GADD INFINUM

Market Insight

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Did you say ever-lasting growth ?

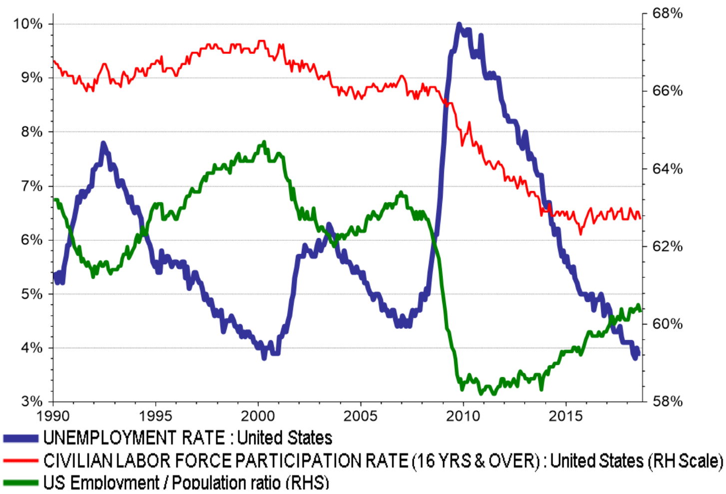
According to the latest statements by the President of the Federal Reserve, Jerome Powell, the health of the US economy is "remarkably positive" and "extraordinarily brilliant". But that's not all: the postr powerful Central Banker does not see why we could not believe that this great cycle is here to last ... indefinitely. A rare optimism, which deserves to take stock in detail on the leader of the world economy, at a time when the trade war threatens. Just to make sure that these are not the same words as those of Professor Irving Fisher who said: "American stocks have reached a permanently high plateau".That was a few days before the crash of 1929. Judging by the markets shakeout that followed the thunderous statements of Powell, its timing is to review. And probably his message as well.

What a great economy than that of the United States!

What's bitten the President of the US Central Bank when he prides the US economy to experience a dazzling form it will never depart? Brushing such a resplendent picture of the US economy, does not it take a risk of being ridiculed in a more or less near future?

When Jerome Powell testifies to the unprecedented vigor of the American economy, he cites in the first place the confidence of households and its immediate corollary, job creations. That's right: falling to 3.7% in September, the US unemployment rate has never been so low since ... 1969! What is remarkable is that the strong growth that had known the United States in the 60s was linked to a "baby boom": today, we speak more willingly of a "grandpa boom". Precisely, it is fundamental to analyze the employment figures, to check whether the improvement would not be somewhat artificial in that the aging of the population induces a decrease in the working population which mechanically reduces the unemployment rate. . Good news, after a steady decline, the participation rate - i.e the percentage of the population that is active - has stabilized: the decline in the unemployment rate is no longer induced by discouraged workers or aging ones who are coming out of the jobless numbers. This is the message in Chart 1.

1. The upturn in employment in the United States is real



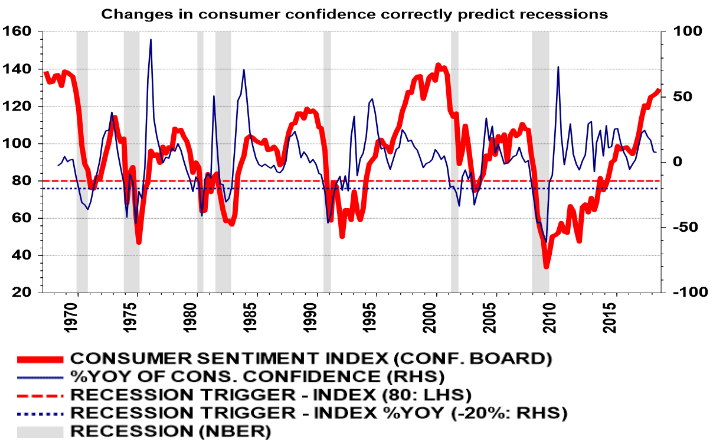
Source: Thomson Reuters Datastream / MacroGuide

We have emphasized here several times the importance of employment figures to boost household confidence. And when we remember that consumption accounts for nearly 70% of US growth, we can understand why Powell cites the labor market in the first place when he has to witness the tremendous growth of the world's economic leader.

