The lightning-rod strategy

September 2017

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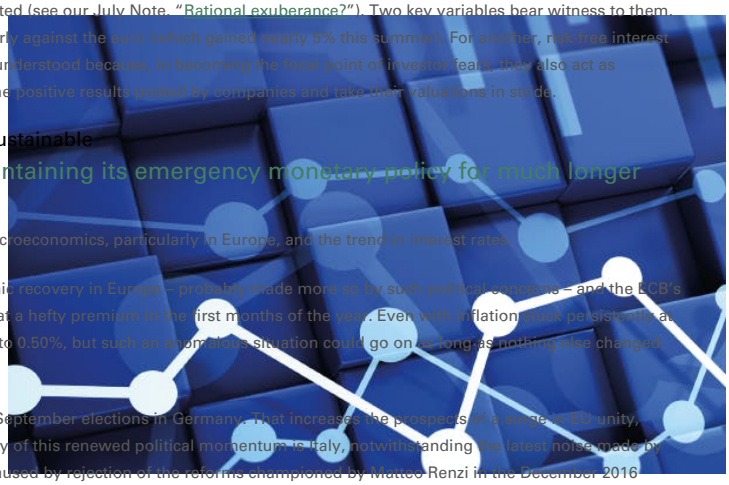
Published
September 1, 2017

Length
6 minute(s) read

The summer of 2017 saw no external shocks powerful enough to test the robustness of financial markets. No financial crisis, no military invasion (just a few provocative gestures from North Korea), primarily benign macroeconomic data and, last but not least, the famous Jackson Hole symposium in August, where the main sign of coordination among central bankers was arguably that they all studiously avoided discussing monetary policy. In other words, nothing worthy of note occurred.

In July and August, the EuroStoxx 50 eased 1%, the S&P 500 added 1.8% and robust emerging markets drove the MSCI World Index up 2.3%. And yet. Beneath such a seemingly calm surface, the tectonic shifts under way in the global economy have continued unabated (see our July Note, "Rational exuberance?"). Two key variables bear witness to them. For one thing, the US dollar's retreat since the start of the year has accelerated, particularly against the euro (which gained nearly 5% this summer). For another, risk-free interest rates have decreased further. Those two remarkable developments need to be properly understood because, in becoming the focal point of investor fears, they also act as "lightning-rods" that have so far enabled both equity and credit markets to profit from the positive results posted by companies and hike their valuations in stride.



The anomalous state of the bond market is becoming increasingly unsustainable

> The European Central Bank won't be able to justify maintaining its emergency monetary policy for much longer

Since the beginning of 2017, we have seen a striking contrast between upbeat global macroeconomics, particularly in Europe, and the trend in interest rates.

Uncertainty on how the French presidential election would play out, a still shaky economic recovery in Europe – probably made more so by such political concerns – and the ECB's monthly asset purchases together put German government bonds in a position to trade at a hefty premium in the first months of the year. Even with inflation stuck persistently at under 2%, the yields on those bonds were already inordinately low, ranging from 0.20% to 0.50%, but such an anomalous situation could go on as long as nothing else changed. But a number of things have changed since the summer.

On the political front, Angela Merkel has consolidated her lead in the polls ahead of the September elections in Germany. That increases the prospects of a surge in EU unity, powered by an incomparably stronger French–German partnership. One likely beneficiary of this renewed political momentum is Italy, notwithstanding the latest noise made by the old leader Berlusconi. The country is gradually emerging from the disappointment caused by rejection of the reforms championed by Matteo Renzi in the December 2016 referendum. In August, the Italian business confidence index climbed once again, this time to a new high since 2008.

On the economic front, the pick-up in leading economic indicators observed at the start of the year has continued across the entire Eurozone. The retail trade index stood nearly 2 percentage points higher in August than in January, reversing an eighteen-month decline. The industrial production index showed similar progress.

Thus, while the European economy has scored only modest gains in absolute terms and though inflation still lags behind the official target rate, the European Central Bank won't be able to justify maintaining its emergency monetary policy for much longer. We believe that the ECB will soon be compelled to announce a reduction in its asset purchase programme, particularly as the stock of eligible assets is fast dwindling (a point with special relevance to German government paper). We estimate that the fair value of German ten-year debt points today to a yield of at least 1%, which the market has so far failed to reflect. We therefore expect that Mario Draghi will be forced to take action in the coming months. This is one of the key market risks that now calls for very active management – including as a way to keep it from spilling over to other asset classes.

The euro's strength is both justified and set to last

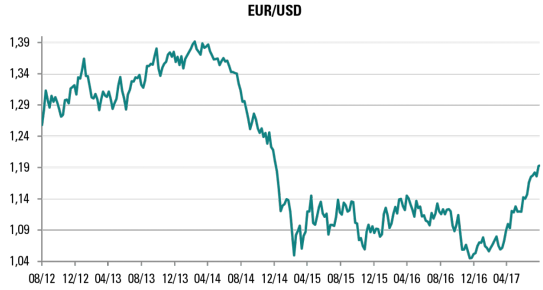
The recent movements in the value of the US dollar, the euro and the yuan foreshadow a radical shift in relative status

The euro has the advantage of being a sort of meeting point for several deep-going economic and political trends. To start with, just when the EU economy is finally picking up, the US business cycle is showing clear signs of fatigue. The Markit US Manufacturing PMI Index has been falling since the beginning of 2017. While consumers have continued to spend, they have done so by depleting household savings (which have dropped from 5.4% to 3.6% of disposable income in the past year) and borrowing money – to the point that consumer credit has hit an all-time high. The banks are gradually responding with stiffer lending requirements.

