Market
INSIGHTS

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What difference at this point does it make?

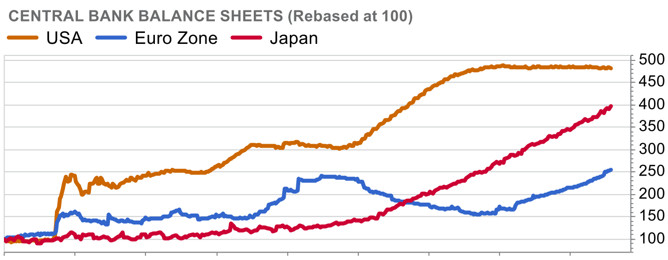
Time to embrace fiscal activism

Major central banks seem to be asking themselves this question – what difference would additional bond purchases or another rate cut make since growth has remained lackluster despite years of aggressive monetary policies? Despite Brexit, the Bank of England refrained from taking any action last month. Despite potential contagion from the UK referendum, weak growth, dangerously low inflation and ongoing concerns with the health of the banking sector, the European Central Bank also refrained from implementing additional stimulus. And, in a surprise move, the Bank of Japan decided to leave both interest rates and its bond buying program unchanged, limiting itself to buying more stocks through ETFs. More importantly, the BoJ announced it will conduct a comprehensive assessment of the developments in economic activity and prices under "QQE" and negative interest rates, the results of which will be released at the next meeting (September 21). Does this mean that central banks are running out of policy bullets and are likely to become more passive going forward? We don't think so (and the Bank of England made this more clear at their August 4th meeting), although both the BoJ and the ECB might have second thoughts about the effectiveness of negative interest rates as a policy tool. However, central banks are still very much focused on driving inflation (and inflation expectations) higher, as well as supporting growth and stimulating credit. As we will discuss later, there is nevertheless a growing belief that monetary policy alone will not be successful at achieving these goals without a little help from another policy tool.

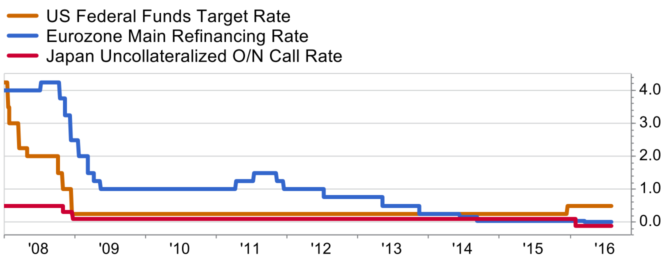
At the other end of the spectrum, here at home, the Fed is still willing but apparently unable to implement its policy of normalizing interest rates and investors are wondering "what difference does it make?". What difference would a second rate hike of 0.25% make to an economy already seven years into an expansion cycle where the unemployment rate has dropped below 5% and consumer spending is growing at a very healthy rate?

So, now what?

More quantitative easing?



Would another rate cut help? Or would a small rate hike hurt so badly?



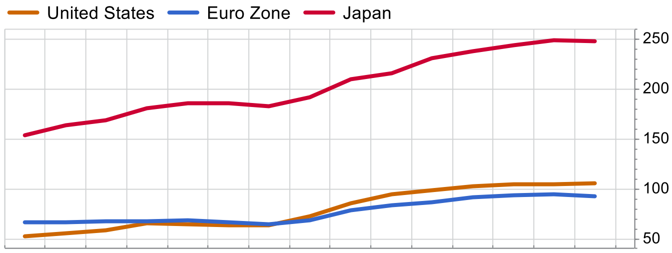
Unfortunately, no one really knows. On paper, this should not be overly damaging to the US economy but the memory of what followed the "taper tantrum" in August 2013 and the first rate hike in December 2015 is still very fresh in investors' minds. Despite the slightly more hawkish tone struck by the FOMC during the July meeting, we believe that any rate hike (as justified as it may be based solely on domestic macro indicators) would lead to renewed market turmoil as long as growth overseas is not on a firmer footing. And, as we have seen in recent past, adverse market developments - such as a surging US dollar, widening credit spreads, flatter yield curves, weaker equity prices or a plunge in oil prices - will most likely have negative consequences for the real economy. As highlighted several times, the Fed policy feedback loop is still alive. While the FOMC is officially data dependent, we believe that financial markets hold the key to what the Fed will actually be able to do in coming months.

Stronger together.

