GADD INFINUM

Market Insight

SUMMER 2017

Will the Fed spoil the growth party ?

Central banks are leading the way, again and again. In the Eurozone, the European Central Bank is shouting victory over the recession. Hitherto accomodating, its policy is becoming neutral. In Japan too, the time has come for rejoicing, as signs of recovery multiply and those of deflation are moving away. As for the Federal Reserve, the economy is doing so well that it does not hesitate to close the tap of the liquidity and to stampede on the brake: by hiking interest rates and ... soon, reducing its balance sheet. Could the Fed removed the punchbowl and risk a recession, coupled with a fall in equity markets? For the time being, the risk appears to be under control, but ... let us stay alert: if we are to rely solely on forward guidance by the Fed for remaining invested in risky assets, we must surely remain vigilant.

Central Banker : from the praise of boredom...

A central banker must be boring. We're talking about his job, not the man. And let the reader answer the question of whether a man can be exciting when his job is boring. So boring, the job of Central Banker? It's Mervyn King who states it. And the man knows what he's talking about: he was governor of the Bank of England until 2013.

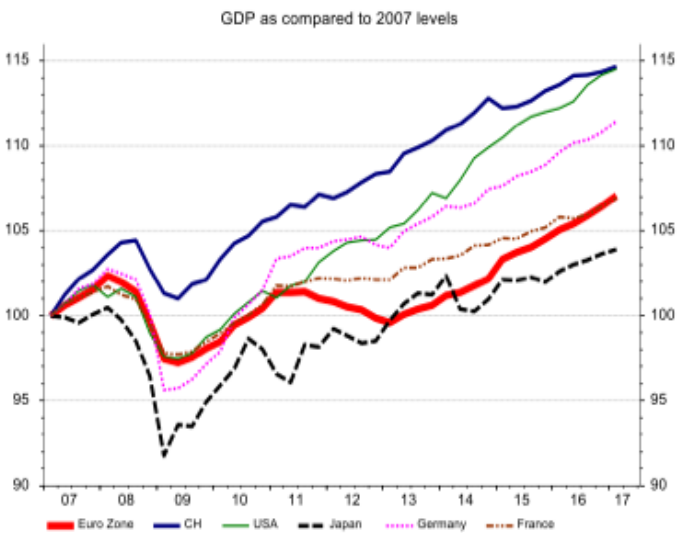
We share Mervyn King's vision entirely. The central bank should ideally set a growth rate of the money supply in line with the country's economic growth and merely play the role of arbitrator for the players in the financial markets, without any interference in the market place. Nothing very exciting, in short.

...to becoming Finance Rock stars

The crisis of 2008 has totally disrupted the routine of the central bankers. With every new unconventional measure more creative than the previous ones, the job of central banker has become much more exciting today. Peter Praet, the ECB's chief economist, recently told a group of economists at a dinner in Geneva that when his boss Mario Draghi comes on stage to deliver his appreciation of the economic situation in the euro area, he feels like Mick Jagger. In comparison, the Copernican revolution seems very little ...

Probably wishing to also taste this euphoric communication, the same Peter Praet is letting himself go and speaks of "Europhoria". He further talks of a somewhat curious growth dynamic in the Eurozone ...

1. Signs of « Europhoria » in the Eurozone ?



The euro zone thoroughly in hysteresis ?

"Europhoric" the chief economist of the ECB certainly is, when he talks about the "incredibly solid" rebound of growth in the Eurozone. He turns even more so when he evokes a somewhat peculiar form of "hysteresis" as the engine of growth.

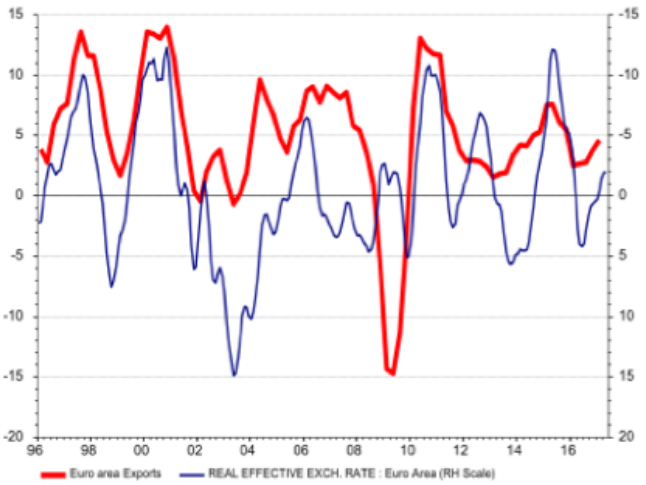
Not to be confused with hysteria, hysteresis borrows from physics the notion of a system which tends to remain in a certain state even when the external cause that produced a change of this state has disappeared. In economics and finance, the term is used when, for instance, the impact on trade of a single exchange rate shock is delayed and sustained.

