GADD

Market Insight

AUTUMN 2014

Macro is dead, long live the macro !

New clues on the state to the global economy quickly destroyed the benign outlook that investors had over the macro environment: such was the abrupt change in investor sentiment during the highly symbolic month of October. The good news is that investors are finally paying attention to the economic cycle and have abandoned their constant watch over the next liquidity injections by central banks. The flip side of the coin of this "renaissance" in macroeonomics is that its exaggerated impact on financial markets reflects their fragility: the dearness of the US equity market does not leave much room for surprises, as innocuous as they may be. Whilst recession fears seem exaggerated, we remain cautious towards risk taking in our investment policy.

Recession, really?

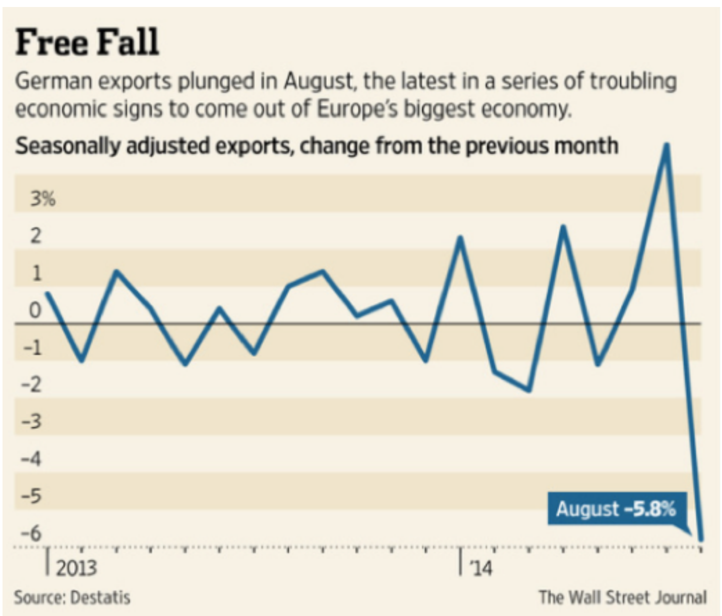
Published in October, the August figure of industrial production in Germany should have added more evidence of this unwavering ability of the Rhenish economy to play its role as the engine of growth in the euro zone. Its massive drop of 4% came as a reminiscent of the 2008-2009 crisis, and the ensuing shock wave in financial markets seemed a logical fit for this month of October that traditionally evokes bad memories to investors.

With some evidence of subdued retail sales in the USA, headlines like "Recession is threatening in Germany" would soon be followed by the likes of "Last pillar of global growth, the American consumer wobbles". So, what should we make of these threats to economic growth ?

Take Germany first. The charts speak for themselves: at first glance, the German industrial production figure appears all the more daunting that it is coupled to an even more dramatic fall in exports. But economic statistics may hide rather trivial realities: usually, the Summer recess is well spread across the different Länder, but this year most Germans took their holidays in August. And as both the production and the export figures relate to the change between August and July, it is not surprising that they show an impressive drop. When expressed in year on year terms, both figures display positive changes in August, albeit on a smaller scale.

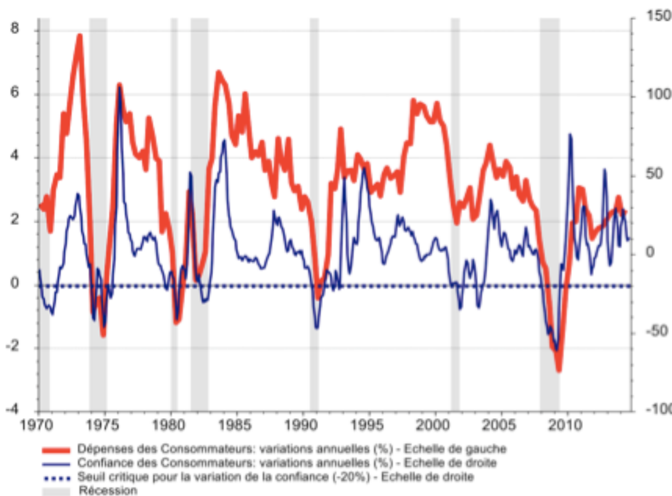
Fall in industrial production in Germany: worst since January 2009 ?

