BANQUE
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RATIONAL EXPECTATIONS OF GROWTH AND IRRATIONALLY OPTIMISTIC VALUATIONS

"Someday everything will be alright, that is our hope. Everything is alright now, that is our illusion"

Voltaire, poem on the Lisbon disaster.

Bruno Desgardins ***25 April 2019***

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Looking at market performances over the past four months, we can see a confirmation, an escalation and an inflection: - Confirmation of our diagnosis at the beginning of the year of rather slower economic activity, although far from a risk of recession in either the Western or the Emerging economies.

- An escalation of fiscal stimuli in the United States, Germany, Italy, France, China and several other countries, such as in India in the run-up to elections.

- An inflection of central bank policies, all of which seem to have abandoned the path of restrictive monetary policy.

This combination of factors has led to exceptional performance in the financial markets, for equities, for commodities and for bonds, despite marked downward revisions in earnings guidance.

1. **Confirmation**:

Compared with its estimates in October, the IMF has reduced its growth forecast for the global economy by only 0.2 per cent, to 3.3%.

- In the ***United States***, stagnation of industrial production and investment, a slight, probably temporary, decline in housing starts, because the 30-year mortgage rate of 4.1% is now far from its peak of 5% observed in 2018, but growth in retail sales in March. These are the characteristics of US growth, and this duality of stagnation in industry/growth in consumption is also to be found in other countries.

Consumption will probably continue to be buoyed by the low unemployment rate of 3.8%, the rise in the labour force participation rate, the 3.2% increase in wages outstripping inflation, and ongoing job creation. Also worth noting is the reduction in the US trade deficit in March, especially with China ($30 billion versus $375 billion over the whole of 2018), but the protectionist measures remain ineffective, and this is exacerbated by the rising price of taxed goods.

- In ***China***, after a start of the year characterised by production indicators below 50, the measures taken by the government, cutting the reserve requirements rate and cutting VAT in some sectors, led to a credit pickup in March by 10.7%, an improvement in real estate (a key sector which, depending on the definition, accounts for 12% to 25% of GDP with prices rising 10% year-on-year in the 70 largest cities), and 6.4% first-quarter GDP growth. There was also a 14% upswing in exports. And yet the economic environment is not without grey areas, because car sales are still 5% lower year-on-year, unemployment rose to 5.3% in February, imports again declined by 7.6% and corporate debt is critical, at 1.55x GDP. Without complaining again of the relative unreliability of the statistics, illustrated by the contradiction between the GDP growth figure and the decline in Chinese imports and car sales, we can note that the 6.4% Q1 growth is lower than the 6.6% rate for full-year 2018. Finally, the country has benefited from the increased weighting of its stock market in the MSCI Emerging Index, which has stimulated buying.

- In ***Europe***, the composite activity index for April (at 51.3) was disappointing but the situation is improving and there is a noticeable recent appreciation of cyclical and bank stocks after a lacklustre start to the year.

In *Germany*, the main sentiment indicator (ZEW) testifies to renewed confidence for the months ahead, and both wage growth and the low level of unemployment should stimulate consumption, even though the GDP growth forecasts for the year do not exceed 0.8%, after 1.4% in 2018 and 2.2% in 2017. The trade surplus of €184 billion in 2018, of which €49 billion with the United States and €27 billion in the automotive sector, is criticised by Trump. Investment there can be discouraged by this, but elsewhere in Europe the falling unemployment rate, often high household savings and positive real wage growth after inflation are all factors conducive to increased consumption, hence an improvement in growth and in markets by the end of the year. Growth could reach 2.1% in Spain and 1.8% in France.

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- Of all the OECD countries, ***Japan*** turned out to be the most disappointing in Q1, because industrial production increased only slightly in February after three months of decline, while in March exports declined by 5% year-on-year and consumption is structurally handicapped by the decline in the population by 450,000 in 2018 (marginally offset by 160,000 immigrants). In 2019, growth will not exceed 0.8%.
- ***Globally***, the few economies in recession (Italy, Turkey and Venezuela) are not surprisingly countries governed by populists who are conducting unrealistic economic policies. Fortunately, moderation prevailed in the elections in Slovakia and Indonesia, with the victory of the incumbent president Widodo over an advocate of establishing Sharia law, General Prabowo Subianto. Also worth noting is the failure of Erdogan's candidates in the municipal elections in Ankara, Istanbul and a few other large cities.
- As a consequence or a reflection of this global growth which is more resilient than was feared, the prices of metals and oil have risen since the start of the year, with copper at a nine-month high and up 10% this year, while iron ore has risen more than 30% since 1 January, and nickel 20%.

