2017: BE CAREFUL WHAT YOU WISH FOR

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04/01/2017 | DIDIER SAINT-GEORGES

As we indicated last month (in "The wind is picking up", December 2016), the global business cycle gradually recovered in the course of the year from the low it hit in the first quarter of 2016, before getting a further, undeniable boost in November from Donald Trump's unexpected win at the polls. This is the backdrop to this start of 2017 and justifies equity markets remaining well orientated, with cyclical sectors driving the trend. Instead of worrying that economic growth figures might be disappointing for the umpteenth time or focusing on the many, oft-decried political risks facing Europe, it could be more relevant to consider the ramifications of the cyclical upswing under way, because they could prove decisive. That upswing is accompanied by two major consequences that we previously highlighted: a return of inflation – also cyclical in nature – and a stronger dollar.

It is necessary to consider the ramifications of the cyclical upswing under way

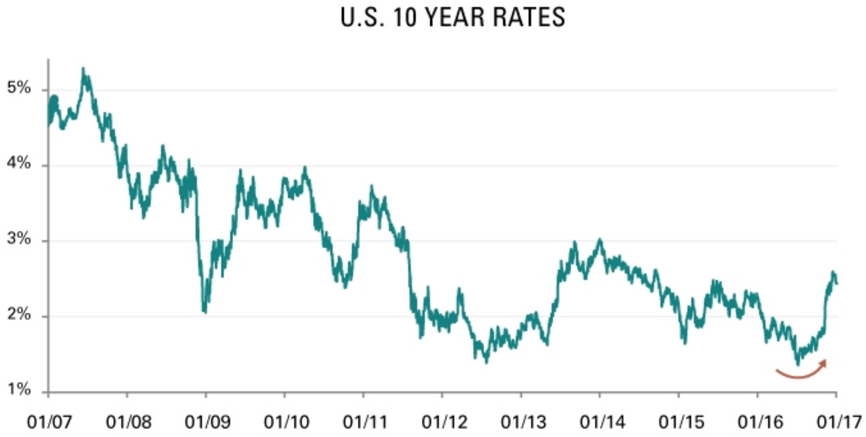
Investors have been yearning for a sustained improvement in the economic outlook for so long that they might forget to think seriously about how such an upturn will impact an already fragile bond market and, as a result, share prices. This would be unwise.

A BUSINESS CYCLE BUOYED BY THE "TRUMP FACTOR"

As we have repeatedly stressed, one of the most common forecasting mistakes is to confuse secular trends with cyclical movements. The worldwide build-up of debt and the shortfall in public- and private-sector investment over the past eight years have saddled the global economy with a feeble potential growth rate and lastingly low inflation. However, that secular trend does not preclude intermediary cyclical movements – quite the contrary. The reduced fire power of governments and central banks today makes it harder for them to cushion and finely steer cyclical fluctuations, meaning that those fluctuations are likely to become more severe. Just such a cyclical movement appears to be taking shape now.

As we wrote in November, the election of Donald Trump is best viewed as an accelerator of the cyclical recovery unfolding: the US economy is getting a second wind. The consumer confidence index has just jumped to its highest level since 2007 – which is well above what most economists anticipated. Business has also responded favourably to Trump's surprise win. The first economic statistics published since Election Day show that orders for durable goods in the US were up by 1.8% in November, moving into positive territory for the first time since 2015. Even better, we are dealing with a global phenomenon. In Japan, the cyclical recovery in industrial production has continued, with output expanding 2.9% in November, a 30-month high. In Europe, although industrial production is still advancing at a slow pace, the IFO's Business Climate Survey points to acceleration in Germany, hitting levels not seen since early 2014. So even before the fiscal stimulus programme promised by Trump kicks in, a cyclical improvement is palpable. This means that the sectorial rotation that equity markets began to witness in the first quarter of 2016 has a good chance of continuing.

A CYCLICAL RETURN TO INFLATION



Source : Bloomberg, 04/01/2017

The first consequence of the turnaround spreading across the global economy for close to a year now has been a gradual pick-up in inflation. The preceding economic slowdown was concomitant with US dollar appreciation from mid-2014 to 2015, a shift that brought with it a steep fall in commodity prices – including an outright collapse in the case of oil. Together, those developments temporarily reinforced the secular trend towards deflation. But then the business cycle went into reverse: a pause in the dollar's upward course cleared the decks for a surge in oil prices and an economic upturn in 2016. These cyclical tailwinds are therefore being accompanied by the first signs that inflation is rising from its previous extremely low level.

We believe that the nominal inflation rate in the United States could easily exceed 2.5% in the first half of 2017, even before any subsequent upward pressure on wages takes effect. In China, the annual rate of change in producer prices has jumped in the past twelve months from –6% to +3%. In the euro area, it went from –4% in April 2016 to 0% at year-end. While that's still too low to qualify as inflation, it shows that the base effect is considerable in Europe as well. The trend reversal under way is what matters for financial markets, and it can be expected to push consumer prices in the same direction (albeit with a lag). Japan's inflation rate remains extremely low, but after falling continually since mid-2014 and even entering negative territory last year, it booked its first uptick in the fourth quarter of 2016.

