BANQUE
ERIC STURDZA

11 QUESTIONS REGARDING THE ECONOMIC ENVIRONMENT AND MARKETS

"It isn't so much that hard times are coming; the change observed is mostly soft times going". Groucho Marx

Bruno Desgardins ***17th May 2016***

There are some big actors on the global stage: the United States with a GDP of $17,900 billion, the European Union with $16,200 billion (the Eurozone alone representing $11,500 billion), China $10,900 billion, and Japan $4,100 billion. At the global level, 20 of the 200 countries account for 85% of the world's production.

Since the end of the 20th century, this global stage has had three features:

- Macroeconomic: a structural slowdown in growth rates, with 2.5% expected for the planet this year, 1.7% for the developed countries and only 4% in emerging countries. This is because the world's population is ageing, the "baby boom generation" is nearing retirement age, innovations generate less productivity gains, inequalities are increasing, buying on credit is curbed by high debt levels, and in new forms of employment self-employed workers are often not highly paid.

- Microeconomic: an increase in corporate profit rates, boosted by an expanding market, with access to more than 1.5 billion inhabitants in China and eastern Europe, a fall in the cost of capital, a decline in the wages/value added ratio, technological transformation and, recently, falling commodity prices.

- Political: middle classes hurt by lost earnings due to forced job changes, destabilized by threats of offshoring, embittered by increasing inequalities, undermined by the social dumping and deregulation arising from the technological revolution, and attracted to populist alternatives and nationalist politicians.

Growth is sluggish, profits are at risk, and public opinions must be catered to. These are all reasons to search for ways of boosting growth. They may be budgetary measures, such as the creation in Europe of a European budget to enhance competitiveness through investment in infrastructure, education and research, or financial measures such as debt cancellations, and fiscal measures to reduce inequalities and increase the marginal propensity to consume, a labour market reform or an ecological revolution to reorient growth models.

What about stock markets? Surprising as it may seem, where politics could give cause for concern, the markets are not impacted. The nationalistic or anti-globalization statements of Trump, Erdogan, Orban, Kasynski or Duterte apparently do not disrupt the markets. Nor are they affected by the political crisis in Brazil, since the Brazilian real has appreciated by 13.9% this year, or discussions on Greece, since the 10-year bond yield, at 7.8%, is well below that of last year. Is this due to the anaesthetizing effect of liquidity injections? Is it due to the impression that the statements will not lead to action?

We will analyse in succession the Chinese risk, the risk of Brexit, oil and other commodities, the consequences of monetary policies, the outlooks for the major regions, the United States, Europe, Japan and Brazil, and then we will end with currencies and equity markets.

What are the two options for China?

1.1 The alternatives: China has two options. It can continue on the path initiated thirty years ago, with an investment-focused model, or else shut down overcapacity and refocus the economy toward consumption.

- Stimulation means taking the risk of increasing the overcapacity that is already large in numerous sectors, such as steel and solar power. Stimulating credit means exacerbating the problems in real estate. In Q1, for example, housing starts increased by 16% whereas about fifty cities are almost empty and the vacancy rate in Chongqinq, a city of 30 million inhabitants, is close to one-third of the building stock. Stimulation means increasing total debt, which since 2008 has already grown from 1.5x GDP to 2.5x GDP, i.e. $25,000 billion! Stimulation means credit easing, increasing the debt of state-owned enterprises, and hence the amount of non-performing loans, already estimated by the IMF at 15% of GDP. The reported debt of China Railways is €557 billion, or one-quarter of French public debt, and is therefore especially eye-opening since there are plans to expand the Chinese railway network from 19,000 to 30,000 km by 2020. Stimulation means exacerbating the deflation that China exports to the rest of the world.

- Conversely, reforming the economy means shutting down overcapacity, getting organized to manage a sharp increase in unemployment, and hence probably labour disputes, until growth can be repositioned in the essential sectors of pollution control, the insurance sector, which accounts for only 3% of GDP compared with more than 6% on average worldwide, and the healthcare sector.