There is a growing belief among economists and policy makers that aggressive monetary easing alone will not be able to lift growth and inflation high enough in the current environment characterized by private sector deleveraging, lackluster consumer spending on a global basis, weak investment spending, banks' reluctance to expand their balance sheets, financial repression, poor demographics and productivity gains. As discussed in the June edition of Market Insights, in the post-Debt Supercycle world, governments will need to embrace fiscal activism in order to complement current expansionary monetary policies. Monetary finance – a.k.a. Helicopter Money – is basically a combination of fiscal stimulus and quantitative easing implemented in a coordinated way without leading to a rise in public debt levels. While this highly unorthodox policy is not yet on the agenda, several governments are expected to move away from years of fiscal austerity and implement some type of fiscal stimulus. The Abe Government announcement of a JPY 28 trillion spending and lending package last month should be seen as the first step towards expansionary fiscal policies in various parts of the world. The shift away from budget rigor has so far been relatively subtle and is still far from universal. While countries like Canada, South Korea and Japan are among those rolling out fiscal stimulus, others such as Germany are still holding firm. Borrowing heavily to support growth in the euro area is still out of favor (courtesy of the EU debt crisis and numerous painful bailouts), but even there, we expect a shift away from austerity in coming months. The UK referendum was a wake-up call for governments around the world that they can no longer ignore the growing voter dissatisfaction with the economic status-quo, rising inequality since the financial crisis (soaring asset prices but stagnant wages), and pushback against global trade (another potentially damaging headwind for future growth). The best answer to rising inequality is to achieve stronger growth (the rising tide that would lift all boats) but this goal appears elusive given private sector debt overhang and extreme caution displayed by firms and banks.

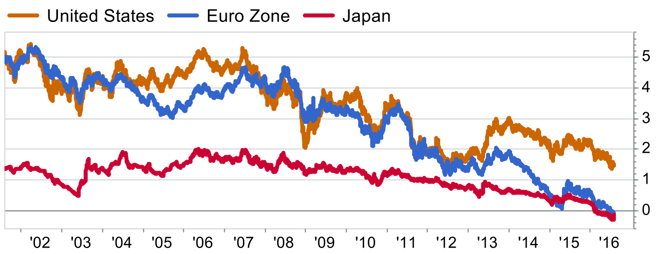
Time for a fiscal jolt

Government gross debt % of GDP



Taking advantage of record low borrowing costs

10-year government bond yield



While it might sound depressing to many that the only solution to problems that were originally caused by excessive debt levels is more government debt, the reality is that fiscal stimulus (lower taxes and/or public spending) would make a lot of sense in the current context.

Although monetary policy has helped keep the global economy afloat despite a succession of crises in recent years, the marginal benefit of more easing has greatly diminished. But one thing that monetary policy can do (through low interest rates, forward guidance and ongoing QE) is to help anchor government bond yields at extremely low (and sometimes negative) levels. As a result, governments can borrow at historically low costs. Assuming typical fiscal policy multipliers, expansionary fiscal policies are likely to be a net positive for the global economy given current extremely low financing costs. Indeed, there might never have been a better time to implement growth-boosting fiscal policies as the demand for government bonds remains elevated (through quantitative easing programs, financial repression "forcing" banks to hold more government paper as well as the ongoing global savings glut).

If you can borrow at a rate lower than the return you can achieve on debt-financed investments, then taking on more debt is actually a sound decision, whether you are a business or a government. Obviously, if rising public debt levels lead to higher bond yields or a crowding out of the private sector, this reasoning might not work as well in practice. But, in the current environment, we believe fiscal stimulus – if and when implemented – is unlikely to lead to rising bond yields (at least in real terms) as monetary policy will continue to act as the necessary complement – i.e. keeping yields low through forward guidance and ongoing QE. As far as crowding out the private sector, this is highly unlikely since the world is currently characterized by excess global savings compared to weak private capital spending. Indeed, low borrowing costs are as much a reflection of excess global savings that they are of easy monetary policies.

There is also a real need for fiscal easing, in particular public spending on infrastructure after years of underinvestment in this area in many major economies.