And the figures give reason to the President of the

Federal Reserve: after a leap forward of 4.2% of GDP recorded in the second quarter, we will probably experience growth of more than 3% in the 3rd quarter and this is the first time since 2010 that the US economy is performing as well. In the immediate future, the outlook remains favorable: our favorite indicator, that of annual variations in consumer confidence, remains well above its "recession" threshold of 20% decline. All the same, the decline in its progression remains to be monitored, as evidenced by the evolution of the curve in blue on the right scale of Chart 2.

2. In the United States, consumer confidence rules out the danger of recession



Source: Thomson Reuters Datastream / MacroGuide

The end of history ... and the end of cycles?

Powell's implicit allusion to the end of business cycles is interesting in more than one ways. It reminds me of the "Great Moderation" medal awarded by another Fed Chairman, Ben Bernanke: the robototization of production processes, deregulation, the continuous shift of economies away form agriculture and manufacturing towards services and, last but not least, ever more sophisticated monetary policies aiming at fine-tuning between growth and inflation, were all factors put forward by Bernanke to explain this "great moderation". This was a kind of "end of history", to quote Professor Fukuyama, who in 1992 saw in the collapse of communism the triumph of liberal democracy and, above all, the end of ideology, as the driving force of history.

The true History will reveal itself and twist both Bernanke and Fukuyama in a scathing manner: the "Great Moderation" was going to change to "Great Recession" barely three years after it was born. And geopolitically, the Cold War would be reborn in another form, in Iraq and Syria.

Will Jerome Powell become famous for a phrase he would have done better to keep in the drawer of wishful thinking? That's my belief. For a very simple reason: the US economy is pushed today by two powerful tailwinds: in the first place, it is the tax cuts that boost growth this year, helped by the positive effects offset of the past weakness of the dollar during the first half of this decade. The first of these engines will be extinguished at the end of the year, and the second will definitely turn into a headwind, the greenback having recovered colors since 2015.

But above all, it is on the side of monetary policy that we must look for the main obstacle to growth! Has the US Central Bank not adopted a resolutely restrictive monetary policy, with, initially, the "quantitative tightening" which results in a decrease in the size of its balance sheet and, second, interest rate hikes that are currently running at the rate of one per quarter?

The question is not whether the growth of the US economy will remain above average, but much more to find the threshold of interest rates that will open the doors of the next recession. And this is where that things get a bit complicated.

Interest rate: what level of intolerance?

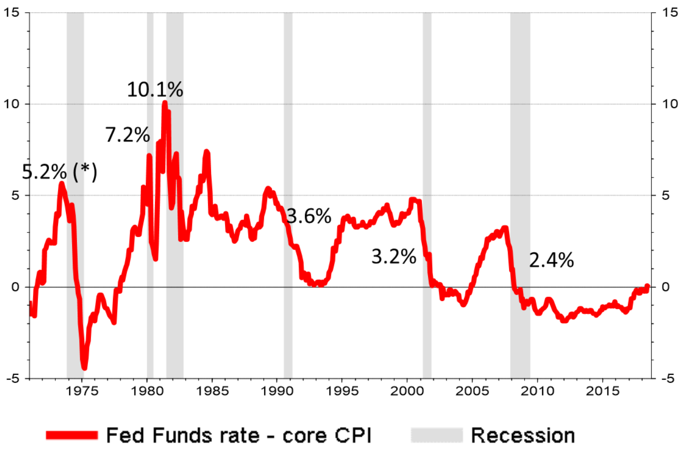
Chart 3 provides us with interesting information about the impact of monetary policy on the US economy. Fed observers often speak of the dual purpose it seeks: to ensure full employment on the one hand, and price stability on the other. There is a third, less well-known one, which is to aim for moderate long-term interest rates. It is in the light of the subprime crisis, and the quantitative easing that followed, that the importance of the latter objective was fully revealed.

