BANQUE
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THIS CLEAR-OBSCURE:
ARE THE FEARS SURROUNDING MARKETS AND GROWTH JUSTIFIED?

"***Learn to see and describe what stands before our eyes***", ***Husserl***

- For almost all asset classes worldwide, 2018 will go down as the worst year since 2008, and December as one of the worst months since 1900. To avoid panicking, let us try to follow the recommendation of the philosopher Husserl, and see and describe what stands before our eyes. Bear in mind that, as shown by the work of ***Dimson*** and ***Staunton***, between 1900 and 2017, in each of the 23 major countries studied, equities were the best asset class and the net return on equities was 6.5% as an annual average, versus 2% for bonds. Bear in mind that *the four concerns which poisoned the market in the autumn have cleared*: fears about oil prices and tensions with Iran are now a distant memory. After the first nine months, Brent was up 30%, while now it is down 20%. Distant memories, too, are the idea of a pickup in inflation and a rise in long-term interest rates which would deter borrowing, fears surrounding the Italian budget, and fears about the poisonous relationship between the United States and China, although they could reappear in April.

- So there is now clarity regarding these concerns, *but, suffering from obscure premonitions, all markets and all asset classes have continued to decline*, due to sometimes less positive activity indicators which substantiate the fear of a slowdown. The decline is also fuelled by deep concern about the actual level of Chinese risk, but although 6.5% growth is low compared to the 10% pace to which we were accustomed, this is equivalent to the GDP of Switzerland each year. We believe that fears of a recession reflect a pessimism which is backed up by neither corporate communications nor macroeconomic analysis. Monetary policies are moderately restrictive, budgetary policies in Italy, France, the United States, Germany, India and many other countries are moderately expansionary, and fiscal policies are often inclined to reduce taxes.

- So what should we do? After a 20% decline in less than two months in some major markets, a 35% year-on-year decline in sectors such as European banks, and a more than 50% drop in certain blue-chip stocks, one is tempted to heed the words of Estragon in ***Beckett's play Waiting for Godot: "It's safer to do nothing at all"***. Volumes are often too small and we prefer to wait a little before adjusting the portfolios. However, we should bear in mind that *cash* in CHF costs 0.75% and cash in euros 0.40%, while cash in dollars now offers a worthwhile return, which is undoubtedly comforting for a dollar client but an indisputable risk for a euro or CHF client. With regards to *bonds*, dollar-denominated short maturities could be considered for accounts in dollars, but in euros and CHF they are still unattractive and, in line with our recommendations which were to proceed with caution over the past two years, we advise against direct positions in the high-yield bonds of indebted companies which have recently suffered severely.

As regards *commodities with the exception of oil*, they seem unattractive given the maturity of the economic cycle. *Gold?* Given its disappointing performance in recent years (its peak, at $1,920 per ounce, dates as far back as 30 September 2011) and its erratic movements even when numerous sources of geopolitical turmoil would have justified such an investment, we are sceptical. Gold cannot represent more than 5% to 10% of a portfolio. *Real estate?* In recent years, in a negative real interest-rate environment, the big Western capitals have attracted Russian, Chinese and Middle East investors, but times are changing. Sanctions against the Russians, planned restrictions on the Chinese, and a fall in revenues in the Middle East, not to mention regulatory, monetary and tax changes, are all factors prompting caution. *Private equity*? We recommend caution. Recent good performance cannot augur that of future years. The abundance of liquidity held by companies in the sector, competition on targets, push prices higher which costs future profitability. This leaves only *equities*, because wealth creation in an economy, proactiveness and adaptability are companies' DNA. The decline has been dramatic and volatility will persist, but as long as you don't sell, losses remain virtual, and stock market history has always set new highs. Without being blind to the length of the cycle, we can lucidly and objectively give a reminder that the global composite PMI sentiment indicators are still above 50 everywhere except in China, and are even at 59 in the United States, 55 in Canada, 53 in the United Kingdom, 52 in Japan and 51.8 in the Eurozone, which should be reassuring.

I. Outlook for the US economy:

Some cite the length of the cycle, a record since 1945, to make alarming predictions of a recession in 2020, but we emphasize that cumulative growth since 2009 has not exceeded 40%, whereas it was 60% to 80% during previous cycles, and an objective analysis cannot as yet confirm the hypothesis of a recession:

- *Consumption*, which accounts for 70% of GDP, is showing no signs of weakening. Retail sales since 1 November have risen 5%, the best figure in the past six years, at 3.7% the unemployment rate is at its lowest level of the past fifty years, and job creations, at a monthly average of 207,000 over 11 months, are in line with the figures for 2015, 2016 and 2017, namely 226,000, 195,000 and 182,000 per month respectively. We may add that wages, up 3.1%, are rising faster than core inflation (currently 2.2%), and the recent fall in petrol prices will boost purchasing power.