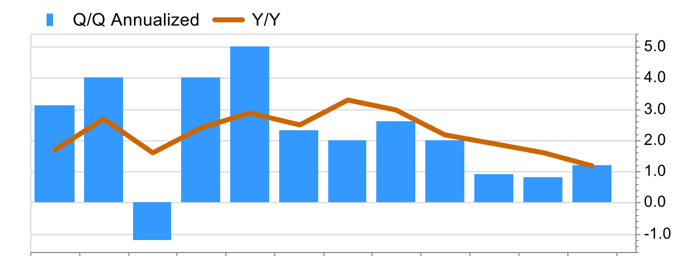
Moreover, fiscal easing appears to be the natural consequence of the current political landscape globally where voters are increasingly voicing their discontent with years of policies that have generated greater inequalities and stagnant wages. In order to fight off voters' anger and frustration which has resulted in rising support for populism, nationalism, anti-trade and anti-establishment rhetoric, loosening the public purse strings could very well be the best and only strategy left for mainstream and incumbent political elites.

Make America grow fast again.

As we have repeatedly indicated in past editions of this newsletter, the US economy is the best house in a bad neighborhood. Still, the current recovery has been the weakest on record since at least the end of WWII. Over the past three quarters, this weak recovery has actually become even weaker with annualized GDP growth dropping to under 1% (0.9% in 4Q2015, 0.8% in 1Q2016 and 1.2% in 2Q2016).

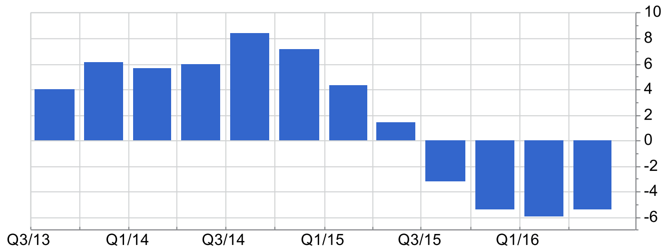
Dismal recovery weakening further

USA real GDP growth



Earnings recession

S&P500 – Y/Y % change in quarterly EPS



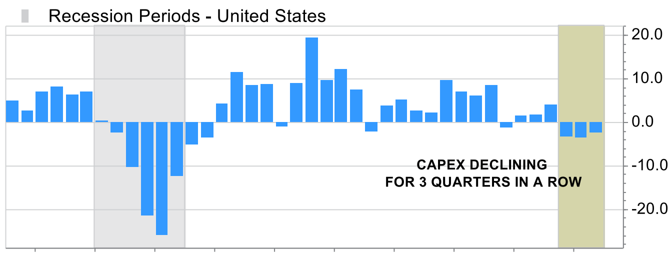
Granted, business inventory liquidation shaved off 1.16% of growth last quarter and one should therefore expect a rebound in the second half of the year. Consumer spending was also a very bright spot, expanding at a 4.2% clip, the fastest growth rate since the last quarter of 2014, a testament to ongoing strong gains in job creation and the mild pickup seen in wages. However, the weakness in capital spending continues unabated with non-residential fixed investment down 2.2% (the third quarterly decline in a row) despite record low financing costs (reducing the hurdle rate for new investments) and tighter labor markets. At the same time, corporate profits are on track for their fifth straight quarter of negative growth on a year-on-year basis and productivity gains have been anemic for the past five years averaging only 0.5% per year (the weakest reading since the rampant inflation years of the late 1970's).

The consensus view (which we share) is that the earnings recession is now over (given easier Y/Y comparison in terms of oil weakness and dollar strength) and that GDP growth will pick up later this year. However, growth is dangerously low and exogenous shocks or policy mistakes could easily tip the economy in recessionary territory.

Dismal productivity gains and weak capital spending (a sign of extreme caution at corporate boards) are particularly concerning since they hold the key to keep the economic expansion alive. Indeed, in the absence of a decisive turnaround in productivity gains (unlikely if capital spending does not pick up), rising wages are likely to put additional pressures on profit margins.

