which have significantly squeezed funding costs. These benefits are beginning to dissipate. Commodity prices have bounced back in the year to date (up 26% on energy, 28% on agricultural commodities and 10% on industrial metals). Although unemployment stands at only 4.9%, very close to what is considered full employment, the true state of the labour market is open to debate. As the labour force participation rate has fallen sharply, from over 67% in summer 2008 to less than 63% at end 2015, there is undoubtedly a reserve of labour available to the economy that is not captured in unemployment statistics. This would explain the relative weakness of pay growth, essential to price growth (inflation). Here again, however, hourly pay has accelerated (up 2.6% YoY), indicating that labour market tensions are beginning to show. Finally, the question of interest rates probably has to be addressed separately. Of course, the lack of inflation and modest growth justify lower than usual rates. However, rates are abnormally low as a result of the Fed's interventionism and ultra-accommodative policy (something in which the Fed is far from alone). Although this situation could continue for some time, commercial banks have begun to tighten their lending terms: the first, as yet faltering step towards higher corporate funding costs.

As the cycle continues, the traditional end-of-cycle excesses will gradually emerge over the coming quarters. We are entering into the period when economic good news will gradually be perceived less positively by investors. While the US economy will not go into recession before the end of 2017, between now and then we should expect inflation to accelerate and interest rates to rise, causing company margins to suffer, earnings growth to be harder won, and less risky alternatives to equities to emerge. Conversely, though this is not our scenario, should the cycle end sooner, equities will still face the same problem: the lack of earnings growth means they will be overpriced and therefore vulnerable. In both cases, then, equities appear to be in danger.
A cautious approach is therefore wise at this stage.

After Brexit… Keeping a watchful eye

By Mark Robinson,
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It is clear that we are entering a period of heightened uncertainty for financial markets. Uncertainty not just for the UK, but the whole of the EU and probably the global economy as a whole: businesses will not know how politicians will tackle some of the difficult negotiations ahead, bond markets do not know what the policy responses will be and we do not know how consumers will respond either. We can therefore expect an extended period of intense uncertainty at both a political and economic level. This is likely to translate into further market volatility and a backdrop that means proceeding with more caution than usual.

The initial response from global markets has been reasonably measured so far, with the exception of currencies and continental European stockmarkets, but it is the second response to the enormity of this vote that could be quite protracted, and possibly more acute. Despite Mario Draghi-like reassurances from Mark Carney, the Governor of the Bank of England, that the financial system and banks' capital requirements have been stress-tested against scenarios more severe than the ones currently being faced (and further reassurances from the Chancellor), the reality is that this is precisely what one would expect them to say. Frankly, we are in completely uncharted waters and those making these pledges have few clues at present as to how much support or intervention might be required, and when.

So, where next for the UK ?

One thing seems certain in the coming months, which is that central banks will continue to act as shock-absorbers: monetary policy will surely be looser than it otherwise would have been had a 'Remain' vote been returned. It is quite possible that UK interest rates will now be cut rather than increased, as was the likelihood a few weeks ago. Whilst a weaker pound should ultimately provide a much needed boost to the UK's export markets, it will equally increase the cost of imported goods. Higher UK inflation can therefore be expected. Under normal conditions some level of inflation could be considered positive for the economy, but these are not normal conditions and the risk of stagflation – even lower growth or stagnation in the economy, together with rising inflation – during the next part of this economic cycle is now a distinct possibility. The UK's Monetary Policy Committee, though, will probably look through any overshoot on inflation in the near term and not respond with higher interest rates. Inflation-linked bonds and gold are likely to see renewed appeal in such a scenario, so it is to these two asset classes that we are increasing and reintroducing exposure respectively. Having more assets, such as gold, linked to the US dollar also seems appropriate whilst sterling and the euro in particular face headwinds, and the prospect of higher US interest rates beckons.

Having already toned down equity exposure and taken a more neutral stance during the second quarter, we are responding to the political and economic questions thrown up by the EU referendum outcome by further reducing stockmarket risk. This is principally focused on reductions in continental European, and to a lesser extent the UK, stockmarkets, where we expect the more challenging conditions to prevail in the near term. We have also reduced the exposure to commercial property.