2. **Escalation of fiscal stimulus**:

- The IMF is urging countries with budget surpluses or low debt (Germany, Australia, Netherlands, Switzerland, South Korea) to stimulate their economies.
- In the ***United States***, Trump's fiscal policy, involving tax cuts without any Laffer Curve effect (the supposed increase in revenues after a reduction in taxes), has brought the budget deficit up to a peak-of-cycle record, $930 billion in February, or 4.5% of GDP, and has exacerbated inequality.
- In ***China***, statements about the need for debt reduction are being fast forgotten; priority is going to tax reduction, especially VAT; bank loans to private-sector enterprises are being encouraged, with the aim of preventing a worsening of the unemployment rate (5.3% in February). Infrastructure spending is again being stimulated, disregarding increased overcapacity. $300 billion of stimulation overall, or 2% of GDP (10% in 2008-9) and $760 billion in bank loans in the first quarter, more than Switzerland's GDP.
- In ***Europe***, all the countries have a budget deficit of less than 3%, Spain and France are at 2.5%, and Portugal 0.5%. Germany posts a surplus of 1.7%, and Greece is exemplary, with a primary surplus of 4.5%. The only real worry is ***Italy***. Fiscal policy is expansionary, but the government is incapable of starting the budgeted asset sales worth €17 billion. Its economy is the only one in recession in Europe, and the only one to post worsening unemployment, at 10.7%. The yield spread with Germany is widening again and the government will have to abandon its unrealistic policy of lowering the retirement age and other inappropriate measures.

3. **Inflection of monetary policies**:

- ***Monetary policies have remained accommodating***: Even after four interest-rate hikes in 2018, US long-term interest rates were just positive in real terms, and the trimming of the Fed's balance sheet had no negative consequences for the economy. In Europe, after €2,600 billion in purchases, the ECB stopped this policy in December 2018 but is replacing bonds at maturity at a rate of €17 billion/month, is planning another LTRO in support of businesses and remains vague regarding a rate hike.
- ***Since the start of the year, central bankers have acted as though a severe economic slowdown was*** on the horizon, even though the monetary policy inflection is expressed in words rather than acts. No interest rate cuts in the United States or in the rest of the Western world, just occasional rate reductions in China on reserve requirements, and in India a cut from 6.25% to 6% in the run-up to the elections, as well as expected rate cuts in Australia and

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Brazil. No resumption of quantitative easing, just posturing of support in the event of a turnaround in the cycle, just declarations to reassure market investors. Since the end of 2017, the Fed has trimmed its balance sheet from $4,500 billion to $4,000 billion, and it will reduce its redemptions from $30 billion at present to $15 billion in May, then stop them all together in October. Between Europe and Japan, there is more than $10,000 billion in bonds with negative interest rates.

- ***An inflection is facilitated by the fall in core inflation rates*** to 2% in the United States, 1.4% in the euro zone in March, and 0.4% in Japan.

- ***Oil prices and inflation, what is the risk?*** The removal of the sanction waivers on Iranian oil pushed up crude prices, because occurring at a time of increased turmoil in Libya, where production has fallen from 1.6m bpd in 2011 to 1m bpd - not forgetting 2014-2017 at 0.4m bpd, and a time of great uncertainty in Venezuela. The price of Brent extended its rise by more than 3 percentage points after the announcement, and is now up by around 50% since bottoming in December. However, it is hard to imagine a marked rise in crude prices at this stage. US production is 12m bpd and is expected to set new records. We put aside the risk of closure of the Strait of Hormuz, through which pass 17m bpd, or 17% of global consumption, 85% of it headed for Asia. We assume that Saudi Arabia (which had reduced its supply from 11m bpd to 9.8m bpd) and the Emirates (which have unused capacity estimated at 0.6m bpd), satisfied by the increased difficulties of their Iranian enemy, will respond to requests by Trump who wants to prevent the prix per gallon, currently $2.85, from going above the $3 level which hurts middle-class America. Moreover, a resurgence of inflation would make a rate hike inevitable, and this would make Trump shudder.