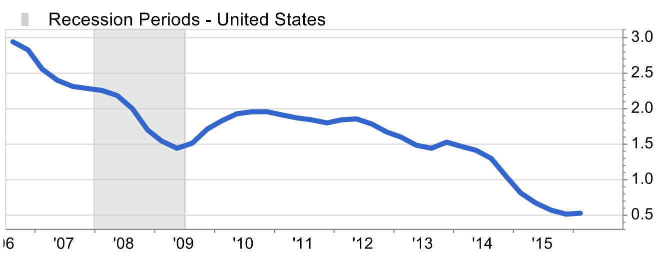
Worrying trends in fixed investment

Quarterly change in non-residential capital spending



Extremely weak productivity gains

5-year moving average



Given weak top-line growth, this could spell doom for corporate profits and, with a lag, lead to a reversal in labor markets. Although the US economy remains the best house in a not so great neighborhood, it will remain stuck in the mud – and at risk of dipping in recession – unless policies are implemented in order to unleash the full growth potential of US corporations. These policies should primarily focus on reducing the heavy burden of regulations plaguing small businesses and the banking sector, reforming the tax code and fostering an environment conducive to stronger foreign trade. While the US economy is predominantly a domestic economy (exports account for less than 15% of GDP), this is not the case when it comes to corporations. Both presidential candidates have espoused an anti-trade deal agenda, which – if implemented – would further pressure global trade (already growing at a slower pace than global GDP) and hurt corporate profits. On the other hand, both candidates are advocating for some level of fiscal stimulus (mostly public spending for Clinton and tax cuts for Trump). Clinton suggests that this fiscal expansion will be financed by additional taxes on big corporations, Wall Street and the wealthy. As we all know, Trump loves debt and he wouldn't necessarily try to find offsetting spending cuts and/or revenues, but instead benefit as much as possible from the current record low interest rates. The upcoming election is already shaping up to be one of the most interesting in recent memory. It will also be one of the most important from an economic perspective as the US economy remains stuck in the mud and desperately in need of renewed momentum and clarity with regards to future policies.

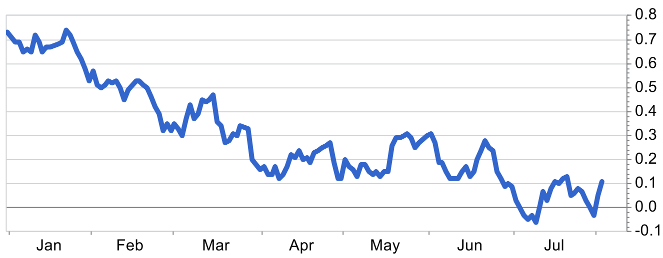
The quest for gold.

The 2016 Summer Olympics just started and for more than 10,500 athletes (among them, 554 Americans, 108 Belgians, and I don't really know how many Russians), the quest for Gold has begun. Between the end of the 2008 Olympics and the start of the 2012 Games, silver actually outperformed gold, rising 102.8% against 91.5% for Gold. As a result, Belgian athletes left London with zero gold medals, focusing instead on second place finishes (a dangerous strategy which led many of them to fail winning any medal at all). Although silver is once again outshining gold so far this year (up 47% versus 27% for gold), I guess that the Belgian debacle during the 2012 Olympics will serve as a lesson for every athlete. While there will be 306 events and probably many more gold medals actually awarded (as a reminder, there are eleven players and several substitutes in a football team), I doubt that this has resulted in such a large pickup in demand for gold that can help explain the 27% surge so far in 2016. Something else must be going on, and that something else has to do primarily with the outlook for interest rates and global monetary policies. As such, the quest for gold is very similar to the search for yield, another investment theme which has been prevalent for several years already.

Surging gold prices

Plunging real yields

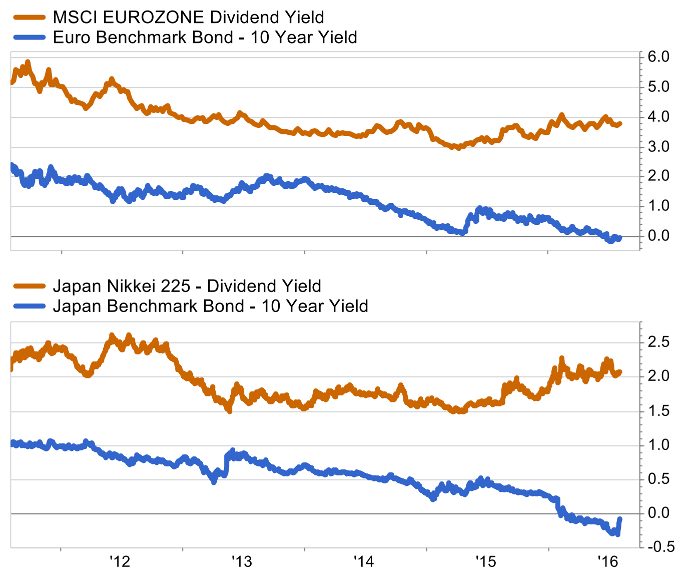
Yield on 10-year treasury inflation protected bond