1.2 What is the policy adopted at present?

The first-quarter growth rate, at 6.7%, is the very lowest in recent years, which could suggest that the leaders are no longer looking to maximize growth. Credit growth has never been as strong, underscoring the difficulty of policy change and testifying to a cruel lack of efficiency in capital allocation. Concretely, despite stimulation, the manufacturing production index is being eroded and exports are stagnant.

Although the official policy of the leadership is to advocate reform, in practice the tendency is towards stimulation. Interest rates are lowered to encourage borrowing, the budget deficit increased from 2.3% of GDP in 2015 to 4% in 2016, banks' claims on the corporate sector will probably be converted into equity capital, there are numerous subsidies for distressed companies, and dumping is patent. As a result, shutdowns of loss-making plants and the reduction of overcapacity will be only marginal phenomena.

Chinese-style state capitalism is destabilizing many Western firms subjected to the laws of the market. Structural reforms are making no headway. For example, the government has announced 1.8 million layoffs for workers in the steel and coal industries, but the decision-making process is long. It would probably be necessary to remove 40 million workers from the labour force. In the meantime, total debt, already at 2.5x GDP, a very high percentage for an emerging country, keeps on rising.

Overall, profits in manufacturing industry declined by 2% in 2015, but in the state-owned enterprises this decline exceeded 20%. Looking at only the steel sector, nearly half of Chinese companies are losing money, but aid measures are increasingly numerous. Overall, aid to state-owned enterprises for restructuring amounted to a total of $23 billion in 2015 and plant shutdowns are not happening.

1.3 What should we think from a Western viewpoint?

- A recession in China would have significant implications for the global economy: with a GDP of $10,400 billion, China is a key actor whose GDP is greater than that of India, Russia and Brazil combined. In 2007 it accounted for 6.7% of global imports, but the figure is now more than 10%. Between 2009 and 2014, Chinese growth was 8.7% per year on average, whereas for the rest of the world growth did not exceed 2% per year. According to the IMF, a slowdown in Chinese growth by one percentage point subtracts 0.23 percentage points from global growth – which is already weak.

- Endeavours to maintain the growth rate contribute to global demand in the short term but exacerbate the problems in many sectors, undermine many companies, such as those operating in the steel sector, and cause redundancies in Western firms.

- Attempts to refocus the system on domestic consumption mean promoting the welfare state, reducing the cost of education, reducing healthcare expenditures which are currently payable by households, extending pension systems and thus encouraging a reduction in the savings rate, which is currently around 50% of GDP, and thereby boosting consumption. The worst of scenarios would be a recession in China, because the yuan would depreciate, emerging markets would collapse and deflation would become widespread.

Potential Brexit: ***"Toute puissance est faible à moins que d'être unie" (Every power is weak unless it is united), La Fontaine.***

Although emotions could prevail, rational thinking should lead the British to stay in Europe: above all, it should be remembered that the two British candidacies, in 1963 and 1967, and its admission in 1973 were motivated by a "Trojan horse" type of approach. Not being a member of a Europe that was clearly a success worried the British. Being a member made it possible to influence policies aimed at the establishment of a large single market. And, 43 years on, it can be said that the British have succeeded perfectly. The Financial Times has demonstrated clearly how much the UK has benefited from the EU. Between 1958 and 1973, per capita GDP in France, Germany and Italy increased by 95%, and in the UK by only 50%. In 1973, the UK was "the sick man of Europe", according to the FT. According to the newspaper, EU membership obliged the UK to be more competitive. As regards Europe, thanks to British influence, it is now merely a large market. Joint policies on budget, energy, defence and diplomacy are modest or non-existent, and citizens' lack of interest in a Europe without a project is therefore understandable. At present 13% of the UK's GDP and 50% of exports are destined for Europe and 9 million jobs depend on exports to the European Union.