But it is especially in the case of structural unemployment, and especially in Europe, that the term is coined. A study by two leading economists (Olivier Blanchard and Larry Summers) highlighted the lasting impact of an increase in cyclical unemployment on the structural jobless rate. The former has its roots in a recession, while the latter results from the rigidities that prevent the smooth functioning of the labor market. The two economists noted that when a recession in Europe leads to an increase in actual (cyclical) unemployment, we also see evidence of an increase in the equilibrium (structural) unemployment. The main explanation given by the two economists is that the "employability" of the long-term unemployed is deteriorating. Thus, long-term unemployment tends to become "self-sustained" when a cyclical shock does not allow it to decrease.

In general, hysteresis is evoked to explain the persistence of high unemployment. Fewer are the positive illustrations of the phenomenon. But ... this is the explanation that the European Central Bank today uses to explain the decline in the unemployment rate registered in the Eurozone.

The positive effect of hysteresis on growth arises here from a reduction in the unemployment rate, which originates in a sustainable change in consumption following the highly expansive monetary policy of the European Central Bank.

2. Exports from the Eurozone benefit from the attractiveness of the Euro

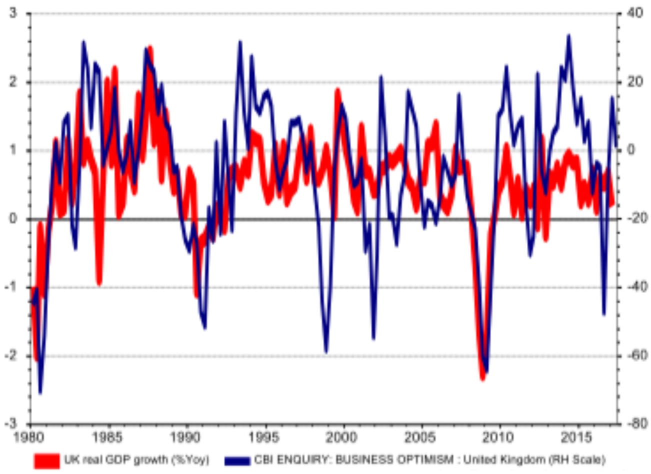


Another encouraging sign for growth in the Eurozone is that exports are increasing, benefiting from a real effective exchange rate which remains attractive despite the recent appreciation of the euro.

Even Eurozone countries lagging behind like Italy, Spain or Greece are expected to return to growth this year. They will probably exceed the average of 1.9% expected for the whole zone.

A shadow in the European picture, the United Kingdom is slowing down sharply. Like many observers, we could hardly explain to ourselves the surprising rebound in consumption just after the Brexit vote. The only plausible explanation seemed to be a reflex of national pride of British consumers to ward off bad luck. Today, this illustration borrowed from the theories of "behavioral economics" no longer applies, and growth prospects are not rosy for the United Kingdom, as evidenced by business confidence in Chart 3.

3. Strong recession in the UK



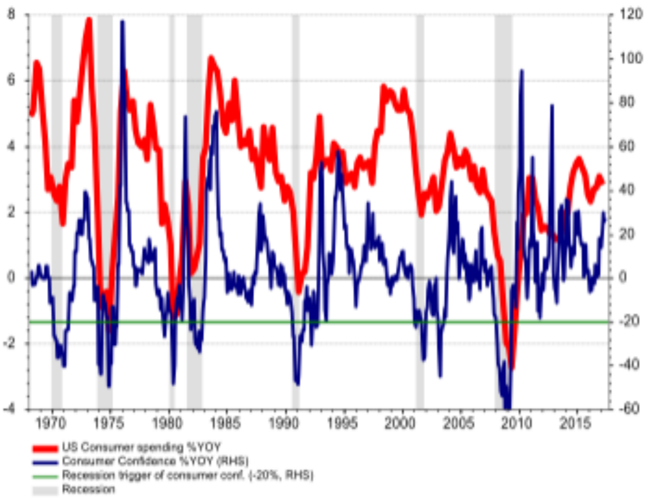
Elsewhere in the world, the macroeconomic framework remains favorable. There is no danger of a clear recession, and inflation remains under control, both in Japan and in emerging countries. Here, countries that have experienced the recession, like Brazil, are now turning to recovery. If there is one major risk to the world economy for the next 2 years we should be focusing on, it has to do with the United States.

The US economy in the hands of the Fed

The US economy is doing rather well. Growth is strong, consumers are confident, boosted as it were by encouraging prospects in the labor market.

US consumer confidence is even one of the best indicators we know to quantify the likelihood of a recession. Thus, the rule that a fall in confidence of more than 20% marks the beginning of a recession has not suffered any exceptions since the 1970s. Moreover, the confidence barometer is equally good to mark the end of the recession. This is given by the increase in confidence above the threshold of -20%, starting from even more marked declines. But we are not there, far from it. As can be seen from Chart 4, consumer confidence has been steadily increasing over the past two years, to display a 30% increase compared to 12 months ago.

