Market Perspective

Secular stagnation? | The US election

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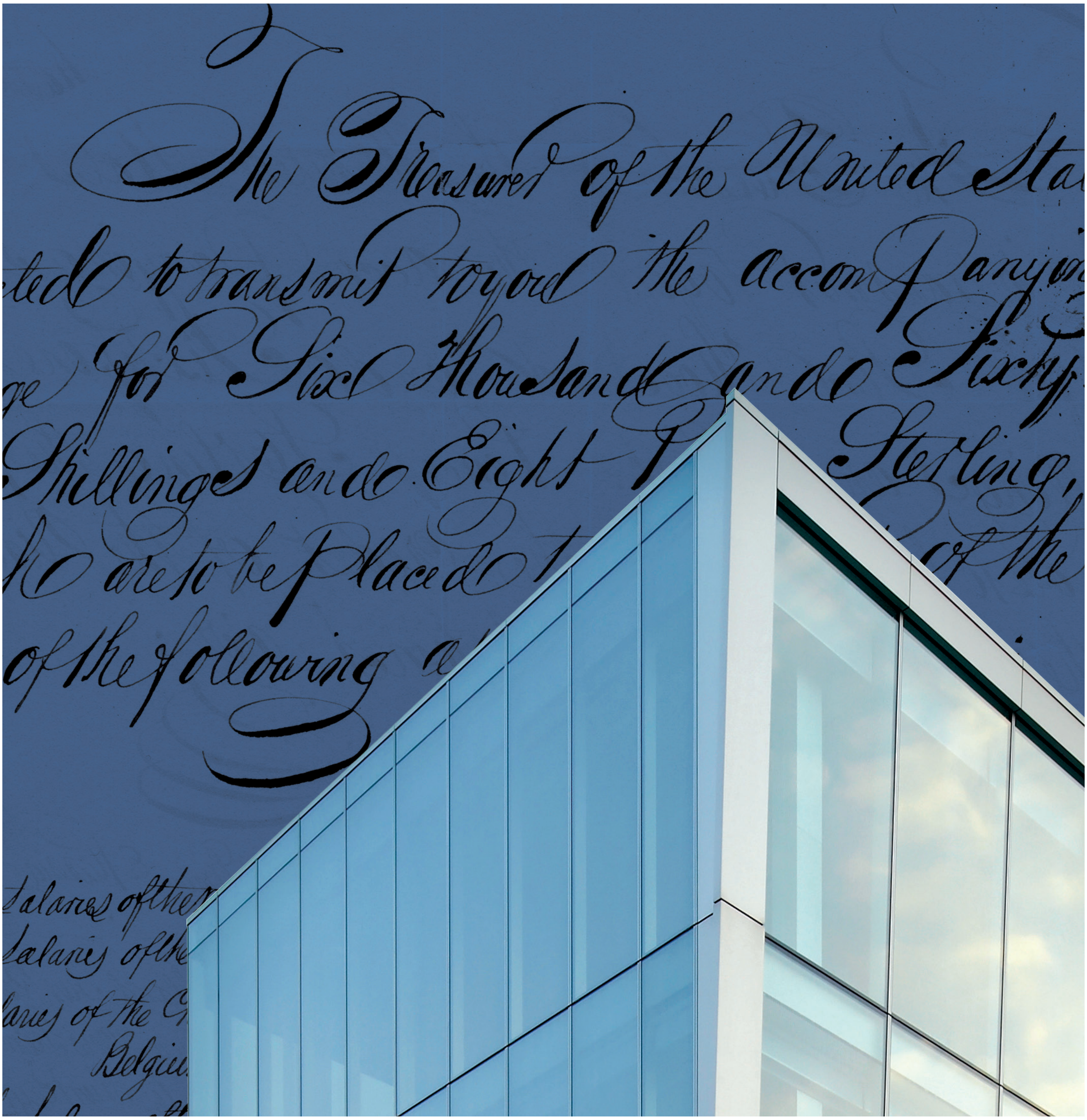

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Foreword

After the UK's EU referendum, and with the US presidential campaign in full flight, The Establishment is getting roughed up. Voters are sticking it to the man – or so we're told.

Democratic deficits and tensions are diagnosed everywhere. The metropolitan chattering classes left behind the rest of the UK; Brussels impoverished Europe; the Beltway forgot a frustrated and stagnating middle-class America. Professional politicians, we read, cynically abandoned their electorates. Voters are now getting their own back.

At least, that's the conventional narrative. But received wisdom is often mistaken about economics, so why should it be any different when it comes to politics? Big themes are seductive. Reality is messier.

A widely predicted global backlash against "the system" after the embarrassments of 2008 did not materialise, and may not now. If there is a system, voters may be more aware than pundits that it could simply be "the worst sort... apart from all the others".

UK voters didn't want the EU, but their (Conservative) government seems to be less unpopular than the opposition. Meanwhile, domestic recession is not inevitable, and rising long-term prosperity is still on the cards. Europe is not a historical theme park on the brink of anarchy. And victory for the anti-Beltway candidate on 8th November is far from certain, and (as we note in the second essay) need not necessarily lead to slump, autarky and geopolitical instability – though it might be safer not to find out.