German exports: in free fall ?



What about the US? Some worry that US consumer confidence is at substantially the same level as before the start of the recession in 2008. Following a drop in retail sales in September, investors hastily jumped to the conclusion that the resilience of US consumers was over and done with. They forget that what matters is not the level of confidence, but its variation. The graph brings this point home: as long as consumer confidence does not drop by more than 20%, we can reasonably rule out any risk of recession in the United States.

US: consumer confidence is still alive and kicking



Elsewhere in the world, the latest evidence points to slower or stagnant growth. In Japan, the three arrows shot by Prime Minister Shinzo Abe fail so far to revive structural growth. The mission will not be achieved as long as wage growth will remain negative in real terms. China's policy of restricting credit begins to "bite" on growth, but it should remain above 7%, which is still significant in international comparison.

Predictably, these concerns about the short-term growth outlook have reignited fears that the evil may be deeper. Proponents of the "secular stagnation" thesis have thus resurfaced.

Secular stagnation, the return ?

Among the many jokes about economists, the one referring to their unique ability to predict the past is like Amélie Nothomb's novels: of metronomic recurrence. True, a common error committed by economists is to overestimate the predictive value of the recent past. The best illustration was probably given by Irving Fisher, a brilliant American economist who would certainly have received the Nobel Prize - had it existed at the time - before he said: "Stock prices have reached what looks like a permanently high plateau". It was a few days before the 1929 crash.

The former President of the US central bank also got caught in the game of easy extrapolation when he spoke of the "Great Moderation" to describe the remarkable reduction in the amplitude of cycles in the US economy, that would persist through a successful monetary policy. It was two years before the "subprime" crisis. With the latter, the "Great Moderation" turned into "Great Recession" and interest in the study of business cycles were reborn from its ashes. Could it return there today if supporters of the theory of "secular stagnation" become the majority?

It is the economist and former Treasury Secretary Larry Summers who said in 2013 that the secular stagnation would become the paradigm of our time. His argument: the "natural" real interest rate became negative in the United States following the crisis of 2008. Given that market interest rates are themselves positive, it is not surprising that growth is so low in the United States.

The challenge remains of course to define the natural real interest rate. At the end of the 19th century, the Swedish economist Knut Wicksell saw in it the interest rate that balanced the price of raw materials. With Keynes, the same rate was defined as one that would allow GDP to achieve the holy grail of potential GDP, the one where all productive resources are fully utilised. Today, the natural real rate is defined as the level of interest rates which ensure that all economic variables grow at a constant rate over time. The reader will understand: the natural real rate is a theoretical concept which is pretty hard to measure.

A recent study by the Central Bank of Italy shows that the thesis of "secular stagnation" has been regularly surfacing after deep recessions. This theory of non-growth has been invalidated by the facts, not because it was based on faulty models or because it did not give good predictions of technological progress to come, but because it underestimated the impact of existing technology on economic growth. We can reasonably conclude on a positive note: there will be no secular stagnation.

The fact that these concerns about growth have been having such a significant impact on the markets shows that investors are concerned about the effectiveness of central banks' policies. Obviously, it is much easier for them to counter overheating economies than to eradicate the danger of deflation. The big question that torments all money managers today is that of when the Fed will start raising interest rates.

When will rates rise in the United States ?

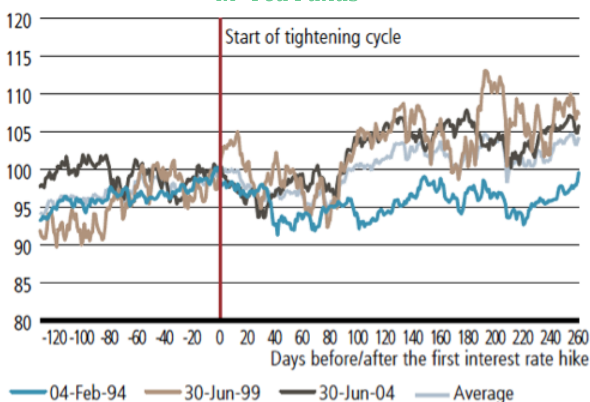
On 25 November, it will be exactly six years since the US central bank opened the monetary floodgates. The first round of quantitative easing was to be followed by two additional ones. In all, more than 3,600 billion dollars have been injected into the US economy since 2008 - a little less than 25% of GDP - through purchases of government bonds and of mortgage backed securities, the very ones which were responsible for the subprime crisis.

