

Investment Outlook 2019. Short View. Long View. Inflection Point.

The last decade

The last decade has seen a remarkable recovery in asset values, and a reasonable recovery in economic growth. The deployment of QE, rate cuts and bailouts were useful in the crisis years for ensuring the functioning of the financial system and the emergency funding of the economy. This prescription has not been without side effects. One of them has been that the bailouts and rising asset values relative to economic growth have increased the gap between asset owners, generally a wealthier group, and labour, generally a less wealthy group. The domination of capital over labour is not a new phenomenon but a secular one, exacerbated by the increasing importance of technology in our knowledge economy. The ability for corporations to accumulate generations of intellectual property whereas labour can accumulate but one, has placed labour at a relative disadvantage. The emergency policies after the last crisis and their continuation policies to boost growth have tended to favour asset owners over labour, extending this trend.

There are various justifications for tolerating inequality (encouraging inequality would be a radical concept). A certain level of inequality is a good thing as it tends to encourage competition and effort. However, what is desired is economic mobility and not the inequality itself. There are other defences of inequality. One is that the standard of living has improved for all, one of the arguments in trickle-down economics. Another is that the composition of the wealthy is constantly changing and that mobility is a sufficient aim. Other arguments point to the drawbacks of potential solutions

such as raising minimum wages.

Raising the absolute wealth of the population is no longer sufficient. The distribution of wealth is also material. The wealthy bid up the price of goods and services crowding out the poor. A good example is urban real estate where mostly the rich can afford to own and the rest must rent or commute over long distances. Education and healthcare are other examples where wealth brings disproportionate access to quality. When it comes to retirement funding, the gap becomes glaring. Whereas a worker can only rely on their ability to continually supply labour, the wealthy earn passive income from asset returns. In ageing populations, this reality is precipitating and creating anxiety.

The stresses faced by the have-nots has reached a point where they turn to populist politics. Some of the populist policies are ill advised but not all. Benefits must be funded and policies that promise benefits without proper consideration as to how they are funded, or which increase national debts without bound are not sustainable. More aggressive taxation can fund social welfare but the devil is in the details and may require regional or global coordination. Chronic and increasing inequality is a drag on growth and needs to be addressed, but vested interests are aligned against redistributive policies. The risk is that policy does not go far enough in addressing the imbalance and people turn to more extreme ideas and politics. Extremist politics is gaining ground across the globe with risky geopolitical consequences.

The slow rate of growth in the recovery has created a general climate of contentiousness across multiple axes stoking xenophobia, trade protectionism, an increase in nationalist tendencies and rising populism. When growth is sufficiently strong, the pie grows sufficiently quickly that the division of the pie is less material. When growth slows, the division of the pie takes priority leading to increased competition and rivalry. The combination of inequality and slow growth can

lead to declining wealth in the majority of the population even as aggregate statistics indicate growth. As a baseline, the real wealth and income of the majority of the people must be rising to avoid a regression and a challenging of the social and economic order. Such challenges tend to be disorderly and violent. Desperate people who see their livelihood, lifestyles and lives threatened do desperate things and are desensitized against extreme actions.

Inflexion point

We are at an inflexion point in the economic cycle. A decade of patchy but positive growth threatens to slow back into contraction. The fiscal expansion in the US is likely to offset the tighter monetary conditions imposed by the Fed and delay the slowdown. Indeed data is equivocal and the US economy is likely to expand for some time to come. The pace of this expansion will likely slow as the cycle ages, as fiscal expansion is halted or slowed by a Democrat controlled House of Representatives. The Chinese economy continues to slow, in part from the natural cycle and in part due to a policy of reducing leverage in unproductive areas of the economy. The European economy is most fragile being one of the most open economies and also one suffering from structural weaknesses from its choice to operate a single currency and monetary policy without further unifying fiscal policy and unified concept of Eurozone sovereign risk. European growth which rebounded in 2017 from a brief respite in global trade is now sagging. The risk of a European recession is now significant and the tools for mitigation appear inadequate.

Trade has been an area of contention since the financial crisis a decade ago. Then, efforts to grow through trade were seen as part of wider policy of reflation and recovery, and the rivalrous aspects were less an area of focus. With time this has changed and the American President Donald Trump has

made this one of the pillars of his policy, escalating a Cold War into the open. The main protagonists of this war are the China and US, but the collateral damage will be their trading partners and countries in the supply chain. If the trade war escalates, the impact on global growth will be significant as productive efficiency is lowered leading to price pressures even as growth slows. In the interim adjustment period growth is likely to dip below the new low-trade equilibrium as the not insubstantial frictional costs of reorganizing supply chains take effect. This is already underway and will likely intensify.

The global slowdown is already eliciting policy response. The Bank of Japan was largely expected to reduce its QE efforts but has lately signalled that it will maintain course. It might even have to accelerate its accommodation in future if the economy slows further. The People's Bank of China, while in the midst of engineering a great deleveraging is already compensating in other areas by infusing capital and liquidity in the banking system. It is expected to do more. The ECB has stopped expanding its balance sheet as a precursor to one day reducing it, and raising interest rates. Now it seems likely that it will have to postpone its planned rate hike from 2019 to 2020, and is likely to have to replace asset purchases with generous repo operations (LTROs), a sort of QE lite, or QE stealth. The Federal Reserve once resolute in hiking rates regularly through 2019 and 2020 has softened its message and will likely slow the pace of rate normalization.

