

Ten Seconds Into The Future. Investment Outlook 2017

US Fiscal Policy

The impact of fiscal policy on the US economy itself has unpredictable elements. The current outlook is that the fiscal plan will create more disposable income and allow more consumption and investment and that this is inflationary and pro-growth. However, there are redistributive properties to the fiscal plan that are likely to increase inequality which suppresses the propensity to consume thus increasing saving. There are also agency issues that might change the optimal debt equity ratio for businesses. Revoking the tax deductibility of interest, for example, will skew companies toward equity financing. The consensus expectation that companies will buy back more shares might not happen. Rising interest rates may also discourage debt finance.

Therefore, the supply of corporate bonds could be constrained while demand could rise which could cause a spread compression beyond historical levels.

A strong USD is positive for European and Asian exporters, all else being equal. However, US trade policy will reduce this impact. Also, countries which cannot fund cheaply in local currency and have funded or need to fund in USD will be at a disadvantage. USD funding will rise in more ways than one, the base line curve will rise but the shortage of offshore USD will raise funding costs even further. The strong USD and rising USD rates scenario favours most countries which can fund in local currency, which means Europe, Japan and China. China, however, has local issues which may lead to tighter financial conditions this year.

If US growth picks up, the trade balance will have a natural

tendency towards deficit. This is the theory. Trump's policies appear to attempt to grow the economy while managing the trade deficit towards balance. Energy self-sufficiency, trade protectionism, and domestic job creation which discourage offshoring and encourage re-shoring will compensate for the deficit tendencies of fiscal policy.

Rising Interest Rates

2008 marked a change in the way economies function and also lifted the veil on changes which had happened before the crisis but which were possibly covered by complacency. One major development is the role of central banks in the economy. Our understanding of how the economy works has not caught up with the fervour with which we have applied new techniques for managing the economy, and indeed how we chase yield and front run central banks.

One question which is useful to ask is, were falling interest rates a good thing or will they fall too far and threaten financial stability?

Japan's experience with NIRP was not entirely a success and had to be modified to near total control of the shape of the yield curve.

Inflation has fallen and seemed unresponsive to falling rates in recent history. Is the correlation between inflation and rates negative or has the correlation turned positive? There are arguments why this could be so.

Rising rates could be the catalyst for a return to normal levels of inflation. Falling rates could have encouraged over-investment and over-capacity leading to too much slack in the economy and weak inflation. Rising rates could be the catalyst for rightsizing the productive capacity of the economy to meet demand.

At some level, rates could get too high, but what do we mean

by too high, what level is too high? Public debt in developed countries has been rising steadily since 2007. In the US, debt to GDP has risen from just over 60% in 2007 to 104% in 2016. Trump's fiscal plans will likely increase the national debt further. Higher interest rates imply a higher debt service and in normal circumstances, the ability of nation to service its debt is a factor in the pricing of its debt. Circumstances have not been normal for some time. If market reverted to the old logic, the cost of debt could rise significantly. Central banks have tamed the bond vigilantes but could they do it again? The Bank of Japan is in a unique position in that foreign demand for JGBs is small and it is able to co-opt the purchasing power of the Japanese public to monetize the national debt. This may not be feasible in USD.

Rates are artificially low. The US 10 year had traded to 2.6% recently and a yield of 3% or 3.5% would be unremarkable. In the short term, yield hungry investors could well bid down yields to 2%. The longer term reality suggests that, looking beyond the noise and volatility, rates should trend up with the 10 year yield trading above 3.5% in the next 2 years. If the correlation with inflation has switched, this could even create an inflation loop which could drive yields higher.

As for the Fed, the task has become harder, and it will likely become more sensitive to inflation. Cutting rates is easier than raising them.

End of the Bond Bull?

From the above analysis, the answer is, the duration bull market is over. However, turning points can span 2 to 3 years. This volatility threatens to be the unfriendly kind, the kind that has no predictable triggers, the kind that confounds the hedge funds who often claim that "volatility is good for us", and the opportunity for loss will be greater than that for gain. For that reason, the prudent strategy is to hedge duration rather than to actively trade it for profit.

The credit bull market is a separate question. The repatriation tax amnesty, the lower taxes, the loss of tax deductibility of interest expense, the rising interest rates, and tighter financial conditions will likely result in a relative undersupply of corporate bonds while yield hungry investors and a potential rise in savings from a more regressive tax code is likely to support demand. The risk for credit is on the upside, that is, spreads can be expected to tighten and to do so beyond recent historical averages.

Parting Notes

The economy and how it functions, the relationships between agents, and the behaviour of agents, has evolved over time and current models may not be adequate to explain the dynamics let alone predict the path of prices and variables.

The cold war in trade which is now becoming a hot war is a part of a more fundamental tension. When global growth rates are high, people are more likely to share and cooperate and the cooperative behaviour implied by Folk Theorem's hold. When growth is slow, people are less willing to cooperate and prefer to play security or short term strategies. Unfortunately, less cooperative behaviour may not be limited to commercial and economic interests but to geopolitical interests as well.

Another interesting develop

ment is the rise of machines. As automation replaces human labour questions beyond economic efficiency arise, notably, the question of who should own the machines. As long as machines do not represent too large a proportion of production, and as long as growth creates new types of jobs the need for an answer can be delayed, but at some point, the question needs and answer.