The economic situation in 2015 is characterized by major imbalances: not counting Greece, the UK's budget deficit is the largest in Europe, the current-account deficit is also the largest, at 5.2% of GDP, and the public debt, at 90% of GDP, is similar to that of France, while the savings ratio, at 3.8%, is at its lowest. Since the start of the year, a wait-and-see attitude has prevailed while the statistics have grown worse.

A very small net contribution: Everyone remembers Margaret Thatcher saying "I want my money back", scarcely six years after joining the EU. In reality, the UK's net contribution represents the equivalent of 0.5% of GDP, the lowest percentage of the major countries. And if the UK were to leave, it would discover that Norway and Switzerland pay, per capita, 90% and 50% respectively of the British contribution. In other words, the UK would save little and would lose its power of influence, because in the European Economic Area certain obligations and certain customs duties would be imposed without any possibility of discussion. Not taking part in the European Economic Area, i.e. choosing a bilateral agreement in line with that negotiated by Canada, would cause it to lose the benefit of the European passport for banks, and would therefore be worse.

For Europeans, an exit by the UK could be the opportunity for a revival policy. Sixteen new members in 18 years was too much or too fast. Efforts should be made to promote stronger integration of a West European core. This would be especially necessary since risks of referendums, of uncertain outcome, could arise in France, Italy or elsewhere.

What price for oil?

The fact that a 2% surplus in 2014 and 2015 entailed a 70% fall in the oil price emphasizes the volatility and the difficulty of forecasting commodity prices. Admittedly there are political factors, with the standoff between Sunni Saudi Arabia and its Shia enemy Iran, whose production increased from less than 3m bpd in December to 3.56m bpd in April. There are the divergences between Saudi Arabia and its Quincy Pact partner, the United States, politically unfaithful and production competitors, the opposition between Saudi Arabia and Russia regarding policy toward President Assad, and dissent between Saudi Arabia and its OPEC partner-competitors in determining their respective efforts and rebalancing supply and demand. In 1985, Saudi Arabia accepted the role of swing producer and reduced its production from more than 10 million barrels per day to less than 2.5 million; in 2015, it had learned from the failure of this strategy and plans to protect its market share.

In our January and February notes, we emphasized the probability of a price recovery due to two factors. The first factor is economic, since a reduction by about 50% in oil companies' exploration budgets between 2013 and 2016, a 79% reduction in the rig count in the United States since October 2014, and new field discoveries at their lowest level since 1954 are drying up new supplies and reducing surpluses, pointing to future pressure on crude prices. The other factor is geopolitical, the result of a Realpolitik approach whereby the Russians and Saudis in particular set aside their political differences to push prices back up, reduce their budget deficits and limit the impoverishment of the middle classes.

At present, at $47 per barrel, the price of Brent will probably stabilize. This year demand has risen by 1.4m bpd, stimulated for one-third by Indian purchases. The non-OPEC supply is 0.8m bpd lower, while the OPEC supply, at 32.6m bpd, is close to a record. The bankruptcies of small American companies specialized in shale gas are expected to continue (11 companies sought protection under Chapter 11 in April, for a total of $15 billion in debt), and Deloitte, in an analysis of 500 groups, diagnosed a bankruptcy risk for 175 of them which have a debt burden of $150 billion.

What should we think of other commodities? Caution.

Volatility for these products is also very high this year, and they are very sensitive to the Chinese economic situation, because China is the leading energy consumer in the world with 25% of the total. Iron ore, steel and copper have all seen major fluctuations. The price rise at the start of the year reflected hopes of a pickup in Chinese demand, far better production figures, with 24% year-on-year growth for cement and 4% for electricity, and the announcement of huge infrastructure investments for the next three years, namely $720 billion, or more than in 2008.

Apparently there are now greater doubts, because demand apparently swelled stockpiles, with for instance a 10% increase in iron ore stockpiles in Chinese ports since the start of the year. Likewise, the raising of coverage ratios on forward purchases is designed to choke speculation on these products.

