



A new fairy tale for the markets?

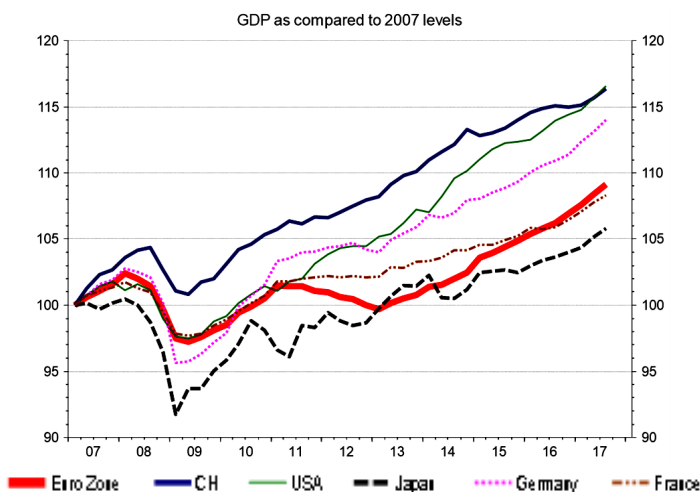
After Goldilocks and its "neither too hot nor too cold, just right" dream growth scenario, the markets are getting a crush for a new fairy tale, that of Peter Pan. According to a study by the Federal Reserve, recoveries do not die of old age. Just like the little green man. We will see what puts an end to their existence. Although it is a little weaker than 3 months ago, global growth remains solid and synchronized. The US economy is even on the verge of overheating and markets are worried about a more pronounced tightening of monetary policy than expected. On the back of new signs of inflation, bond yields should continue to creep up, which will inevitably generate volatility in Equity markets.

Recoveries do not die of old age

Former Fed President Janet Yellen used to say it loud and clear: for her, it is a myth to believe that recoveries die of old age. A study by the San Francisco Fed brings this point home: even when a recovery persists, the probability that it will come to an end fails to increase over time, unlike humans. And the author of the study concludes that recoveries are like Peter Pan: they refuse to grow old.

Chart 1 shows this: in most developed countries, growth exceeds, and sometimes even by far, the pre-crisis peaks of 2007.

1. The recovery will soon be 10 years old



In terms of duration, the current recovery in the United States ranks 3rd of all phases of economic expansion during the post-war period. Measured by the yardstick of its size, however, it ranks last among the 9 recoveries that the United States has experienced over this period. To be sure, recoveries that follow major financial crises tend to be lackluster, especially when they are not confined to a single country.

What catalysts for recessions?

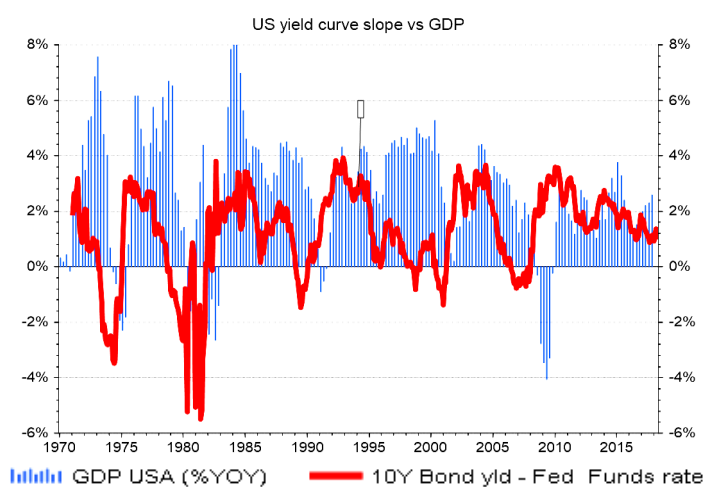
If recoveries do not go off by themselves, what are the triggering factors? Since 1960, the world has experienced 122 recessions, 27 of which have been associated with financial crises. But it is the oil shocks that hold the upper hand, with 41 causes of recession. Next come monetary policy errors: they have caused as many recessions as financial crises, while inappropriate fiscal policies have resulted in 15 recessions. Lastly - 10 of the 122 recessions - we find shocks to external demand, like a recession in the United States caused by a hard landing of the Chinese economy.