To judge the harshness of the monetary restriction, the real interest rate of the Federal Funds is the best possible yarddstick: it expresses indeed the "premium" that puts the US central bank on nominal interest rates to curb inflation.

At first sight, the message in Chart 3 is reassuring: in the past, real interest rates have reached much higher thresholds just before the recessions of the US economy. If the past is of any use in predicting the future, we would in any case have 2% margin on nominal rates before we have to worry about a possible recession. It is therefore not before a level of

4.25% of the Fed Funds that we should seriously mention the word "R". At the current rate of a quarter point increase per quarter, it is not until the 3rd quarter of 2020 that we should be worried.

3. Recession in the United States: at what level of interest rates?

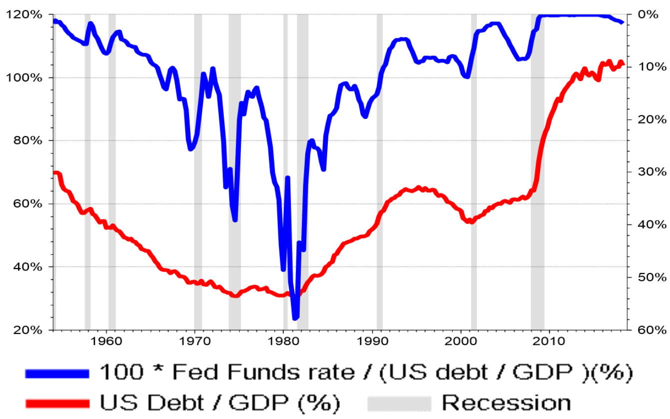


(*) The figures in the chart show the level of Fed Funds in real terms (without inflation) just before the recessions (indicated by the gray vertical bars).

However, this analysis needs refinements.. It should be noted that the interest rate "trigger recession" has been trending down since the 80s. And we must remember that at the time, indebtedness - both private and public - was well below the current levels.

It is therefore fundamental to relate interest rates to the level of indebtedness to bring out the opposite relationship between these two variables: the higher the debt, the lower the interest rate that will trigger a recession. This is the message in Chart 4.

4. High indebtedness lowers the level of rates triggering recession



The red curve shows the evolution of US public debt since the 1950s. It is in percent of GDP and on the left scale. The curve in blue, and on a scale reversed to the right, shows the ratio (in%) between the key rates and the debt / GDP ratio. At the nadir of the latter, in 1980, the Fed Funds recession rate was about 60% of the debt ratio, or about 18%. We note a remarkable phenomenon: during the so-called "30 glorious" period, between 1950 and 1980, the debt-to-GDP ratio fell by half, from 70% to 35%. Not that the Americans have tightened their belts - it's not really in their habits - but rather thanks to a mechanism that all governments dream of and which unfortunately does not exist today: you boost government spending and / or you lower taxes. This increases the deficit of the state and therefore its debt but ... the impact on growth is proportionately higher, which makes the debt / GDP ratio decreases. A dream that must certainly be shared by the Italian Minister of the Interior, Matteo Salvini but ... he can dream on: today, the multiplier between public debt and GDP is less than 1, which translates into an increase of this ratio when fiscal policy is more expansive. The message in Chart 4 is that the recession trigger rate is lower today, given the massive US indebtedness. We estimate it at 3%. As for bond yields, a similar analysis leads us to the conclusion that 4% over 10 years is a penalizing level for both the markets and the US economy.