As an illustration of this volatility, the price of iron ore was $188 per ton in 2011, $38 in December 2015 and is $55 at present, while a company such as BHP Billiton, a major player in the sector, posted its first loss, of $5.6 billion, in 2015. Like for copper, the price rise at the start of the year went hand-in-hand with swelling stockpiles in China. So some vulnerability persists, even though, like for oil, the lack of investment will tend to rapidly rebalance supply and demand.

The banking sector's total exposure to the energy sector worldwide does not exceed $550 billion, or 0.8% of its $70,000 billion in loans. There is therefore no reason for concern about this.

What should we think of central banks' policy? "Premeditated blindness", Paul Léautaud.

Since 2008, whenever central banks provide additional liquidity, the diagnostic always mentions the insufficiency or even the inefficiency of the previous measures, to such an extent that doubt creeps in about the effectiveness of monetary policies. Eight questions deserve an answer:

Why this abusive use of power by central banks? Abundant liquidity injections have four consequences. Firstly, more than 20% of sovereign debt is at negative interest rates. Secondly, governments profit from this to issue debt with maturities of 50 or even 100 years, and are less concerned about reducing their debt, currently estimated at $44,000 billion. Thirdly, many investors are rushing into risky high-yield bonds. Lastly, these injections create uncertainty and volatility. Low interest rates, the dream solution, are therefore becoming part of the problem.

The shortcomings of these policies have been their inability to stimulate corporate investment and push inflation up to 2%. Everyone knows that it is not money that creates wealth but investment.

Banking regulations as a cause of the credit squeeze: To avert the risk of another bank failure, banks are required to have more capital, more easily marketable assets, less leverage and a better match between loan duration and the duration of funds. As a consequence, banks are restricting credit and a shadow financial sector, not subject to these constraints, has been able to develop. Examples are credit hedge funds, US Money Market Mutual Funds and structured investment vehicles (SIVs).

What should we think of "helicopter money"? Three considerations: Firstly, "helicopter money", i.e. the distribution of money to everyone by the ECB or another central bank, is a measure that is increasingly being considered, but the policy of liquidity injection de facto achieves this objective indirectly, because by lowering interest rates it allows governments to finance their debt and their welfare spending. Secondly, it is probably not up to an unelected institution to take such an initiative, and fiscal policy could achieve a similar result. Lastly, if it is planned to distribute 200 euros to each of the 250 million bank accounts in Europe, the cost would be €50 billion, and there is no guarantee that this sum will be spent.

What should we think of negative interest rates? Conceptually, they reflect a lack of confidence in the future, the idea that the future will be worth less than the present. Concretely, they drive down banks' return on equity, they make pension fund management more complicated, they adversely affect insurance companies, and they are an incentive for companies to replace labour with capital. In light of these negative aspects, we can query the advisability of this decision by central banks especially since it does not even result in an increase in the volume of lending to SMEs or in the sought-after currency depreciation. The subject is topical in Japan, since two-thirds of debt is traded at negative rates and the economy remains lacklustre. We note that if the banks do not pass on the negative interest rates to deposits, the cost of credit is increased.

What should we think of the soundness of banks? Banking regulations as a cause of the credit squeeze: to avert the risk of another bank failure, banks are required to have more capital, more easily marketable assets, less leverage and a better match between loan duration and the duration of funds. As a consequence, banks are restricting credit and a shadow financial sector, not subject to these constraints, has been able to develop. Examples are credit hedge funds, US Money Market Mutual Funds and structured investment vehicles (SIVs). Remembering that it was "shadow banking" that facilitated the securitization of sub-primes, and given that outstanding loans are close to half those of the banks, there are grounds for concern. The same could be said of "cat bonds", catastrophe bonds marketed by insurance companies looking to reduce exposure to part of their risks.

The doubt concerns not so much a bankruptcy risk, because the banks have been recapitalized, as their capacity for generating profits. The reassuring aspects are Basel III which reduces banks' debt leverage, the establishment of the "European banking system" which formalizes aid, and the creation, in Italy, of a bad bank, the Atlante fund which will be able to absorb part of the €360 billion of non-performing loans.