The missteps of monetary policy as a factor of recession ... let's talk about it! Today, the Fed erring on the wrong side is the main source of concern for investors. This is evidenced by the numerous studies that closely follow the phenomenon of flattening of the yield curve in the United States.



2018 marks the return of the yield curve as a leading indicator of economic conditions. Its slope, or, more precisely, the difference between long and short interest rates, is an excellent pulse of monetary policy. When the central bank seeks to boost growth, it lowers short rates. Long rates follow the movement but with a smaller scale. A marked positive gap between long and short rates is evidence of accommodative monetary policy, and vice versa. Thus, an inversion of the curve, where short rates exceed long rates has almost always been followed by a recession, as shown in Chart 2.

2. The return of the yield curve as a leading indicator



How is the inversion of the curve possible? It should not be forgotten that a rise in interest rates takes about 18 months to impact the real economy. Today, the risk that the Fed is mistaken and "over-kills" inflation to finally provoke a recession is real, a bit like a person who continues to eat because the body is slow to transmit to the brain that it is satiated.

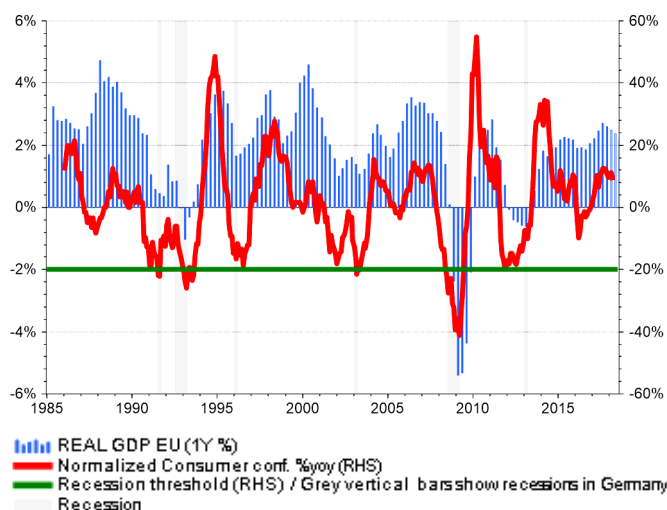
Synchronized, global growth prevails

The strength of growth is not only visible in the United States. It is well established in Europe too. This is evidenced by purchasing managers' indices being well above their 50s and ... our new standardized indicator of consumer confidence, shown in Chart 3. Like the results for the United States, we have found that in Europe it is not so much the level of consumer confidence that counts, but rather its annual variations. Once this confidence is normalized to filter out the zero values, we find that a 20% drop is a very reliable indicator of entry into recession. With a current increase of nearly

10% of this confidence, we are currently far from this recession threshold.

The strength of growth in the Eurozone is even provoking a debate within the European Central Bank. Some see a danger of overheating in the fact that the unemployment rate has fallen to the level of full employment given by the NAIURU (Non Accelerating Inflation Rate of Unemployment). Others, such as President Mario Draghi and ECB chief economist Peter Praet, recall that the NAIURU is an estimate and that full employment remains a difficult notion to measure. The debate is important because it will underpin the pace of further tightening of the ECB's policy. In our eyes, this hardening should only occur gradually.

3. In Europe, consumer confidence supports recovery



Elsewhere in the world, growth remains strong. In Japan, the aggressive monetary expansion of the Central Bank has come to fruition, and deflation is no more than a memory, even if real wage increases are still waiting to boost domestic consumption. Russia and Brazil have turned the corner of the recession and growth remains more than satisfactory in other emerging countries.