Since December last year, the Fed has eased off the accelerator. Its bond buyback program ended in October this year. The question now is to know when the central bank will put the foot on the brake.

Thanks to the yield curve, we can locate the first increase in official interest rates around the second quarter of next year. But more than the exact timing of this shift, it is the expected market impact that we need to identify. In this respect, the comparison with similar experiences in the past is useful, although such “Excelisation" of history should always be taken with a grain of salt.

There have been three rounds of interest rate hikes in the past 20 years that have followed at 5-year intervals: in February 1994, in June 1999, and finally, in June 2004. The first chart below displays the evolution of the US stock market 6 months prior and 12 months after the start of tightening of monetary policy (the horizontal axis indicates working days). We can see that there have been stock price falls of approximately 6-10% during the first 3 months which followed the first rate hike, during the 3 cycles under review. Within 3 months, the market always regained its pre-hike level, except in 1994, when it took 12 months. It must be said that the tightening was particularly agressive in this case: between February 1994 and February 1995, the Fed hiked interest rates 7 times, propelling them from 3 to 6%. On average, stock prices displayed positive returns during the 12 months after the first rate hike, even if on a smaller scale compared to the 6 months prior to the tightening of monetary policy. It also turns out that the performance of stock market indices was more

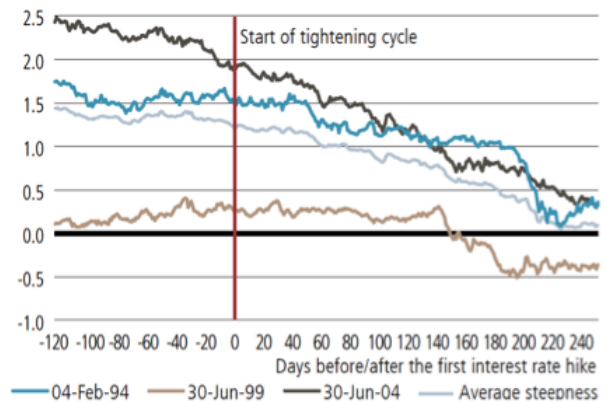
Evolution of S & P500 before and after the first rate hike in "Fed Funds"



pronounced outside the United States.

Regarding bond markets, it is striking to note on the chart below that the yield curve tends to flatten in the 3 phases of tighter monetary policy, a sign that the bond market "absorbs" well course changes by the Fed. This comes as a reassuring piece of evidence at a time when many investors fear a sharp rise in bond yields on longer maturities due to rising short-term rates.

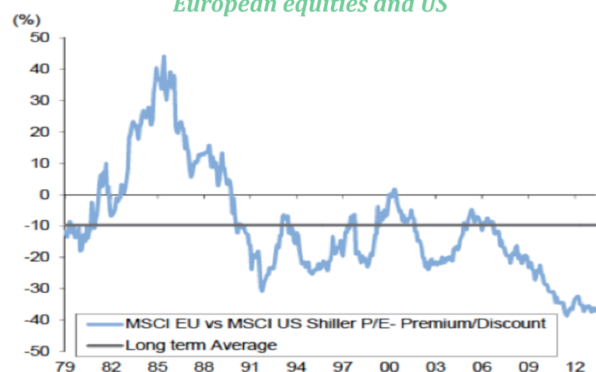
Evolution of the yield curve (10-year-2 years) before and after the first rate hike "Fed Funds"



The market assessment calls for caution

The valuation of some stock markets is little incentive to risk-taking. We reiterate here the message of caution given last July, especially on the leading market such as the United States. With regard to the latter, the actions of the euro zone today offer a good alternative. The European Central Bank should intensify its accommodative policy soon, at a time when the Fed opts for restriction. The weakness of the euro is thus expected to continue, which will not fail to boost European growth through exports. Added to this is the fact that the relative valuation of the European exchange remains very attractive vis-à-vis that of the US market. But this recommendation is once again made within an investment policy that calls for caution.