In conclusion

In the coming weeks and months it will be important not to become too distracted by the twists and turns in this specific political and economic debacle, but equally consider the significant overlap with, and impact on, the wider global economy : economic growth in both developed and emerging economies was already facing several headwinds for the latter half of 2016 and beyond, and these have now been joined and accentuated by fresh EU and political risks. Before we know it, for example, the media and market heat on the Clinton-Trump pressure-cooker will have been turned up: the threat of higher US interest rates, and the complications of divergent global monetary policy, could therefore be firmly back on the agenda. The second half of the year could be just as lively as the first, but just because we are taking a more cautious stance with stockmarket and property positioning does not necessarily mean that opportunities for making progress in the months ahead have been restricted. We are monitoring the position closely and, just like the underlying managers with whom we are entrusting day-to-day investment decisions for our clients, we will remain as active or inactive as is necessary in these unpredictable and challenging times.

Central banks: from emergency to chronic dependency

By Bryan Goh,
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In 2008, the global financial crisis forced central banks to flood the financial system with liquidity to avert systemic insolvency. In the years immediately following, central banks provided progressively more liquidity to sustain a recovery. The severity of the problem allowed central banks to act with little consideration for side effects.

8 years on and the global economy has recovered albeit at a moderate pace. The US economy appears capable of a 2% equilibrium growth rate, Europe 1% and China a rather suspect 6.5%. Japan still flirts with recession despite being the pioneer of QE. Successive waves of QE have had weak impact on the real economy which is in a state of chronic dependency.

While central banks' policy and the market's reaction functions have been predictable in the past, two factors have changed. One, the world is in a state of weak growth, not emergency, and thus policy is more aware of side effects. Two, central bank policy may be reaching its limits. The market's reactions to policy in the recent past have been fretful.

Finance and economics is faddish and the current thinking is drifting towards helicopter money. Helicopter money practice is government spending financed by the creation of new money. With policy at its limits some economists are prescribing helicopter money to spur growth. Whereas QE provided cheap credit to encourage private demand, helicopter money replaces this private demand with government demand. This seems to make sense as the problem is weak demand and not insufficient credit.

Not every central bank is expanding its balance sheet. The US Federal Reserve broke ranks in 2013 announcing an end to QE and in December 2015, raised interest rates. The ECB, BoJ and the PBOC remain firmly in accommodative mode. The Fed's position, however, has shifted somewhat towards dovishness on concern regarding international markets and political uncertainty. Policy divergence is now much less pronounced.

If the Fed entirely abandons hiking rates either this year, or in the foreseeable future, markets are likely to react poorly which would cause a de facto tightening of liquidity conditions through wider credit spreads. The Fed is therefore faced with a particularly delicate situation.

The ECB has lagged the other central banks in its QE and has room to do more. QE was initiated fortuitously at the beginning of a cyclical recovery in Europe which continues today but is at risk of petering out. Despite stretched budgets and pledges of fiscal rectitude, Europe may yet be an early adopter of helicopter money.

The PBOC has eschewed outright asset purchases and instead provides cheap financing to the policy banks, a strategy which affords it more control in allocating credit. Its policy is risky, as it increases system leverage, but reduces debt service, while defusing certain unstable structures such as local government conduits.

The BoJ is perhaps the most advanced of central banks in terms of cycle and experimentation. It may appear that the experiment has failed with the BoJ reticent in the face of weak data. Given the size of the national debt and the quantity of JGB's owned and bought by the BoJ one could argue that helicopter money was already a reality in Japan. In that context, its limited efficacy is an ominous sign to the Western world.

The cost of bailing out banks during the financial crisis prompted an overhaul of regulatory regimes. These include Basel 3, Solvency II, and Dodd-Frank, to name a few. The thrust of regulation has been to require banks to hold more capital to protect depositors and tax payers from banking failures. The aim of regulation has often been at odds with the aim of facilitating economic growth. Banks are essentially being asked to make more loans and take less risk, a contradiction that remains unresolved.

Two themes have emerged from this. One, banks are improving their balance sheets by raising more capital and reorganizing their balance sheets to consume less capital. Two, alternative channels of credit have grown. Bond and loan issuance has increased significantly since the crisis as banks retreat from lending. The reorganization of bank balance sheets is a continuing one which is creating interesting investment opportunities. These strategies are particularly interesting as they are less driven by macroeconomic forces and sentiment and are driven instead by the evolution of regulation, resulting in less correlated return streams.

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