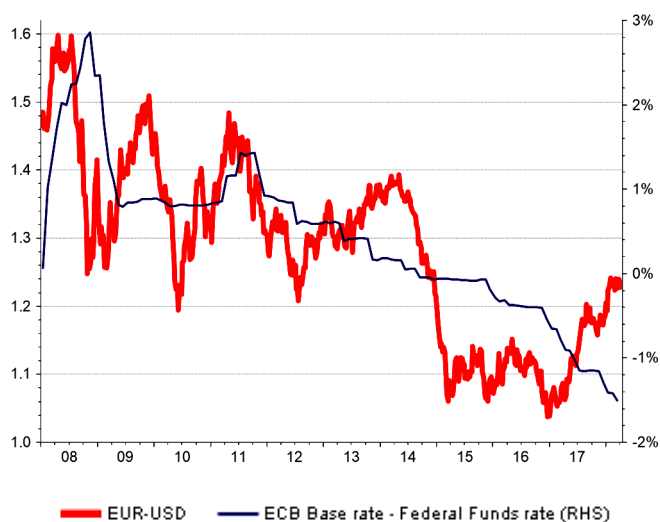
The big unknown for the next few months is the impact of a trade war waged by President Trump. We think it will be limited, and the fact that China remains the biggest creditor of the United States in terms of debt financing should lead the US President to more reason in its trade negotiations.



Is the dollar defying fundamentals?

Until the end of 2016, predicting the evolution of the US dollar was child's play. Or almost. It was enough to ensure that the stronger vigor of the US economy relative to other geographic areas of the world would result in an interest rate differential that increases in favor of the greenback and hop ... its strengthening would follow without difficulty. Compared with the end of 2016, the dollar has lost 15% of its value against the euro, while the interest rate differential has steadily increased in its favor. Chart 4 shows brings this point home. Some will see evidence that macroeconomic analysis and the movement of currencies are not always best friends. For my part, I see more of a lesson of history.

4. The dollar ignores the interest rate gap

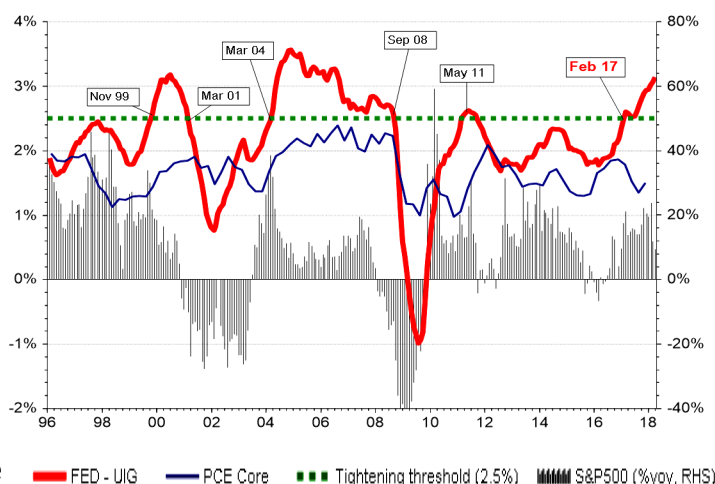


To be sure, the current combination of a restrictive monetary policy and an expansive fiscal policy in the United States bears a strong resemblance to the policy mix under former President Reagan in the early 1980s. At that time, the President had followed the advice of economist Arthur Laffer, a proponent of the so-called supply theory, according to which a reduction in the corporate and household tax rate could ultimately increase tax revenues: for this dream to come true, you just needed the reflationary impact on growth to be greater than the drop in the tax rate. This policy of "Reaganomics" had resulted in a surge in the dollar, which had risen from 1.90 to 2.70 against the franc between 1982 and 1985. This theory looked very attractive on paper, but was largely invalidated by the facts. Both the public and current account deficits soared and the greenback had to pay the "twin deficit" bill, plummeting from 2.70 to 1.27 francs between 1985 and 1987.