In conclusion, equity market risks do not emanate so much from excessive absolute valuation, aside from the technology sector. The expected earnings growth remains good, which avoids an expansion of valuation multiples into bubble territory. Rather, they derive from the relative valuation of equities versus bonds. In the United States, there are no lack of reasons for pushing bond yields upwards: overheating of the economy, which translates into more pronounced inflation against the backdrop of rising wages, expansive fiscal policy, restrictive monetary policy, both by repeated interest rate hikes and by the Central Bank's reduced balance sheet. In Italy, it is the danger of a slippage in public finances and sharp tensions with the EU that cause these tensions on bond yields.

We maintain that the main risk for the equity markets is that the phenomenon of TINA ("There Is No Alternative") is transformed into TAMA ("There Are Many Alternatives") and that investors rediscover the attractiveness of returns to 3% on liquidity or 4% on bonds, especially when stock markets play roller coasters.

Michel Girardin, ***Senior Economic Advisor***

Money-market and fixed-income

The US economy remained robust during the summer in terms of both consumption and employment. GDP growth forecasts for 2018 are now above 3% and are likely to stabilize at a high level for 2019. US wage hikes, which had been moderate during the first half, are now on an annual pace of almost 3%. Inflationary fears are returning to the fore and are being stoked by the 15% rise in oil prices within a few months. Despite far more modest growth in Europe and Japan and flat growth in the main emerging markets, monetary policies are diverging even more. The Fed confirmed its 2018 and 2019 rate hike guidance in September, while the ECB and BoJ are sticking to an accommodative stance for the moment. US bond yields are beginning to rise appreciably, with 10-year government paper moving from 2.82% to 3.25% since the end of August. In the euro zone, the 10-year Bund returned close to 0.50%, while fears over the Italian economy pushed the sovereign BTP yield to spreads of 300 bps vs. Germany. We are gradually reducing the weighting of high yield and emerging debt (to 10%) in our balanced portfolio, while raising the weightings of investment grade and corporate bonds denominated in euros and US dollars (16%), along with cash (11%). We continue to reduce the average duration of the bond allocation.

Equities

US companies' exceptional earnings (with a 25% annualized growth) in the second quarter reinforced investors' belief in the US market's upside. Despite the unfavorable backdrop of a US trade war, the S&P 500 gained about 8% during the summer, driven mainly by growth and tech stocks. European corporate earnings were far more modest (9% annualized in the second quarter). Amidst a tense political environment in Italy, European markets fell during the third quarter. Within the balanced portfolio, we continue to prefer Europe (17%) to the USA (13%), while partially hedging these allocations. We are overweighting Japan (6%), which is receiving renewed confidence after the re-election of its prime minister, Shinzo Abe. We reduced our emerging allocation during the summer to 4%. 84% of this is in the Asia-Pacific region, including China, India and Taiwan. In the equity allocation, technology, consumer cyclicals, financial services, industry and healthcare are the main sectors represented. Given the return of market volatility, our weighting of equities, including hedges, was lowered to about 38% of the balanced portfolio.

Currencies

We are keeping our long USD position at 14% of the balanced portfolio, in order to ride the greenback's rally and the euro's slide.

Alternative

The alternative allocation (15% of the balanced portfolio) is almost complete. It is split mainly between long-short equity market-neutral (55%), macro (18%), multi-strategy (7%) and event-driven (6%) strategies. The portfolio's average volatility was 2.3% in the first nine months.

Outlook

With the return of controlled inflation, the US economic cycle at last appears to be on a more virtuous trajectory. After almost three years of monetary tightening by the Fed and one year of fiscal stimulus by the Trump administration, growth and employment are at highs, while inflationary pressures are being reined in by more expensive credit. But this subtle blend of growth, employment and inflation must be handled with care. If growth gets out of hand, the economy will overheat and inflation will emerge; if interest rates are overly dissuasive, employment and growth will undermined. We can ride this virtuous cycle in US growth for a little while longer and the knock-on effect that it could have on other, currently weaker global economies. In the short term, the spike in bond yields is leading to sudden readjustments in equities. We are treating this return to market volatility with extreme caution and great selectiveness on these two asset classes.

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