But it is understandable that the banks often trade at prices below their book value, because they have had to pay heavy fines, e.g. $110 billion in the United States in the property market, and this has not ended. Moreover, in each country, the banks hold substantial portfolios of domestic sovereign bonds, bonds at negative interest rates represent holdings of between $7,000 and $9,000 billion and, finally, it is hard to earn money with relatively flat yield curves.

What should we think of inflation? The eternal question and the same answer. Inflation is not a threat, even though in the United States service prices have risen 2.7% year-on-year and rents 3.7%. Liquidity injections are more deflationary than inflationary, because they keep unprofitable businesses alive, they fuel investment in overcapacity and they can result in financial losses. Inflation would not be a solution to the debt burden, because long-term interest rates would rise again. Low inflation is beneficial for purchasing power because it often results from increased flexibility in wage setting or keen competition in services through the "Uberization of the economy" and its variants.

What should we think of the Fed's action?

Since the 1950s, the Fed has announced an initial interest-rate hike less than 1.5 years after the cycle low.

This time, it waited 6.5 years after the cycle low before making its first rate hike at the end of 2015. And the probability of a second interest-rate hike in June is low, even though the core inflation rate, at 2.3%, exceeds the 2% target. The Fed's eyes are focused on the PCE index, based on consumer spending, and this has only reached 1.7%.

What should we think of the ECB's action?

Mario Draghi has a stated objective of a 2% inflation rate, and an unstated objective of refinancing the countries of southern Europe. Since the core inflation rate is only 1% and the situation of the southern countries is still fragile, he has therefore decided to increase the ECB's purchases to €80 billion per month and accepted to buy up to 70% of a given bond, which will drain the market and kick-start buying of corporate bonds. This represents a "moral hazard" but should pave the way for a pickup in loans to businesses. All these announcements have caused a fantastic fall in long-term interest rates for southern European countries and, at the end of 2017, the ECB will hold 20% of the debt stock.

To conclude, it would be excessive to write that monetary policies have been ineffective. Without them, Europe would still be in a crisis. Without them, to take just one median example, France would borrow for 50 years not at 1.60% but, like in 2010, at 4%. But these injections are not a substitute for other economic policies and do not remove the need for structural reforms. Regarding fixed-income management, it depends more on interest-rate expectations than the risk represented by the underlying assets, so a cautious investment stance is still essential.

Banque Eric Sturdza SA • Rue du Rhône 112 • Case Postale 3024 • 1211 Genève 3, Suisse

T +41 22 317 9811 • F +41 22 310 3880 • www.banque-es.ch

What should we think of the Eurozone? ***"I look for great men and I have found merely actors of their own ideal", Nietzsche.***

Europe is gradually sliding toward a crossroads, between on the one hand numbness and a slow disintegration, and on the other hand a revival of federalism. Many seem to have forgotten that, before the advent of the euro, the economic situation of the weak countries was no better than at present. Others want to believe in the establishment of a genuine federal budget to finance infrastructure investment, joint policies in energy, defence and research.

The economic situation is improving modestly. From the fiscal viewpoint, the deficit is expected to be 1.9% this year and public debt slightly more than 90% of GDP. Regarding growth, the figures are satisfactory in Germany and better in several countries, while the unemployment rate, currently 10.2%, is falling. From a business viewpoint, euro depreciation in recent years and the fall in commodity prices are benefiting companies, especially French companies, because the margin rate has increased from 29% to 36%.

What risks? Greece? Greece has received only slightly more than €20 billion of the promised €86 billion. Cancelling its public debt of €310 billion, or 1.8x GDP, seems hardly conceivable for countries such as Germany and France, who are keen not to worsen their own debt ratios. But in practice, Greece's debt will not be repaid, and what matters most is to keep up the fiction surrounding this debt: the average maturity, before a forthcoming extension to 37 years, is already 32 years, and the interest rate on this debt is unlikely to exceed 2%, which is a very low rate in light of the risk.

What should we think of the US economy?