The short view

FX

One of the most unpredictable markets is FX. The USD had been strong as the Fed first signalled QE taper, then executed it, raised rates and began to shrink its balance sheet. The

Democrats winning the House probably marked the end of USD strength in the short term. However, the market still prices in eventual normalization at the Bank of Japan, and the ECB, a view that will likely fade as more data emerges in the coming months. The People's Bank of China, has only just begun to compensate for its deleveraging efforts and will likely announce further cuts to reserve ratios, further relaxation of collateral standards for repos, and recapitalize the Chinese banks to enable them to lend. At a more visceral level, which is often useful in FX, in a more turbulent and uncertain world, it is hard to envisage viable alternatives to the USD as a haven currency.

Equities

Central bank accommodation the world over will support risk assets. However, valuations in US equities has not retrenched as much as it has elsewhere. While growth in the US will remain the most robust by comparison, Chinese, Asian and European equities have already priced in a slowdown.

Duration

USD duration could outperform given that the Fed has already tightened and could be approaching the last third of its cycle. The focus should be at the 3 – 5 year sector where the curve is still steep. The flatness of the curve further out suggests value in shorting the 30 year treasury. A less hawkish Fed might be construed as less responsible and justify a greater term premium.

EUR duration could outperform also and across the curve. The EUR curve is relatively steep and the ECB is likely to have its hands tied as to normalization.

Credit

Investment grade spreads widened throughout 2018, surging in the last quarter before tightening sharply in Jan 2019. There

is some value in IG but there is also more leverage in issuer balance sheets. At best this is a neutral allocation. High yield spreads also widened over 2018, surged and receded. There is some value too in HY but there will be volatility.

The leveraged loan market, despite deteriorating lending standards, remains attractive. The floating rate nature of the debt removes the duration element and the seniority of claim provides more security than bonds of equivalent issuers. The complexity of this asset class and the risk of issuers playing creative games with assets and cash flows presents some risk, so these markets are best accessed through specialist fund managers. And then there is the CLO, which packages leveraged loans into leveraged vehicles that issue bonds of various seniority of claim, allowing the investor to choose their risk. The rules and limitations imposed on CLOs in order to support their credit ratings is a useful and important filter at a time when loan standards have declined. Loans and CLOs are some of the most interesting investments in credit given the uncertainty over growth and interest rates today. And finally, mortgage bonds. A tight labour market and moderate growth in the housing market make a sound basis for US mortgage bonds. The mezzanine tranches, known as credit risk transfer bonds are the most attractive in the residential arena.

Energy

The chronic underinvestment in capacity will create undersupply in the coming years. Oil prices are likely to rise under this scenario. However, given the flexibility and capacity of US shale, the short term price action will be driven by a strategic game theoretic evolution in the markets as OPEC, led by Saudi Arabia, attempts to limit the influence of US producers. This involves at times OPEC oversupplying the market to coincide with periods of stress in credit markets on which US shale is highly dependent upon. In the even longer run, the migration of dependency on fossil fuels to

sustainable and renewable energy sources will see a decline in the importance of oil. At this time frame, the direction of oil prices will be unpredictable as both supply and demand contract.

Generally:

Once an analgesic has been discovered it is difficult to wean off. As the global economy has slowed, central banks have shown their propensity for accommodation. The weakness in Q3 of 2018 was largely due to Fed Chair Jerome Powell not rolling the so-called central bank put. As markets tumbled, he rolled the put, and markets have since stabilized. The ECB had talked an optimistic outlook up until the Jan 2019 meeting, but will very likely roll its put if the European economy continues to weaken. The PBOC already rolled its put with RRR cuts and expanded MLFs and a new policy to support issuance of bank perpetual bonds. For shorter time frames, central bank accommodation policies can be very positive for asset prices. As long as the central banks keep rolling their puts, maintaining ample liquidity and financial support, asset prices will be supported. This is the short view.

Threats to this outlook include a drastic slowdown in economic growth in one or more regions. Europe is an area of concern given how rapidly its economy has weakened. While it is this weakness that provides the ECB justification for slowing its normalization, if too acute, such a slowdown could trigger a change in the narrative and further accommodation could be a sign of panic.

The trade war is another factor. The current assessment is that tensions have peaked but will remain, a sort of regression to a state of Cold War. If, however, a volatile and unstable White House decides to escalate the confrontation, sentiment could deteriorate very quickly. The Chinese response and strategy is quite predictable, parry but do not escalate.

The short view thus recommends a largely risk on position justified by accommodative central bank policy and a moderately slowing economy avoiding recession.

The long view

We maintain our faith in price discovery except when prices are falling. This was certainly the case in 2008 during the financial crisis when central banks and governments mounted a concerted effort to support markets and maintain the proper functioning of the financial system. The policies we learnt and employed in the aftermath were palliative rather than curative, but sufficient for our short term purposes. The danger was that underlying causes would not be addressed or that the solutions would be used inappropriately or excessively as most palliatives tend to be.