- *Real estate*, accounting for just over 15% of GDP, has lost its momentum, but prices are still rising slightly. Stocks are at a low level, housing starts have never exceeded 1.2 million in recent years, far from the 2.2 million level of 2007, and the spectre of 2010, when 12 million homes were worth less than the debt supposed to finance them, is not about to recur.

- *The impacts of monetary and fiscal policies*: Six comments could give reassurance.

Although the nominal policy rate is 2.50% after four interest-rate hikes in 2018, the real interest rate is only 0.25%, far from the 2% seen at previous cycle peaks. This is not enough to deter investment, job layoffs have not increased and nonperforming loans (still less than 1%) have not worsened. The same comment can be made about the 10-year interest rate of 2.63%, which is less than the economy's 3% growth rate in 2018 and barely higher than the 2.3% growth rate expected by the central bank in 2019.

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Although the yield differential between 2-year and 10-year bonds was still 78 basis points in February, and is now only 15 basis points. The inversions of the yield curve since 1945, on 18/8/78, 16/12/88, 12/6/98, 4/2/2000 and 30/12/2005, were followed by a recession only after time lags of sometimes nearly three years (two years on average), and in the meantime the market often rose.

Although the Fed is continuing to shrink its balance sheet at a rate of $50 billion per month, it has extended its purchasing to prevent an upward spiral in long-term interest rates which would be justified by the worsening debt burden and external imbalances.

Although the fiscal policy effects of the reduction in the corporation tax rate from 35% to 21% are wearing off, many US states are increasing their spending on infrastructure.

Although the Fed plans to raise its interest rates another two times in 2019, rates are still negative in the major European countries and in Japan.

Although earnings growth will inevitably fall back from 22% to 8%, the 9% decline of the S&P 500 in December exaggerates the trend.

- The tariff war has not benefited the United States: the tariffs are not reducing US imports; on the contrary, trade between the United States and China is still expanding. In the last ten months, the US trade deficit worsened by 11%, even reaching $55 billion in October. The deficit with China alone reached a new peak of $38 billion in the same month. At the same time, the Chinese slightly reduced their stock of US government bonds to $1.13tn and China's foreign exchange reserves declined to $3,000 billion, while the yuan recovered to 6.86 against the dollar, but could go above 7 next year.

II. Outlook for the Chinese economy:

- Indisputably, since 2009 China has accounted for more than 30% of global growth each year. Without doubt, recent growth in retail sales has been the lowest in the past 15 years. Undeniably, the detrimental effects of over-investment are perceptible in numerous sectors. To take just one example, while the Chinese buy 29 million motor vehicles each year, far more than the 17.5 million sold in the United States, the country's production capacity is 43 million!

- However, while everyone is right to worry about overcapacity, the decline in return on investment, increased nonperforming loans and the spiralling growth in the debt of the provinces and state-owned enterprises, the country still has the ability to provide stimulus, and it has chosen to reduce taxes and lower the cost of credit. The government is choosing to encourage credit, and it is well known that in this country, where, unlike in the United States and Europe, financing by the stock market or by bond issuance is struggling to expand, the channel for financing the economy is still bank lending.

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- China is the rising power, and its relationship with its partners, which are relatively declining powers, will continue to have its ups and downs. Given that Chinese GDP measured on a purchasing power parity basis rose from 40% of US GDP in 2001 to 115% in 2016, irritation or jealousy is understandable, while it is less understandable that China should keep its emerging country status obtained in 2001 when it joined the WTO (World Trade Organization). China must accept the fact that it is a developed economy, and therefore remove the barriers to entry set up in many sectors, i.e. it must facilitate foreign investments acquiring majority stakes on its territory.

III. Outlook for Europe:

The European Parliament elections in May give cause for concern, because populist movements seem to be gaining ground, but unlike last year, none of them wants to leave the euro.

- *From a stock market viewpoint*, share prices have fallen by about 25% from their highs of the past twelve months, and yet corporate profitability is high, default rates are low and debt has decreased.

- *From an economic viewpoint*, wages increased 2.2% in the third quarter even though core inflation is only 1%.

- *From a monetary viewpoint*, the ECB has stopped its quantitative easing but will continue to reinvest the proceeds from its maturing bonds, possibly in longer maturities to prevent a rise in long-term interest rates. Credit growth is still firm, the cost of credit is low, there is no prospect of the ECB eliminating negative interest rates before the second half, and it is possible that TLTRO II, for EUR 725 billion, could be extended beyond the 2020 deadline to help the Spanish and Italian banks in their financing efforts.

- *From a budgetary viewpoint*, Italy and France will let their deficits go slightly higher, which will boost consumption.