Undeniably, the handling of the crisis has been more convincing in the United States than in Europe. Europe just recently regained the GDP level of 2008, while the United States has exceeded it by ten percentage points; retail sales in Europe are still slightly lower than those in 2008, while US sales exceed the 2008 level by eighteen percentage points. Admittedly, on a per capita basis, the differences are smaller, because the US population is growing while Europe's population is stagnant, but US profits exceed the 2008 profits by one quarter, while profits in Europe are still far lower than in 2008.

Since the bottom of the cycle in March 2009, the recovery cycle has been longer than average, but it has also been almost twice as weak in terms of the growth rate. Recently, in Q1 2016, the growth rate, at 0.5%, was the lowest in the past two years, small business confidence is weakening, capital spending is drying up and, although household wealth has reached a record of $86,300 billion, this wealth suffers from being very highly concentrated.

There are several reasons for this weak growth. Firstly, although the unemployment rate has been halved to 5%, the 40 million employees laid off between the end of 2007 and early 2009 have found jobs that are less well paid, as shown by a recent Princeton study. 80% of the jobs created are in relatively low-paid sectors such as retailing, restaurants and healthcare. Moreover, the labour force participation rate of 62.8% is structurally lower, the overall unemployment rate remains high, at 9.7%, and wages, up 2.3%, have increased by hardly more than inflation. Also, the percentage of self-employed workers has increased from 10% of the labour force in 2006 to almost 16%, or around 24 million people, but their pay is often modest.

Secondly, the recovery of the real estate sector is curbed by a decline in the percentage of home owners. Young people, burdened by $1300 billion in student loans, more than 20% of which are considered in default, and hampered by the difficulty of finding skilled jobs, are living longer with their parents. Memories of the sub-primes have curbed mortgage lending, and housing starts declined by around 9% in March.

Growth has slowed, manufacturing output recently declined, the activity index in services shows a dip, and job creations are weaker. Risky loans, sub-primes, student loans, auto loans which account for the high level of auto sales, at 17.5 million annually, and loans to the energy sector ($275 billion for oil, or 7% of the total) are all increasing, and the month of March was characterized by a record number of defaults. All these factors should prompt the Fed to postpone an interest-rate hike.

What should we think of the Japanese economy? Caution.

Consumer confidence is low. The wage increase in March was the lowest of the past two years. Even with large cash piles, companies hesitate to take decisions which would commit them on a long-term basis. Shinzo Abe's popularity rating is declining, because, except for the recent deregulation of the electricity market, the structural reforms mentioned have hardly materialized. The second round of the VAT hike will probably be postponed to avoid risking a weakening of consumption.

What should we think of the Brazilian situation?

Brazil had succeeded in posting average growth of 3.9% per annum between 2001 and 2011, but the situation has deteriorated dramatically and, since the return of democracy in 1988, Brazil has never experienced two consecutive years of recession like at present. GDP fell 3.8% in 2015 and will fall by a further 3.5% in 2016.

On a per capita basis, the fall is even steeper, -4.6% in 2015, which is problematic against the backdrop of a significant increase in household debt since 2008, from 27% to more than 40% of gross disposable income. We may add to this a record 7.6% unemployment rate, very high inflation of over 10% due to the depreciation of the Brazilian real last year, a budget deficit exceeding 10% in 2015, a public debt ratio which will worsen to 75% in 2016, and debt servicing charges which consume 45% of the budget. The next government will have to carry out a courageous reform of the pension system, because although the population is young, the cost of pensions, at 11.5% of GDP, is equivalent to that in old, advanced countries such as Germany.

What should we think of currencies?

$: It is likely that at the most recent G20 summit an agreement was reached to stop the currency war and stem the appreciation of the dollar, because a strong dollar was reducing global liquidity. Janet Yellen's wait-and-see policy also helped. There are several benefits: a halt to capital outflows from emerging countries – concretely, since then there has been an appreciation of emerging currencies. Secondly, the decline of the US dollar has led to a recovery in commodity prices, thereby alleviating tensions in the oil-producing countries. Finally, the dollar's decline has halted the relative appreciation of the yuan and hence the temptation to devalue. The dollar is still 20% higher than its level of mid-2014. The Eurozone posts a large current-account surplus, but it is hard to imagine that Mario Draghi would not react to a further appreciation of the euro.