Debt levels

Treasuries and central banks have been enlisted to support both asset prices and near term economic growth while borrowing ever increasing amounts from our own future, amounts which are unlikely to be repaid by the economy as a going concern. This implies that either there is a future slowdown as a result of servicing and repaying this debt, or some creditors will not be repaid. Alternatively, this can be achieved in continuous fashion by engineering inflation, either in the real economy, or in asset prices. The gap between inflation in assets versus the real economy, in say wages, has already widened exposing stress points and raising questions as to sustainability.

High debt levels also mean that interest rates cannot be allowed to rise too quickly or too far, lest debt service becomes unbearable. There is therefore a limit to how far

central banks will allow interest rates to rise, unless they are unable to maintain that limit.

Policy:

The efficacy of quantitative easing and interest rate policy in providing short term relief and growth mean that the strategy will be deployed in case of recession or market crisis. History has shown that policy has never been able to be fully reset before the next crisis occurs. Policy is subject to strongly diminishing marginal returns. The result of this is that short term crisis management policies are deployed in ever increasing size, or more creative short term solutions are formulated to deal with crises and recessions. The Japanese experience provides some guidance as to the future of Western developed world policy, characterized by ever increasing debt, quantitative easing, de facto debt monetization and zero interest rates. Japan is able to operate this policy for protracted periods because of its high level of savings, even now declining, and that its debt is internally funded. Countries requiring external funding of its national debt will face rate and FX volatility and possible default, especially if funded in hard currency. The ECB is uncomfortably close to having a recession without having had the opportunity to reset or normalize policy.

Politics:

The rich poor divide coupled with slow growth resulting in the reality or perception for the majority of the populace, of declining wealth and purchasing power, is creating turbulence in the geopolitical landscape. Inequality between nations has receded as frontier and emerging markets have caught up to the developed world, reducing the inter-national rivalries to an extent. However, inequality within nations has risen to levels precipitating a desire for change, often any kind of change. While risks of inter-national conflict have declined, the lines of conflict within nations have sharpened. The razor

thin margins of election results, the instances of hung parliaments, of weak coalitions, of the rising Far Right, are symptomatic of these conflicts.

Europe will be an interesting example to watch. Far Right parties control Italy and are gaining traction in Germany, Austria, Hungary, and most recently Spain. France is facing a popular revolt from the Gilets Jaunes. The coming European Parliamentary elections in May 2019 are a potential focal point for the Far Right. There appears to be a new coherence across Europe's populists absent in previous elections.

Exacerbating political risks is the rise of strongmen like China's President Xi, America's Trump, Russia's Putin, Turkey's Erdogan, Hungary's Orban, and most recently, Brazil's Bolsonaro. A period of apparently unfair policies and unequal distribution of wealth and opportunities has created demand for the indignant, assertive, populist leader. General conditions today include, the failure of moderate parties to gain sufficient support individually, or indeed to work together to form stable coalitions, economic anxiety arising from slow growth and inequality despite healthy aggregate growth data, the perception that policy has favoured the elite at the expense of the masses and that the system is rigged.

The China – US rivalry will likely dominate the geopolitical topography for some time to come. The current trade spat is but one dimension in a wider struggle for supremacy. A confrontation between the greatest power and the power in ascendency is almost inevitable. It is likely that the rivalry will expand beyond trade to commerce, and to geopolitics and the projection of power and influence beyond their respective borders or regional spheres of influence. A technological arms race is already underway and is at risk of escalating in more aggressive ways.

Given current general conditions, the world cannot afford a sustained or acute slowdown, either globally or in any

significant region or country. Even a single nation could serve as a focal point for wider conflict and division. A significant economic slowdown would potentially impoverish sufficient people to precipitate political change in an unconstructive fashion. The likely policy response to recession or crisis is also likely to be unpopular and reinforce the view that the system is rigged against labour in favour of asset owners. The conditions would be conducive to the rise of an opportunistic, populist strongman to commandeer popular support against the status quo. Such an opportunist would likely emphasize nationalism, protectionism, and rejection of the current economic system.

In summary:

The short view is quite benign. A cyclical slowdown is already underway outside the US and will at some point find its way into the US. The slowdown is likely to be shallow given the policy tools available and the willingness of government to use them. Valuations are reasonable in most markets following the sharp corrections in Q4 2018. While the non-financial sectors have increased operating and financial leverage, banks have, by reason of increased regulation, reduced leverage. Consumer debt, which passes through the banking system is similarly deleveraged. The banking system has been strengthened to lower the risk of financial contagion.

The long view is clouded and fraught with risks from the economic to the political. A surfeit of debt, mostly sovereign and corporate, hangs over the outlook threatening default, devaluation or financial repression. The political risks are perhaps even higher than the economic or commercial and threaten potential regime change.

The short view recommends being risk on, at least as long as the central banks are willing to underwrite asset values. The

long view recommends caution. Taken together this implies a strategy akin to the game of Chicken, or brinksmanship.