GADD
WEALTH MANAGEMENT

Market Insight

SUMMER 2019

Equities for recoveries, bonds for crises?

The stock market is at its highest, while bond yields are not very far from the floor recorded 3 years ago. Equity markets enjoy economic recoveries, and bonds performs well during recessions, see crises. Do these two markets therefore give contradictory answers to the question of whether the world economy is at the end of the cycle? We will see that it is not so. And that the world economy is doing rather well, although it is showing signs of abating, especially in Europe. The good news of these failures in the engine of growth is that central banks are slackening their monetary policy, to the delight of investors in financial markets.

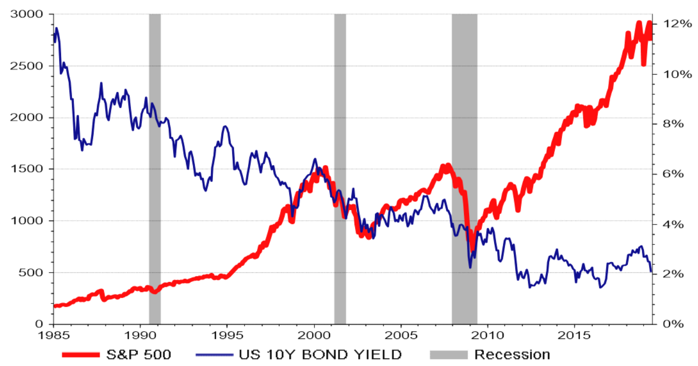
Conflicting messages on the markets?

Behavioral Finance, and its recent development that is Neuro-finance, show us that we must integrate the psychology of investors to anticipate the direction of the markets. We have cognitive biases, gregarious behaviors that lead us to excess of optimism or fear. Sometimes we find ourselves under the concomitant influence of these two extremes. This is the case today, with seemingly contradictory messages from the equity and bond markets about the growth prospects of the global economy.

US bond yields that plummet to the bottom recorded in the summer of 2016 - to the point of causing a reversal of the yield curve - would show a slowdown in growth, or even a recession? The answer is negative, and the message of the 1st graph is clear: for the 3 recessions that the United States has known since 1985 (indicated by the vertical gray bars), it is the Stock Exchange that has correctly reflected the recessions, not the bond market! The bond yields have been on a structural decline ever since Paul Volcker, the former Fed Chairman, eradicated inflation in the early 1980s.

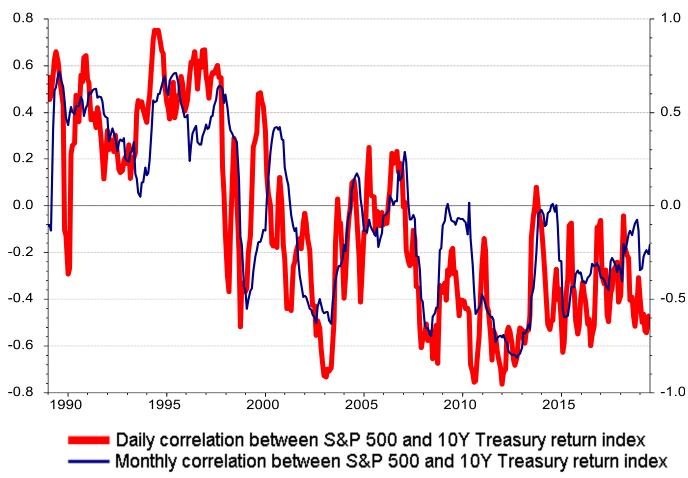
Falling bond yields with a stock market that is at its highest should translate into a positive correlation between equity and bond indexes. However, this is not the case, as Chart 2 shows: with a few rare exceptions, the correlation of these two asset classes has been negative since the end of the 1990s.

1. The stock market is the true barometer of growth



Source: Thomson Reuters Datastream

2. The correlation between the equity market and bonds remains negative



Source: Thomson Reuters Datastream

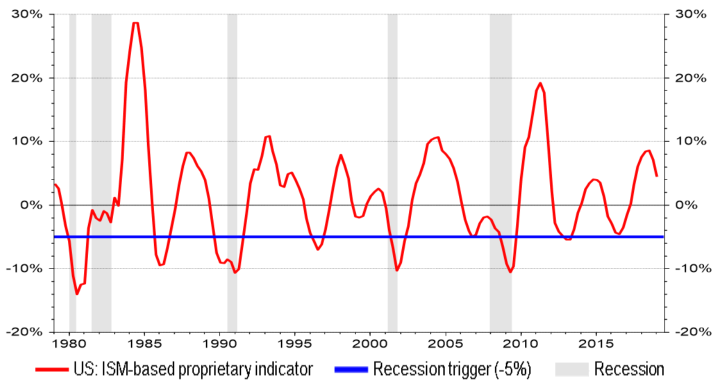
In fact, the contradiction between stocks and bonds is only apparent. Bond markets are only interested in growth prospects in so far as it provides guidance on future trends in interest rates, a key variable to determine the performance of fixed income securities. If they are softening today, it is because central banks are giving slack to their monetary policies.

