October 2014

Everybody has a plan - until the plan does not work

Virtually no one had predicted lower rates in 2014, much less the current year's 70 basis point rally, believing increasing inflation would dominate global rates, led by payroll gains and a recovering consumer. But with hindsight, the 2014 'risk-off' scenarios tended to outweigh the 'risk-on' factors, sending global rates lower. Our central question over the past year was answering when global economic recovery would trigger inflation and interest rate rises. Our recent Economic Roundtable discussion (attended by a range of senior economists, strategists, and other global investors) attempted to analyse the dichotomy between a range of 'risk-on' and 'risk-off' drivers of global growth and inflation, in order to ultimately assess the overall pace of progress as we near the end of 2014.

We began our discussions with the worry over continuing to have a market consensus view of low growth, low inflation and low volatility in a world characterised by political sterility, little fiscal discipline and central banks picking up the slack through accommodative rates and further QE. We recalled the end of 2013, when markets forecast increasing growth, inflation and central bank rates. As US Treasury yields approached 2-year highs, economists were virtually unanimous in their calls for higher rates, and investment managers increased the short interest-rate and long US dollar positions. And then promptly got carted off to the hospital as the first quarter of 2014 unfolded…

With a main goal of not getting carted off to the hospital in 2015, our analysis of the issues the global economy will face over the coming year, grouped into their 'go'/risk-on or 'woe'/risk-off corners, is laid out below:

RISK OFF FACTORS

Geo-political risks – Ebola, ISIS, terrorism, US Congress…

A virtual consensus determined that the world had learned to live with on-going turmoil, with history suggesting that new risks could temporarily halt growth, but that most foreseeable risks would not drive global markets lower. However, should the risk of war increase, either in the Ukraine or Middle East, history shows that long wars can be inflationary – perhaps a very non-consensus outcome in the current market environment (and a reminder that these risks may not always be deflationary). US political risks were deemed immaterial to the global economy, Obama being something of a lame duck before the elections, and now more so – so no real change there (however, the debt ceiling fight in early 2015 is again a real risk as are temporary spending budgets contemplated by Congressional Republicans).

Regulatory environment – will higher costs of capital and increasing regulation mean smaller dealer inventory and decreasing liquidity?

Smaller bank balance sheets combined with consolidation in the fund management industry and growing large institutional investors (such as sovereign wealth funds) could lead to a selling crisis where technicals far outweigh fundamentals (similar to 2008). Regulatory and market dynamic changes have led to short-term liquidity gaps becoming the rule, not the exception, and we are reminded of Keynes' quote, "markets can remain irrational longer than you can remain solvent". A strict sell discipline which emphasises reducing risk despite fundamental views will become more critical in the coming period. We will see more 40bp moves in US Treasury and corporate bond markets off of seemingly no real news, driven by a lack of liquidity and no underlying fundamental rationale.

Commodity and oil prices – what impact on global economies?

Is consumer price inflation dead? There was general consensus that oil prices were in a secular decline given technical innovation. Beyond shale/fracking technology the announcement of a fusion generator was viewed as a global game changer, albeit with a likely 10 to 20+ year lag (while we had no fusion scientists on our panel, we viewed prospects for an energy revolution remaining a long-term deflationary force).

China/emerging markets – are they long-term deflationary forces, and what are the prospects for a hard landing in China?

Asia remains a long-term, deflationary force due to a cheap workforce and policies intended to bring people out of the agricultural into the manufacturing sector. Domestic demand is growing and will eventually become a larger force, but not in the next two years. Asia offers good relative value compared to the US – you get paid in the form of higher returns to take the increased volatility risk (and greater transparency means an improving credit story). Consumers, not commodity producers, will benefit from lower commodity prices.

Risk remains as the recovering US economy leads to a stronger USD and pressure on Asian countries to raise rates. While markets will continue to worry about China and the growth of the 'shadow banking' sector, we don't see a major debt crisis in 2015. This growing debt may represent China's largest economic problem, however, central government intervention will limit the risks of becoming a major threat, but short-term growth may prove more challenging. The central bank will continue to provide liquidity to the financial system while defaults will be managed through intervention. Investor losses will be realised, but minimised, as authorities take over more loans and/or move assets to regulated banks. In the medium term, China may move toward a slightly lower growth path, as some loans prove to be unproductive.

However, these risks are manageable because growth rates remain high (particularly vs. the rest of the world) and the domestic nature of debt and high savings rates will help. The banking system has low leverage, a large domestic funding base and fairly low levels of non-performing loans. The central government's high foreign exchange reserves and modest government debt will also ease the burden. Further reform programmes, albeit with slow implementation, will allow a smooth transition from investment to consumption. We expect growth to remain in the 7.0% to 7.5% range over 2015.

European periphery and a potential UK EU exit. Can a peripheral crisis be prevented and for how long? Are fiscal fundamentals and lack of structural reform insurmountable in parts of the periphery?