- ***Monetary policies and currency fluctuations***: The impact of monetary policies on currencies is moderate, 2% on the EUR/USD this year and 1.9% on the USD/JPY, as the successive central-bank interventions cancel each other out. Keep an eye on the Swiss franc, which, after falling recently, could strengthen on the slightest market turnaround. With 2.5% GDP growth in 2018 and 1.5% expected this year, and public debt under control thanks to negative interest rates (sometimes for maturities up to 15 years) a budget surplus of 2.8% of GDP, and constant surpluses since 2003 (except in 2014), the country represents stability. Gold investment could also be considered at the current price of $1270/ounce.

Conclusion: 4 points to make.

- ***Complacent markets?*** Is it not rather ironic to note that this year Italy has been the strongest performer of the major Western markets? Do 10-year bond yields of 1.20% and 3.29% in Portugal and Greece not reflect some complacency, when their public debt/GDP ratios are as high as 120% and 180%? Does sterling's 1.4% rise against the US dollar this year not reflect a rather care-free attitude? Is it not frivolous to buy BBB-rated bonds when the stock of such bonds, in the United States alone, amounts to $2,700 billion? Corrections will occur, as is happening in Brazil, Turkey and India. In ***Brazil***, investors who became euphoric due to the election of Bolsonaro now realise that the reforms will be hard to implement, GDP growth prospects have been revised downward, the currency has fallen 2% against the US dollar this year, and the stock market's performance has been half that of the Euro Stoxx and the S&P500. In ***Turkey***, sentiment is weakening, the official unemployment rate is 13.5%, interest rates have had to be raised to 25%, the currency has again depreciated by around 10% (after 30% last year), inflation exceeds 20%, and foreign exchange reserves have collapsed to $28 billion. While the political tango with Russia, with the purchase of a nuclear power station and anti-missile systems from the Russians with whom they are setting up a gas pipeline

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bypassing Ukraine, and the harmful effects of inflation on interest rates and investment, give justifiable cause for concern. In ***India***, a Modi victory seems to be anticipated by the markets, but his record is skimpy: unable to create the 10 million jobs needed each year to employ the young market entrants, unable to attract foreign capital, to promote investment in industry - which still accounts for only 18% of GDP, unable to raise productivity in agriculture - which still accounts for around 50% of jobs but generates only 20% of national income, and still little deregulation of the labour market, with businesses finding it difficult to lay-off staff.

- ***Contrasting economic trends***: two trends seen in many countries in recent months, the stagnation of industry and hence of investment, and growth in services. The former phenomenon accounts for the weak growth in productivity and wages. The latter accounts for GDP growth, because economies are predominantly service economies.

- ***Deferred deadlines***: China/United States, Brexit, North Korea, Venezuela, all these geopolitical issues are slow to resolve. The finalisation ***of the agreement between the United States and China*** will not take place before end of May/early June. The ***Brexit*** issue, which is monopolising the attention of the political class and has side-lined the UK on the international stage, is poisoning the European election campaign. Growth has slowed to 1.4%. In the interests of Europe, one almost hopes for a "no deal" solution, because in that case there would be numerous relocations of companies and subcontractors in the automotive sector (see the statements by Japanese carmakers) which employs a total of 850,000 workers, and in aerospace (see the statements by Airbus), as well as in finance. A "no deal" which would result in a downgrade of the country's credit rating (currently AA according to Fitch) and lead to a reintroduction of customs duties, when 50% of the UK's exports go to Europe. ***North Korea*** has not hesitated to bring Russia (its historical ally from 1950 to 1991) into the diplomatic arena, and to test new missiles to force sanctions to be lifted, which does not point to a rapid agreement with the United States. In ***Venezuela***, the persistence of Maduro in power is astonishing given the depth of the economic crisis and the sharp fall in oil revenues, with production divided by three since 2015 to 0.7 million bpd, $150 billion in external debt and 87% of the population below the poverty line in a country that is supposed to be rich.

- ***Lax monetary policies***: Given the inability of countries (apart from Germany, Switzerland and the Netherlands) to reduce their debt, given the growth in corporate debt as companies are intoxicated by the god-send of low interest rates, and given the foreign-currency debt of some emerging countries, central banks seem doomed to laxness, especially if they yield to the pleas of the likes of Trump, Erdogan or Modi. Low interest rates are admittedly a compensation for income stagnation, but they also prop up zombie firms, hence creating overcapacity and deflationary pressure on margins, and they encourage real estate debt and hence bubbles. As a result, in the US the debt ratio has increased from 1.5x GDP before the 1980s to 3.6x, and in China from 1.5x GDP in 2008 to 2.5x in 2018. Which should worry future generations as much as concerns on the Environment.

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