4. The US economy in full confidence

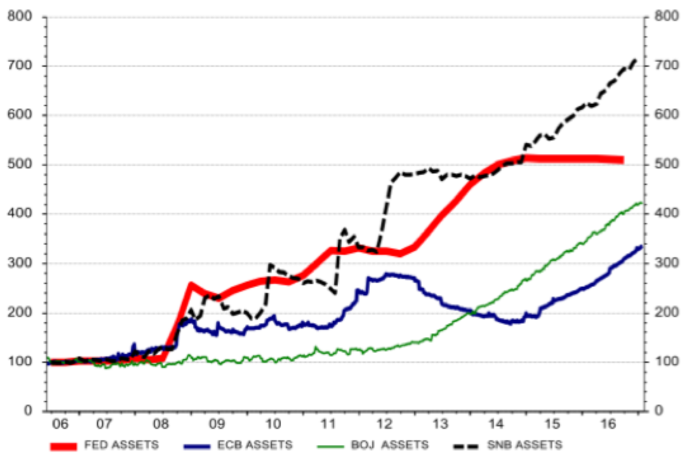


The unemployment rate is expected to remain below its full employment threshold, generating some tensions on labor costs. Inflation should remain close to the Fed's 2% target, but it remains largely under control, justifying gradual tightening of monetary policy. The fall in the price of a barrel contributes to maintaining the US economy in a largely disinflationary environment. This is the ideal scenario of "Goldilocks", this girl whose happiness lies in the "neither too hot nor too cold, just right": the big challenge for the Central Bank will be to pilot its monetary policy to avoid an overheating of the economy without risking too high dose of restriction of the liquidity likely to cause a recession.

The crucial step for the markets is the decline in the Fed's balance sheet. It is probably after its meeting on October 31 that the weight loss program will kickstart and ... it is not without risk for US economy and the financial markets. With its quantitative easing, the Fed has quintupled the size of its balance sheet, as shown in Chart 5. By 2023, it will be reduced from some 4'500 billion to 2'500 billion. The transaction will be effected by the non-renewal of government bonds, as well as mortgage-backed securities that mature.

The big unknown is the impact of the transaction on bond yields. Of course, the fact that it is a matter of non-renewal of matured bonds rather than the sale of existing bonds allows us to believe that the tensions on yields will be less. If only because the Central Bank is venturing into uncharted territory, this "exit" strategy is a serious threat, capable of provoking a recession, combined with turmoil on financial markets. For the time being, we remain confident that the normalization of the Fed's balance sheet will happen without too much hurdle, for two reasons. On the one hand, the US central bank has become a master in "forward guidance", with the aim of preparing market participants for any bad news, such as rate hikes, and the downsizing of its balance sheet.

5. Reducing the Fed's balance sheet : Danger ahead ?



But above all, the Fed makes no bones today about it's determination to make the normalization process contingent upon macroeconomic conditions remaining stable. It is true that the explosion of central bank balance sheets in the G7 countries has not had any inflationary impact. The reduction of the balance sheets is thus more a cosmetic operation than an absolute necessity. However, we should remain wary of any Fed "overkill", as it is not easy to make fine adjustments of monetary policy to ensure persistence of the « Goldilocks » scenario.

Michel Girardin, *Senior Economic Advisor*

Source : Thomson Reuters Datastream / MacroGuide

Money-market and fixed-income

With the global growth still robust and the US economy being driven by consumption and employment, the Fed stuck to its tightening cycle, raising its key rates once again by 0.25% in June, to 1.25%. Meanwhile, US inflation fell back below 2%, driven mostly by lower oil prices. The yieldcurve tightens temporarily in the US, where the 10-year government bond trades between 2.10% and 2.30%. Within the euro zone, ECB policy remains accommodative on the whole amidst a planned winding down of quantitative easing. We are making no change to the bond allocation of our balanced portfolio, which is still based on a short average duration of 3.5 years and a prominent portion (16%) invested in high yield bonds, which offer 300-400bp spreads over sovereign bond yields. Investment grade bonds account for 9% of allocation, and convertibles 3%. Money-market investments were lowered to 6%.

Equities

Stubbornly low interest rates and a robust economy continue to make the environment favourable to equities. However, the US market is trading at more than 18 times 2017 forecast earnings vs. a historical average of 16. Even so, valuations are likely to stay high as long as earnings growth stays on track this year and bond yields turn up only moderatly. We added 5% to the equity weighting (50%) in our balanced portfolio in favour of Europe (19%), Japan (6%) and emerging markets (6%). US equities account for 16% of the allocation.

Commodities

For the moment we are avoiding commodities investments, but we have decided to bring in a new 3% gold allocation as a hedge against the main risks.

Currencies

The widening gap in interest rates between the US and the euro zone should help the US dollar rally after its current bout of weakness. We have expanded our tactical long USD position from 9% to 15%.

Outlook

Central banks' "full whammy" in recent days in favour of a less accommodative stance in their monetary policies and on excess asset valuations brought two things to mind: economic growth that could slow back to potential and inflation that could pick up. The central banks feel the time may have come to gradually normalise their monetary policies and for the markets to revisit their forecasts. This gentle reminder is reminiscent of the "irrational exuberance" remarks of former Fed chairman Alan Greenspan a few years back regarding the financial markets. The "Goldilocks" scenario may be mostly behind us. In the meantime, the economic environment remains, on the whole, favourable, and we are not planning to take our profits in the short term.

Armand du Pontavice, *CIO*

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