Yen*:* As the yen nears 105 against the dollar, the finance minister Taro Aso wants to stop the currency's appreciation. But what are the means available to him? The Bank of Japan has already intervened heavily and is no longer capable of repeating the transition from 75 yen at end-2011 to over 120 in 2015.

£: Sterling could continue to recover, because the prospect of a Brexit has moved further away, but the economic fundamentals are poor, and the current-account deficit, at 5.2% in 2015, is the highest in the post-war period.

Emerging currencies: The dollar's decline has boosted emerging currencies with high interest rates and is conducive to a resumption of the carry trade. We are thinking of the Brazilian real, the Indonesian currency, Malaysia and other currencies of non-emerging countries, such as the Australian dollar and the New Zealand dollar.

Gold: Gold has risen 20% this year, and silver 23%, boosted by uncertainty regarding global growth, the weaker dollar and the widespread adoption of negative interest rates.

What should we think of stock markets?

Today, the problem is not so much that stock markets are too expensive, but that growth is too weak. Investors are still swayed by central bankers. They bought equities when Draghi extended the ECB's means of action, when Yellen postponed an interest-rate hike and when Kuroda introduced negative interest rates, but these are merely factors providing short-term support.

In the United States, selectivity is a must. The first-quarter earnings reports were rather disappointing. Stripping out energy and financials, they are positive, but overall they declined by 5%, for the fourth quarter running, and in particular revenue growth, at -1.9%, was weaker than expected. Admittedly, the return on equities is 2.2% for the companies of the S&P 500, which is satisfactory, but the dividends of S&P500 companies are 50% higher than in 1987 and, in recent years, they have increased faster than earnings. Moreover, we note a sharp increase in debt and a timid increase in cash flow. Much of the debt contracted is not used for investment but to pay dividends or to finance share buybacks ($180 billion in the first four months).

In Europe, the recent appreciation of the euro is the main cause of underperformance by European indices. We may add the heavier weighting of financial stocks, 21% versus 15% in the S&P, affected by the widespread adoption of negative interest rates. Possibly, too, European countries' greater exposure to weaker emerging economies played a negative role.

In Japan, the Bank of Japan can acquire 7% of the market capitalization, households hold more than half of their financial assets in cash, and share buybacks, a recent policy in Japan, have become more widespread in the past two years. All these factors of support can hardly overcome scepticism regarding the effectiveness of the policies implemented.

Banque Eric Sturdza SA • Rue du Rhône 112 • Case Postale 3024 • 1211 Genève 3, Suisse

T +41 22 317 9811 • F +41 22 310 3880 • www.banque-es.ch

Conclusion:

"Le doute n'est pas agréable mais l'assurance est un état ridicule" (Doubt is not pleasant, but certainty is a ridiculous state), Voltaire.

Are there grounds for fearing a banking crisis? No, according to the IMF, which considers that more than two-thirds of banking crises have been the consequence of a real estate bubble, something which is hardly perceptible at present. Loans to the US energy sector are a definite cause of concern, but they represent 5% of GDP, whereas in 2007 mortgage loans were equivalent to 70% of GDP.

Are there grounds for fearing the bursting of a bubble? In bonds more likely than in equities. But as long as liquidity injection persists, the risk is moderate.

Could we hope for stronger economic growth? In the short term the answer is no, and we can subscribe to Gordon's thesis of anaemic growth that insufficiently disruptive innovations cannot stimulate. He rightly notes that the digital revolution mostly concerns communication and entertainment, i.e. 7% of GDP.

Banque Eric Sturdza SA • Rue du Rhône 112 • Case Postale 3024 • 1211 Genève 3, Suisse

T +41 22 317 9811 • F +41 22 310 3880 • www.banque-es.ch