U-turn of monetary policies

While at the beginning of the year we were counting on future interest rate hikes, it is for their declines that we are taking out our abacuses today. In the meantime, growth prospects have darkened, especially in Europe. But most importantly, inflation continues to be largely invisible, offering a blank check to Central Banks, as every time they seek to boost growth. What is it really?

Impacted by the trade war with China, the manufacturing sector in the United States is showing signs of decline. The same goes for bilateral trade with the US into China. This is reflected in Charts 3 and 4. But the weight of the manufacturing sector in the United States has been steadily declining for 20 years. While it represented 16% of GDP in 1999, its current weight is only 10.4%. What's more, our proprietary indicator constructed with the ISM index shows that we are still far from the recessionary threshold. The services and consumer sectors continue to perform well in the United States, boosted by consumer confidence propelled by sustained job creation.

3. Downturn in manufacturing activity in the United States ...



Source: Thomson Reuters Datastream / Macroguide

In China, net exports are impacted by tariffs. Growth is falling, but the central bank has room to ease monetary conditions.

4. ... and international trade in China

Source: Thomson Reuters Datastream / Macroguide

If there is a geographical area where the danger of recession is more marked than elsewhere, it is in some European countries, such as Italy, the United Kingdom and, to a lesser extent, Germany. With a larger share of exports to GDP than in the United States or China, Europe is very exposed to the Sino-US trade war. It is not surprising that many of our indicators are close to their critical thresholds. In this context, the truce between Presidents Trump and Xi bodes well for growth in Europe, helped by a more accommodating policy of the European Central Bank.

Overall, the macroeconomic framework remains close to the "Goldilocks" scenario where growth is "neither too hot nor too cold, just right". The more accommodative monetary policies of Central Banks and the truce in the trade war are all good news for the financial markets. This will allow Central Bankers to study in more detail the new currency that Facebook plans to create in 2020.

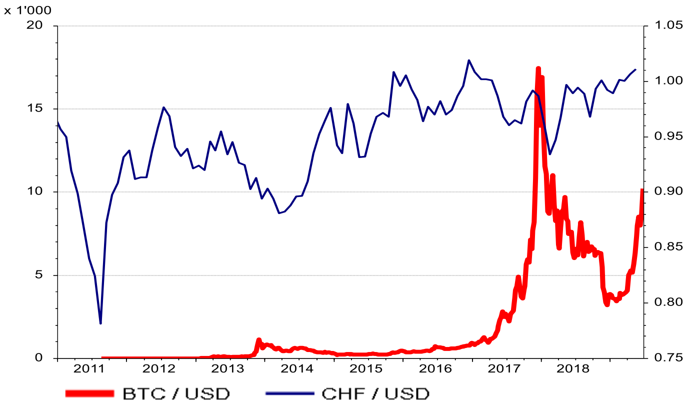
Libra: a new sovereign currency?

Bruno le Maire is worried. About the Libra, the new currency that Facebook plans to launch next year, the Minister of Economy and Finance in France has decreed that it could not and should not become a sovereign currency. Ah, but ... if a new currency cannot become sovereign, why should it be added that it must not become so?

But first, where does the name "Libra" come from? The latin word refers to a unit of mass, which is at the origin of ... the pound (libra pondo means "the weight of a pound") . Libra also indicates the sign of the "Balance" and ... undoubtedly the founder of the cryptocurrency, David Marcus, uses this image to represent the balance that must have a "stable coin", namely a digital currency backed by real assets. Like the Libra, precisely.

The Libra will be backed by a basket of liquid financial assets denominated in the main currencies. This makes it a "stable coin", a very popular category currently in the world of crypto-currencies. The goal is clear: to offer a much less volatile currency than other crypto-currencies like Bitcoin. The graph below does not require any comment to illustrate the volatility of the latter.

5. The Libra should be much less volatile than Bitcoin



Source: Thomson Reuters Datastream

Can the Libra be a Sovereign currency? A currency is called sovereign if it is issued by a central authority, and it fulfills 3 main functions: to be an intermediary in the exchanges, to constitute a store of value and finally to serve as unit of account for the economic calculation or accountability. This currency is meant to be "fiduciary" (Fiducia means confidence in Latin) in that its durability is due to the trust that its users place in its value and its current and future capacity to serve as a means of exchange.

In terms of the exchange function, I do not think we can do better. The new currency will serve as a means of payment to Facebook's 2 billion users, more than a quarter of the world's population. Regarding the unit of value, it is a question of convention. Nothing would prevent Facebook from publishing its results in Libra and serve as an example to other companies.

And trust? This is the central point, with fundamental implications for our society. The Swiss National Bank rejects the idea of crypto-currencies and other digital currencies, even if they are backed by central banks, under cover of which we can not trust an algorithm. Can we, should we have more confidence in a centralized organization made up of human beings? Don't we say that error is human?

Could a decentralized system based on ultra-sophisticated technology such as Blockchain inspire more confidence than a centralized, human-based system? The question needs to be asked. In my 30 years of analysis of central banks, I can in any case testify to several cases of errors on the part of central bankers, which, perhaps, could have been avoided if monetary policy had been entrusted to computers.