- *From a political viewpoint*, reassurance comes from Italy, and uncertainty from Brexit:

In *Italy*, the 10-year interest rate, which had reached 3.45% in the autumn, is now only 2.73%, because the budget deficit target initially announced as 2.4% has been reduced to 2% and the calculations have been made based on a growth outlook revised from an unrealistic 1.5% level to a target of 1% validated by the Bank of Italy. The basic income has nearly disappeared, and Salvini's flat tax will only benefit a handful of very small enterprises. In fact, each of the two coalition partners is preparing for early elections after the European elections in May.

In *the United Kingdom*, speculation regarding the various possible scenarios, Theresa May's plan, a hard Brexit or another referendum, is futile. We will avoid the slightest prediction. ***"Ignorance is better than false knowledge", said Boileau in his Epistles.*** If a no-deal Brexit were to prevail, the cost would be borne primarily by the United Kingdom and secondarily by Europe. Bear in mind a few essential statistics. While around 50% of British exports are destined for Europe, only 10% of the exports of the 27 are destined for the United Kingdom. While these exports represent 12% of the UK's GDP, exports from the 27 to the United Kingdom amount to only 3% of their GDP. Although since the start of 2016 the pound sterling has depreciated by 20% against the euro and 15% against the dollar, the trade deficit has not been reduced and the country has therefore become poorer. If the United

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Kingdom finds itself alone, it will represent a market of only about sixty million people, which is not very likely to make third countries want to offer it trade advantages similar to those enjoyed by the EU. If Brexit occurs then the automotive industry will suffer, because 80% of cars are exported to Europe and taxes will amount to 10%. More generally, what can be expected of an industrial sector which accounts for only 10% of GDP? Of course, the country will no longer have to share its fishing zones with France, but this sector accounts for only 0.5% of GDP, and until 2022 the government will have to pay the CAP contributions and will be subjected to taxes of 20% to 40% on its exports to Europe.

The belief that China will make the United Kingdom its Trojan Horse in Europe hardly makes sense if the country leaves the EU. It is a mistake to believe, like ***Marc Roche,*** that Brexit will be a success. He is right to reiterate that the country's attractiveness is based on low social protection, unemployment benefits limited to six months and is a small amount, and a number of days' leave limited to 20 plus 8 legal holidays. The country devotes only 9% of GDP to healthcare and that the fixed amount of pensions is low, at €675 per month, while the education system is of good quality, with three universities in the Top 10 of the Shanghai Rankings. But imagining a Singapore on the Thames, a tax haven, is unconvincing, because the strength of Corbyn's electorate points to a refusal of a further weakening of this already weak social welfare system.

Conclusion: **"*The friends of truth are those who search for it and not those who boast of having found it", Condorcet.***

No doubt these lines may be considered optimistic in light of the prevailing political confusion, the market turmoil and the dramatic downturn in all asset classes. But, modestly, we have just tried to compile objective information.

- *Financial risk*: This is structurally the major concern in a world which has a debt burden of more than three times GDP. Without economic growth, it would be impossible to repay this debt, and without low interest rates, solvency problems would arise in numerous countries and many companies. Governments, which are also faced with the risk of social strife, will do everything to preserve growth, and the central banks will juggle to curb long-term interest rates.

- *Political risk*: The United States will soon go into the election campaign, and Trump will not do anything likely to hamper the country’s growth and will avoid over-costly measures against China. China will probably open its borders wider to equity investments and lower its customs duties. Political risk also includes the rise of populism, as a consequence of an offset of the nationalization of certain private debts, the increase in public debt ratios and fiscal austerity in the wake of the 2008 crisis. The challenge of liberal order, fewer inequalities and a halt to the pauperization of middle classes will affect profit growth and market performances, but will not cause a structural bear market.

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- *Economic risk*: Global growth will slow down, but that is logical due to the diminishing effects of fiscal stimulus in the United States. Tempering this, note the fall in commodity prices which will result in lower inflation rates, below the low 2% average seen since 2012 for core inflation. This slowdown will permit an easing of interest rates and a reduction in the cost of credit, and will therefore facilitate growth and boost purchasing power.

- *Monetary policy risk* is the fear of two interest-rate hikes in the United States in 2019 at the worst, and an unpardonable error if Donald Trump dismissed Powell, whom he appointed in January! Elsewhere, in Japan the policy of quantitative easing will continue potentially at an annual rate of 13% of GDP, but since the budget deficit is 8%, bonds are sometimes not available. In Europe, it is not certain that the ECB will be able to eliminate negative interest rates by the end of the year.

- *International risk*: The Syrian crisis is not on the markets' radars, and nor are tensions between Russia and Ukraine in the Azov Sea, or the depressing bankruptcy of Venezuela. Tensions with Iran could reappear, but they would probably have hardly any other effect than to boost oil prices.

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