It therefore makes sense to view the euro–dollar exchange rate in 2017 as the mirror image of what it was in 2014, when the United States enjoyed a much rosier economic outlook than the Eurozone. In addition, now that Donald Trump's populist ranting has come up against hard, stubborn facts, investors have pretty much said goodbye to their hopes for large-scale tax reform. The Republican Congress will manage at best to pass a 2018 budget including tax cuts which, while certainly welcome, will be inadequate to the task of countering the cyclical slowdown currently unfolding.

On a deeper level – and contrary to his own professed aims – Trump is doing lasting damage to the geopolitical credibility of American power in relation to the other major world regions. By pulling out of the Trans-Pacific Partnership (TPP), by hinting that the US nuclear umbrella might not continue to protect NATO's European member states and by turning the strategic decision-making process into an improvised, incoherent jumble, the current President is eroding US global leadership – and offering Europe and China a golden opportunity to bolster theirs. The recent movements in the value of the US dollar, the euro and the yuan in part foreshadow a radical shift in relative status.

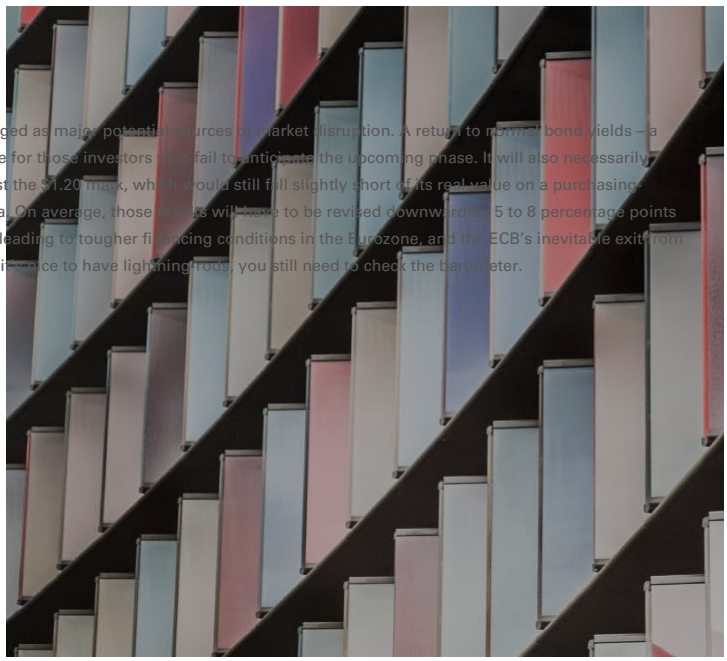
It is worth noting that the price of gold – the ultimate reserve currency – has also benefited from that trend since the start of the year. This means that it is now rational for global asset allocators to start rethinking the long-term weight of the dollar in their portfolios.



Source: Bloomberg, 28/08/2017

Sovereign bond price distortions and a new paradigm for the euro–dollar pair have emerged as major potential sources of market disruption. A return to normal bond yields – a change Mario Draghi won't be able to postpone for much longer – is likely to spell trouble for those investors who fail to anticipate the upcoming phase. It will also necessarily affect the equity risk premium. As for the euro, we might just be in for a surge to well past the $1.20 mark, which would still fall slightly short of its real value on a purchasing power parity basis, and which could prove damaging to corporate results in the euro area. On average, those results will have to be revised downward by 5 to 8 percentage points for every 10% gain in the euro. More critically, however, those two shifts – a strong euro leading to tougher financing conditions in the Eurozone, and the ECB's inevitable exit from its hugely accommodative monetary policy – may well happen simultaneously. So while it is nice to have lightning rods, you still need to check the barometer.

Source: Bloomberg, 31/08/2017



Investment strategy

Equities

After a lull in July, equity market volatility shot up again in August against a backdrop of geopolitical worries. The US stock market experienced a genuine correction during the month, whereas emerging market stock indices showed greater resilience and ended the month considerably higher, with the Brazilian market even up by over 5%.

The recent political turmoil in the United States has raised doubts about whether President Trump can push through a large enough infrastructure spending and tax reduction programme to shore up an ageing business cycle. Those doubts have led us to start gradually reducing the weight of cyclical stocks in our equity strategy.

In specific terms, we have scaled back our holdings in US airlines, closed our positions in Japanese financial stocks and taken substantial profits on our European bank stocks. And as we haven't reinvested the proceeds of those sales, equities now account for a slightly smaller share of our total portfolio.

Fixed income

While credit spreads as a whole have held fairly steady over the summer, yields on "core" sovereigns have slid from their peak in late-June. That goes in particular for German government bonds, whose price is increasingly disconnected from economic fundamentals.

We have accordingly kept our fixed income strategy largely unchanged. We continue to hunt selectively for yield in segments like emerging market local-currency debt, notably Brazilian and Russian, and Italian sovereigns, given that the Italian–German yield spread widened in the first half of 2017 to the highest levels seen in the past three years. At the same time, we will be carefully monitoring the liquidity of our private placement bond portfolio and giving greater weight to high-quality names and short maturities.

This is all part of preparing for possible blowback from the gradual normalisation of ECB monetary policy. Low inflation has fostered a kind of complacency among investors, who assume that monetary policy easing will go on, whereas normalisation will increasingly become a necessity for central banks around the world. Lastly, we have maintained our short positions in Bunds in order to steel ourselves for the shock that a spike in German yields might trigger.

Currencies

The euro's steady appreciation since the first quarter continued through the month of August. That trend above all reflects weakness in the US dollar, which has even lost its safe haven status, as demonstrated by the accelerating rise in Europe's common currency following the recent geopolitical tension sparked by North Korea.

It will therefore come as no surprise that we have continued to favour the EU single currency and to short the British pound. The latter position in fact contributed substantially to the forex performance of our Funds in the wake of sterling's sharp slide in July and August.

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