A cryptocurrency like the Libra is badly named. If the Greek etymological origin of the word "crypto" suggests that the currency would be hidden, the currency of Facebook is anything but that. It will certainly not be the "shadow currency", as a German parliamentarian recently called it. And for good reason: Blockchain's technology is transparent and unalterable. It is very difficult to corrupt it and the confidence attributed to it by its users is largely due to the fact that this great register that constitutes the Blockchain is accessible to all, and, above all, unalterable!

Let's be clear: we can not vilify Facebook for failing to properly protect the confidential data of millions of users, and simultaneously fear that the new currency it will create is used for malicious purposes by shadow financiers !

That said, the purists refute the idea that the Libra is a real cryptocurrency, in that it violates a fundamental principle of the Blockchain, that of being a decentralized system where transactions must not receive prior clearance to be validated. The Libra is based on a centralized control system managed by an association of partner companies, where transactions are previously authorized by a system of validation nodes.

Basically, the Libra is a simple evolution of the currency to a digital form. What makes it a real potential monetary revolution is the massive use that could be made of it. The intrinsic value of crypto-currencies and digital currencies is directly related to the number of users who trust them. As such, I believe that the fears of the French Minister of Finance that the Libra may one day become sovereign are entirely justified. No wonder so many voices rise here and there to curb the enthusiasm of the Techfin Facebook in Palo Alto and Geneva …

Michel Girardin, *Senior Economic Advisor*

Money-market and fixed-income

Macroeconomic momentum remains shaky, held back by a gradual slowdown in global economic activity that is now spilling over into the US. The US economy nonetheless continues to be driven by robust consumption and a solid job market. On the whole, nothing suggests that a global recession is at hand except perhaps a possible escalation in the Sino-US trade conflict. And, in fact, trade tensions have abated somewhat, although no agreement has yet been reached. The receding in inflationary pressures is letting central banks shift back to highly accommodative language and leave the door open to interest-rate cuts. Bond yields continue to decline, with the 10-year US yield now testing the 2% barrier that it had moved above in late 2016. In Europe, the 10-year Bund hit an all-time low of -0.40%. The narrowing of government bond yields is spilling over into other segments, including corporate and high yield. We have decided to move our bond portfolio's allocation more into line of the global indices, in order to reduce its relative risk. In investment grade, we have gradually raised our weightings of government bonds (10% of the balanced portfolio) and corporate bonds (12% of the balanced portfolio), while rebalancing them geographically. Meanwhile, we have lowered our weightings of high yield (10% of the balanced portfolio) and convertibles. We are now adjusting portfolio risk and duration through the sale of 10-year German and French government bond futures. We are keeping the portfolio's duration at about three years.

Equities

Torn between disappointing macro momentum and more dovish monetary policies, the equity markets continue to post gains. Risks raised by trade talks and tensions with Iran are putting a damper on investors' mood. However, valuations for the moment are not showing any excesses in absolute terms, and stocks are still especially attractive compared to bonds. Given the prospect of a dip in earnings growth this year, price/earnings ratios in both the US (at about 16.5x) and Europe (13x) are still close to their medium- and long-term averages. The US market is now at its all-time high and pulling all the world's main equity markets in its wake. We have made no change to the allocation of our equity portfolio, which continues to overweight Europe (17% of the balanced portfolio) and Japan (4% of the balanced portfolio) and to underweight the US (15% of the balanced portfolio). We have left our allocation in Asia-Pacific ex Japan and emerging markets unchanged at 7%. In investment style terms, growth stocks (31% of our US portfolio and 12% of our European portfolio) continue to outperform value stocks this year by about 8% (17% of our US portfolio and 25% of our European portfolio). We took advantage of the dip in indices in May to reduce our US tactical coverage. Our net equity exposure is now 39% of the balanced portfolio.

Currencies

The outlook for US rate cuts is dragging down the dollar and triggering a sudden rally in gold, which is back to its 2013 levels. In the balanced portfolio we have held onto our 13% long USD position, as well as our exposures of 3% to gold and 2% to yuan-denominated bonds.

Alternative

Since the portfolio was set up in late August 2018, the main alternative strategies have trended in decorrelated fashion. Positive risk-reward contributions have come from Global Macro and, to a lesser extent, Multi-Strategy. Event-Driven has made no contribution at all, while Equity Market-Neutral's contribution has been negative. All in all, the alternative portfolio's contribution was slightly negative during the review period and in the first half of 2019, due mainly to the heavy weighting (45%) of the Equity Market-Neutral strategy in the allocation.

Outlook

Global growth is having a hard time stabilizing but is still at a pace of about 3.5%, driven by the strength of the Asia -Pacific region and by the resiliency of the US economy. Monetary stimulus in the US and Europe should help ward off a recession and stretch out the cycle. However, this has already been priced into the main asset classes, whether bonds or equities, which are at historic highs. Without catalysts of a fundamental nature, investors would be wrong in thinking that central banks have a magic wand that will ensure growth and keep the market indices moving up. We are sticking to our cautious stance on risky assets.

Armand du Pontavice, *CIO*

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