Although different investors see different things in gold and some believe there is never a good reason to invest in the shiny yellow metal, I believe the case for gold is pretty straightforward in the current environment. Since the introduction of treasury inflation protected securities in 1997, the single best determinant for the direction of gold prices has been the trends in real bond yields (i.e. the yield on TIPS as opposed to the yield on traditional, nominal treasury bonds). Gold prices tend to move higher when real rates are either declining or sitting at very low levels. Intuitively, this makes sense since low real yields reduces the opportunity cost of owning gold, one of the very few investment that does not pay a coupon or a dividend. Moreover, low real rates are also an indication that monetary policies remain highly accommodative and that central banks are implementing policies aimed at generating higher inflation going forward, another factor which is often seen as a positive for gold prices. Today, bond yields are not only extremely low, they are in many cases negative, even in nominal terms as nearly 40% of developed market sovereign bonds trade with a negative yield. Since inflation is positive in most cases, real yields are even deeper in negative territory. The opportunity cost of holding gold instead of government bonds is therefore not really a cost anymore. Moreover, many investors – rightly so – look at gold as a quasi-currency, one whose value cannot be "manipulated" by central banks through aggressive policies. Beggar-thy-neighbor policies are another factor which should support gold prices in the medium term. As evidenced by the recent pickup in volatility in currency markets, most economies are either unable and/or unwilling to accept a rising currency.

Stocks are the new bonds?

Dividend yields significantly higher than bond yields



Putting it all together: What it means for investors.

Bonds remain a strong source of diversification.

The current environment is particularly challenging for investors. Staying in cash basically means earning nothing in nominal terms and losing money in real terms. But what should you buy when you don't feel like buying anything? Bond yields are close to historic lows as official interest rates are stuck close to zero through aggressive monetary policies and a global savings glut (excess savings versus investment). Although, at these levels, bonds don't look like a great investment, bond yields are nevertheless unlikely to move up significantly and long duration has been (and will likely remain) a strong source of diversification for balanced portfolios.

Consider stocks that look like bonds.

While low bond yields are often seen as an indication of weak growth prospects, equity prices (which are sensitive to economic and earnings growth) are at record high levels (at least in the US) despite disappointing business activity, an earnings recession and a succession of mini crises in recent months (Brexit being the last one, at least so far). Valuations are not particularly attractive either with both traditional valuation measures based on trailing or forward earnings/sales/book values, as well as cyclically-adjusted measures, already firmly above their long-run averages. Yet, it would be a dangerous strategy to assume that the only way for equity markets is down. First, equity bear markets usually develop ahead of economic recessions and recession risks over the next 12 months still appear relatively limited. This is not to say that markets could not experience another correction but we would expect such a correction to be relatively limited in magnitude and in duration. Indeed, a sell-off would probably be met with a new wave of buying from investors either currently on the sidelines or still standing on a decent amount of cash, once again yielding nothing. This brings us to the other reason why betting on an equity bear market does not look like a good strategy at this stage. Lower for longer bond yields will continue to drive flows into equity markets and other asset classes where investors can at least benefit from higher yields, as well as some level of price appreciation. Stocks that look like bonds should therefore continue to benefit. In bond-land, areas offering a decent yield pickup versus depressed government yields are also well positioned to attract further investors' flows, at least for as long as recession risks remain limited.

Stick to your plan.

As discussed, even if governments gradually move away from austerity and embrace some level of stimulus, central banks will act to complement these moves by talking or bringing down bond yields. As such, and despite the fact that it might feel very uncomfortable, if you have a long-term plan (and I hope you do), you should keep your plan. Now is not the time to deviate too much from your long-term allocations.

Areas worth consideration.

At the risk of sounding like a broken record, some areas of the markets continue to offer a better risk/reward in the current environment. In no specific order, we would point to stable dividend growers, REITs, international equities, minimum volatility strategies, high yield bonds, EM debt and gold.

As Baron Pierre de Coubertin (widely considered as the father of the modern Olympic Games) famously said (in French, but I will translate in English): The most important thing in the Olympic Games is taking part. As far as your portfolio goes, the most important thing right now is to **stay the course**, **remain invested** and **be well diversified**.

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Source for charts: FactSet as of 08/03/16

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