FIXED INCOME MARKETS: TROUBLE AHEAD

The ultra-loose monetary policies still being pursued by the leading central banks has so far delayed the adjustment by fixed income investors to the renewed upward pressure on prices. The yields on German government bonds currently do not exceed 0.30%, which is barely above their level in early 2015. Even US Treasuries yields have not made it past their mid-2014 levels despite recent gains. Given the emerging combination of a cyclical upturn and a return of inflation, we can look forward in the coming months to a major test of market confidence in the central banks' determination to keep interest rates close to their floor. That is the leading market risk that we need to prepare for in 2017.

A STRONG DOLLAR – THE OTHER CONSEQUENCE OF TRUMP’S AGENDA

As we argued in December, “Capital flows into the United States could plausibly speed up as a result [of Trump’s policies]. We should view this as a very powerful, lasting force behind the dollar ?” The current appreciation in the greenback hardly warrants comparison with the dollar surge that followed Ronald Reagan’s election in 1980, when the overall context was entirely different. It would be instructive to look at what occurred more recently following the introduction of the Homeland Investment Act passed in 2004 during George W. Bush’s presidency. As the Act provided a tax incentive for repatriating money invested abroad, it led to a capital inflow of some $300 billion in 2005. Its primary impact was to drive the US currency up by 15% during that year (even though a sizable share of the repatriated funds was already dollar-denominated). For now, one might reasonably expect the recent dollar rally to be followed by a lull. But with gradual monetary tightening by the Fed and a shrinking US current account deficit on the horizon, the greenback could soon be gaining ground once again – particularly against sterling and the yen, both of which are very fragile currencies.

Given the fragile state of the bond market, the cyclical recovery could well create its own antidote

MORE TO GOOD NEWS THAN MEETS THE EYE

The US Congress may conceivably end up taking some of the sting out of Trump’s big spending plans. Then again, if the new President makes good on his protectionist rhetoric, his policies could well lead to a contraction in world trade. Meanwhile in Europe, the issue of mounting political risk seems to be on everyone’s mind, as it should be. The odd thing, however, is that in focusing on these risks, we may be overlooking what matters most from a financial markets standpoint – the economic upturn is global in nature; the Trump factor is only one of its components. This recovery no doubt accounts for how the stock market has behaved over the past three months. But we are dealing here with a strictly cyclical phenomenon that may well create its own antidote in the course of 2017, given that the central banks have artificially kept interest rates at rock-bottom levels for years. Strong upward pressure on bond yields, particularly if it coincides with a rising dollar, will lead to much tougher financing conditions for the US economy – just when the current boom might begin to run out of steam. Initially, equity markets will continue to reap the benefits of the cyclical upswing under way; but eventually, they will be confronted with the wrenching adjustment of other asset classes to the new state of play.

As the power of central banks wanes, the business cycle is recovering its central importance for financial markets. And so will active portfolio management for investors.

With that outlook in mind, we wish you a vibrant, profitable new year.

Source : Bloomberg, 04/01/2017

INVESTMENT STRATEGY

EQUITIES

Equity markets finished the year with an impressive rally that prompted us to keep our exposure to this asset class at near-maximum level. On the whole, emerging markets are back on even keel, though with noteworthy differences from country to country. Oil exporters did particularly well on the back of a better than 10% oil-price rebound during the month of December, thanks to both the stronger fundamentals that we highlighted throughout the year (further growth in demand and limited output by non-OPEC producers) and the November agreement by cartel members to cut production. Moreover, tacit cooperation by non-OPEC oil producing countries in restricting output should make the new policy that much more effective. Given that oil companies stand to gain from this shift, we beefed up our selection of US energy-sector stocks with the addition of Hess Corporation in early December.

But our best performances in the month came from the Japanese and above all European markets, where our bank and oil-company stocks took the lead. We expanded our selection of Japanese financial stocks to add Nomura Holdings in December. At the same time, we kept our long positions in futures contracts on the Eurozone bank stock index to tactically capture the rally in bank shares under way.

In today’s tight markets, careful portfolio construction will be as essential as ever to balancing performance generation with prudent risk management.

FIXED INCOME

The surge in US government bond yields came to a halt in December, with the ten-year Treasury note ending the year below the 2.5% mark. The key highlight of the month turned out to be a retreat in interest rates in Europe, Brazil and a number of other emerging markets. That allowed us to take substantial profits, particularly on Italian and Brazilian government paper. Narrower credit spreads in Europe were likewise good news for the financial-sector bonds in our portfolio.

In December, we left our fixed income strategy largely unchanged, continuing with risk reduction and our selective positioning in both European credit and local-currency emerging-market debt to hedge against currency risk. We also maintained our policy of shorting US Treasuries, although convergence between the breakeven inflation rate and the real inflation rate in the United States may limit the short-term potential for US yields to rise further.

CURRENCIES

In December, the greenback’s upward climb of the preceding two months continued, but with waning momentum. It is unclear at this stage whether the US authorities will allow financing conditions to tighten under the simultaneous impact of a stronger currency and higher interest rates, but we will be sticking to our foreign exchange strategy of treating the US dollar and, to a lesser extent, the euro as safe-haven currencies.

Even though the rebound in crude oil prices provided a boost in the fourth quarter to the rouble and other currencies highly correlated with oil prices, emerging-market currencies have on the whole remained extremely volatile. The yen, meanwhile, has weakened further. The greater visibility created by the Bank of Japan’s pledge to maintain ten-year yields close to 0% has sparked a return to carry-trade strategies that drive down the Japanese currency. We have accordingly maintained our yen hedges.

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