Bankruptcy does not frighten Americans, as is well known. Fatal mistakes neither. The same Laffer advises President Trump today and invites him to follow his old recipe. The Reaganomics are reborn today in the form of Trumponomics. But the dollar hardly benefited from the similar movement on interest rates that led to its spectacular rise in the 80s. The currency markets jumped directly to the deficit box and ... the dollar is suffering today already of the future consequences of Trumponomics.

In the last chart, we take the new inflation indicator calculated by the New York Fed (the "Underlying Inflation Gage" or UIG), which takes into account the price of assets, unlike the underlying index of the price of consumer expenditures (Core PCE). At 1.9% in March, the latter is close to the target set by the Fed of 2%. Although it does not publish a target for the UIG, we can see that each time it has exceeded the threshold of 2.5% in the past, the US stock market has entered a turbulent zone. This threshold has been exceeded since February last year, which justifies further tightenings of monetary policy and encourages caution regarding exposure to risky assets.

5. The global inflation indicator justifies the hardening of the Fed



Michel Girardin, *Senior Economic Advisor*

Source: Thomson Reuters Datastream / MacroGuide



Money-market and fixed-income

The global economy stayed on a solid footing in the first quarter, and pressures began to emerge gradually on prices and wages, albeit slowly and still unevenly. In the US, the job market stabilized at about 4%, which is at the threshold of full employment, but did not bring out excessive wage pressures. Meanwhile, commodity prices moved up. Oil continued to appreciate and is now up more than 12% on the year to date. Global inflation continued to inch up in an overall environment that is still structurally deflationary. The Fed continued to raise its short-term rates (the key rate is now at 1.75%), while the ECB policy stuck to its accommodative stance. Against this backdrop, bond yields crossed the 3% threshold in April in the case of 10-year US government bonds and 0.60% for the 10-year German bund. Within the balanced portfolio, we raised our investment grade weighting to 12% by bringing in attractively yielding bonds denominated in Chinese currency. We plan to increase this weighting with euro-denominated sovereign or corporate bonds carrying positive yields in order to mitigate the negative yields on cash. We are keeping the portfolio's duration at about four years.

Equities

Despite continued strength in global economic activity and solid corporate results over the past two quarters, the outlook for more hawkish monetary policies, inflationary pressures, and the initial stirrings of a trade war between the US and China have revived investor fears on how long growth can continue. Volatility indices have moved back up and the equity markets now appear to be stuck in a phase of across-the-board consolidation. In our balanced portfolio we have decided to lower our equity weighting to 45% to reflect our more cautious stance on risky assets. We continue to underweight the US (14%) and to overweight Europe (17%) and Japan (5%). The emerging markets allocation (6%) is mainly invested in China, India, Korea and Brazil. Our main sector themes are consumer

goods, technology, financial services, manufacturing and healthcare. Our active hedging of the S&P 500 and the Euro Stoxx 50 so far this year has cushioned the impact of market declines considerably.

Currencies

The current US dollar rally appears to be driven by widening yield spreads between the US and other regions, the euro zone and Japan in particular. We are holding on to our long USD/EUR tactical position with the objective of closing it out under 1.15.

Outlook

The monetary fixed income agenda is causing significant distortions on the markets. The fact that the US economy is at an advanced point in the cycle has pushed the Fed into increasingly restrictive rate hikes, followed by a shrinking in its balance sheet, for more than two years now. In contrast, the ECB, the SNB and the BOJ are being forced to keep their interest rates low, and even negative, in order to provide support to their economies, which they feel are excessively shaky. For a European investor there is no point in looking for a substantial fixed-rate return in euro or Swiss francs, unless he is prepared to take on high duration or credit risk. Only USD yields have become attractive once again, but hedging forex risk costs about 2.80%, which wipes out the gain on yield. So the only options for our European investors are equities, forex risk or dwindling cash positions. We hope that, within a reasonable amount of time, these regions' monetary policies will converge towards the US's, so that they offer yields that better match their levels of growth. Until then, we plan to restructure our alternative allocation, which accounts for about 15% of the balanced portfolio, in order to enhance its returns and to decorrelate it from risky assets.

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