Relationship between the price-earnings ratio of European equities and US



Michel Girardin
Economic Advisor

Short-term and fixed-income

The Fed will only raise interest rates if growth levels permit. World economic growth has come to a standstill recently, particularly in the European Union countries. The Fed's timing was expected to be during the second quarter of 2015, but now it could well be put back to the second half of 2015. In Europe, the latest low-key measures taken by the ECB disappointed investors, who were waiting for a substantial quantitative easing programme, along the lines of those implemented by the Central Bank of America. Even if there is little chance of the legal framework being amended to authorise the massive purchasing of sovereign loans, the ECB will continue for a long time to adopt an expansionist monetary policy. In this quite unexpectedly generous monetary context, sovereign bond rates are continuing to fall to around 2.20% for the US 10-year Treasury bond and to 0.8% for the German 10-year Bund. We are maintaining our policy and conserving a limited exposure in government and good quality corporate bonds (investment grade), while at the same time favouring high-yield bonds (18%), notably in the emerging markets, and liquidities (22%). Bonds and liquidities amount to 50% of the balanced portfolio.

Equities

Concerns about growth in the euro area and some of the emerging markets strengthened to the extent that the market is beginning to question whether the United States will be able to remain an island of expansion. Indeed, the American economic situation looks healthy with an estimated GDP of 3% for 2014, an unemployment rate below 6%, strongly growing job creation and company results mostly matching or in excess of analysts' expectations. On the other hand, the news from Europe suggests a growing risk of deflation and a slowing down of the economic situation in the old continent. In Japan, the shrinking of real salaries and the increase in VAT have heavily penalised domestic demand and only large exporting companies are enjoying a strong position aided by the depreciation of the yen. As for the emerging markets, their growth rates are weaker than usual. These concerns stimulated by worsening geopolitical tensions and the lowering of commodity prices have caused equity volatility indexes to rebound to their highest levels for 3 years, provoking a healthy correction, hopefully only temporary, of the markets. We are keeping the equity segment of our portfolio unchanged at 44% and continuing to favour European equities (21%) in preference to American equities (11%). We have slightly reinforced our Japanese equity holding (5%). The falling market phases have been put to good use to successfully secure a systematic hedge for part of our equities portfolio.

Currencies

The increasing gap between the economies of the United States and the rest of the world can be seen by the appreciation in the value of the US dollar against the main currencies, especially the euro and the yen. This increase in value, excessive in the short-term, could carry over into 2015. In the balanced portfolio we have decided to systematically cover the exposure in currencies other than the reference currency. However, we reserve the possibility of adopting tactical positions with currencies.

Outlook

"Slow and steady wins the race". The American economy's hare and the Fed's monetary tortoise are both going down the same road with the same objective: to win the bet for the stable, sustainable growth in the American economy. Since 2009, US growth has taken off again progressively, backed up by a generous monetary policy careful to avoid any return to recession. Results have been achieved. At the end of 2013, American growth was back on the rails and the Fed decided to progressively turn off the liquidity tap. But since the beginning of 2014, the American economy hare has started running faster with the increase of job creations, a lowering of the unemployment rate, a rise in the GDP and company results. On the other hand, the monetary tortoise is keeping to ponderous pace, reducing its liquidity injections in small stages and planning to keep interest rates near zero "for a considerable time". Who is going to win? An American growth, rampant, out of breath, overheating, at a standstill – or a monetary policy, which will have corrected its course and got the measure of a healthy sustainable economy? Everybody knows the ending of La Fontaine's fable. The sensible tortoise arrives before the intrepid hare can catch up with her. Let us put our trust in the Fed to accompany American growth into a virtuous cycle, while "making haste by going slow". Once again, the rest of the world will be following.

Armand du Pontavice
CIO

GADD & CIE SA

www.gadd.ch

GADD & CIE SA
I.C.C. – Route de Pré-Bois 20
P.O. Box 1920
CH - 1215 Geneva 15
T + 41 22 799 90 00
gadd@gadd.ch

GADD & CIE LUXEMBOURG SA
Rue de l'Eau 4
L - 1449 Luxembourg
T +352 26 26 741
gadd@gadd.lu

GADD & CIE (Luxembourg) SA
Nybrogatan 11, 6 tr.
S – 114 39 Stockholm
T +46 8 558 038 19
gadd@gadd.lu

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