A €1 trillion balance sheet expansion, bringing the European Central Bank (ECB) balance sheet back toward the €3 trillion levels we saw in 2012 is only the beginning… While it is unlikely that sovereign bonds will be added to the ECB's programme in the near term (given current German concerns over debt mutualisation), eventual negative shocks stemming from the lack of structural reform and fiscal discipline in some peripherals will eventually change German opinion on the consequences of such action. However this is likely a beyond-2015 problem, as peripheral economies not reaching their fiscal targets and unimplemented austerity measures can be papered over with the ECB's continuing support. Nonetheless, we foresee tightening European credit spreads amidst greater ECB easing and favour peripheral sovereigns with improving fiscal fundamentals. Greece is the real risk with a few participants predicting a default within the next 2 years, but there is a first mover advantage in default in the form of a weaker currency and debt removal (however, ECB QE will slow the process, meaning a 2015 event is unlikely).

Australia – tougher transition from mining investment to manufacturing servicing sector in the face of a still strong AUD

Amongst the panel, there was general consensus that the Reserve Bank of Australia (RBA) would remain on hold over 2015 even as the currency weakened. While housing markets may prevent the RBA from reducing rates, we foresee an 80% probability of rates on hold, a 15% probability of a cut and a 5% probability of a hike. The jobs story will be critical in the months ahead as the successful transition from mining investment to manufacturing/servicing remains a challenge.

RISK ON FACTORS

US payrolls – will the jobless rate falling toward 5% and growing wage inflation lead to an improvement in the US growth story? Is this the end to US QE Asset Purchases, or will we see QE4? Can BOJ and ECB take over from the FED?

Six years of QE has allowed equity market PE's to move back toward pre-crisis levels, and has helped the rich in form of higher equity prices, rising home values and 20% of new jobs getting significant wage increases (but we question whether gains in asset prices will now have as much of a wealth effect as in the past now that investors have made up for their 2008/2009 losses). QE has helped the less well off in the form of jobs, albeit low-paying and temporary. Why are wages so low? Globalisation of labour markets, and rents going to people who write code; innovators & entrepreneurs, not workers. Today, technology is disrupting the status quo similar to industrialization disrupting the agricultural status quo in the late 19th and early 20th centuries, and depression risks remain. How much of new QE gets into the economy? Given reluctance of banks to lend and consumers/businesses to borrow, it is estimated that the US economy moved from 23 cents of each dollar getting into the economy as a result of QE to a current 2 cents, meaning future QE will have little impact on the economy.

USD strength – time for the US to allow dollar to rise? Are we in a new currency war?

A simple yet strong consensus; the entire panel were dollar bulls who found it hard to see a massive rally, rather expecting a slow steady revaluation of the USD vs. the rest of the world.

Who will tighten monetary policy in 2015? (RBNZ, BOE, FED, RBA, ECB, BOC)**

Again, broad consensus. Aside from a small probability of the RBNZ, no one.

Can the rise of asset prices (equity/credit/housing) continue, and how high can the market go?

A return to the roaring 20's? To what extent can continued easing policy allow risk assets to continue to perform? While QE has distorted both asset prices and risk, concerns over widening credit spreads appear overdone; we're not seeing forced liquidations and we know it's hard to sell corporate bonds because if you do, you won't get them back. Equities have more room to rally than corporate bonds, where it's hard to see more than a 20 to 30bp rally given spread tightness. The biggest worry is EM – at risk should the USD continue to rally and easy EM money will come out – then HY for two reasons, 1) underwriting quality deteriorating and rise of low doc covenants, and 2) heavy reliance of floating rate in a low rate environment which allows unsound businesses to remain afloat (when rates rise some HY companies will become considerably riskier).

ECB & BOJ QE

How important will it be to risk assets? Critical to European and Japanese economies. ECB QE will allow European risk assets to perform well and 'paper over' fundamental problems of undercapitalised banks, lack of structural reform in labour and product markets, and questionable fiscal discipline in some peripherals. Greece is most likely to default – the panel majority thought default probabilities increasing dramatically over the next few years.

Overall themes and market strategies

Although central bank policies are having a more limited impact, central banks have little choice in maintaining easing biases and QE – politics and fiscal reforms have failed, making currency devaluation the only viable plan left. However, currency devaluations don't work very well when everyone does it. The US is in a better position, given steady, moderate jobs growth and greater fiscal discipline/progress toward budget balance in recent years due to the sequester compromise.

In this environment we see duration as the new carry. While longer-term bond yields look fairly unattractive, they're likely to stay low, making carry and positive 'roll-down' over 2015. Demand for an income stream in the form of fixed income will be a key investor goal over 2015.

The panel's favourite trades for 2015 were as follows:

- Short Yen, Euro and AUD vs. long USD
- Flattening US, Australian and German yield curves, short 2 year rates s vs. 10 and 30 year rates
- Long Nikkei vs. short US S&P
- Long Chinese equities & bonds
- Buy volatility wherever you can
- Long technology vs. energy stocks

US S&P500 P/E

Source: Bloomberg