Investors should keep an open mind, and be sceptical of Big Ideas. As we explain, most economies are (as usual) moving forwards, and profitability can stabilise. We have some worries about monetary policy, but they are not urgent. Growth-related assets, which we favour, are not especially expensive. Bonds do look dear, though with little inflation, and those central banks still in thrall to gloom, they again seem likely to stay so for a while yet.

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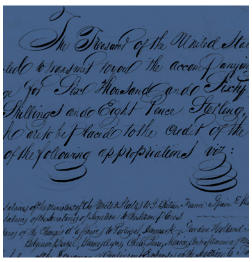

Cover image:
Foreground: Our office at New Court, London
Background: A letter to Nathan Mayer Rothschild from the American Treasury Department, 21 November 1834 concerning general business transactions. Courtesy of The Rothschild Archive.

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Values: all data as at 31st August 2016.
Sources of charts and tables: Rothschild & Co and Bloomberg unless otherwise stated.

Secular stagnation?

Some pessimistic forecasts may be looking backwards

They may not mean to, but they do: economists often forecast by looking backwards.

The tendency to drive by the rear-view mirror, by looking at events and trends in the past, is most visible when the economy unexpectedly falls into a big hole. Very quickly they construct a narrative to explain why it had to happen – and why the economy will never escape from it.

To be fair, the view out of the front window is pretty poor: the future is simply unknowable. But that hunger for a plausible narrative – an ex-post rationalisation seized to keep an otherwise seemingly random and absurd world at bay – is a good reason for treating received wisdom with a healthy degree of scepticism.

The received wisdom rationalising why we fell into the huge hole created by the Global Financial Crisis (GFC) in 2008/9 is accompanied by a litany of alliterative worries such as debt, demography, deflation, decadence, depletion (of scarce resources) and danger (of the geopolitical kind).

We have written about why each can be overstated, and why we saw the GFC as a liquidity event, not a collective insolvency. But the familiar D-words are now being bundled with new worries in the spectre of "secular stagnation", a soundbite encapsulating the idea that Western living standards have gone ex-growth.

The gloom is often inconsistent. We are asked to worry about both a shortage of labour (demography) and a glut of it (deflation); and about too much innovation (the march of the robots), and too little (no new big inventions).

But it has a stranglehold on the policy debate. Central banks are being urged to distribute free (or "helicopter") money because of it, and some have considered doing so.

And it may be as good an illustration of rear-view-mirror driving as we're likely to see.

The idea is not new. The prevailing outlook has been a miserabilist one in the past; notions of a "new normal" are closely related. It was revived, however, in late 2013 by US economist Larry Summers.

It may however reflect a backward-looking and mistaken assessment. By late 2013, a 10-year moving average of US growth, for example, had already slowed markedly, to below 2%, a half-century low (figure 1). Was the diagnosis of secular stagnation a prediction, or a subconscious assessment of bad news that had already happened?

Arithmetically, the slowdown largely reflects the GFC itself. But grim though it was, the crisis did not destroy labour, natural resources, physical capital, or technology: the key factors of production, and with them potential future growth, were unaffected by it. And as the crisis drops out of the 10-year moving average, they will rebound – as a shorter one, for example, has already been doing (figure 2).

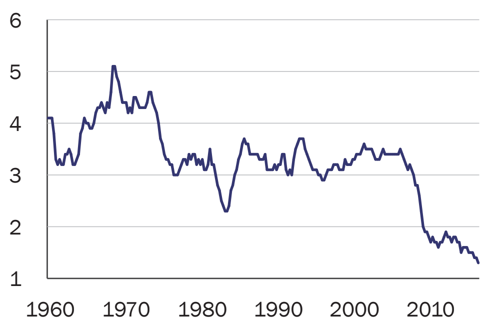
If anything, this might understate the impact of the GFC on the dynamics of trend growth. Arguably, pre-crisis growth was boosted unsustainably by financial excess: we shouldn't expect to return to it.

In fact, some measures of recent trend growth in US real private final demand (consumer spending plus residential and business investment) have been little different from the pre-GFC period, at roughly 3%. It is government spending that shows most sign of a lasting growth shortfall – not a big part of the secular stagnation narrative.

There will be another crisis and/or economic downturn at some stage. But we have shown elsewhere that debt and demography in particular are not playing the gloomy roles

Figure 1: Secular stagnation?

US real GDP growth, 10-year moving average, annualised %



Source: Datastream, Rothschild & Co

assigned to them, and we doubt economists are any better at predicting innovation (or its absence) than scientists themselves. Watch that 10-year moving average in three years' time.

Meanwhile, back on the ranch...

Currently, the US economy seems to be growing sufficiently to continue creating jobs and boosting living standards. Second-quarter disappointment was driven by de-stocking, which looks transient. Consumer cashflow remains healthy. There are signs, albeit tentative, of a pick-up in wage growth, and US core inflation remains a bit firmer than in Europe.

Guidance from the Federal Reserve should thus probably be taken at face value: if decent growth continues, interest rates may rise a second time, perhaps before year-end. More importantly, corporate profits will likely revive as the hit from lower oil earnings fades, underpinning stock market valuations. (Our thoughts on the US election are outlined in the second essay.)

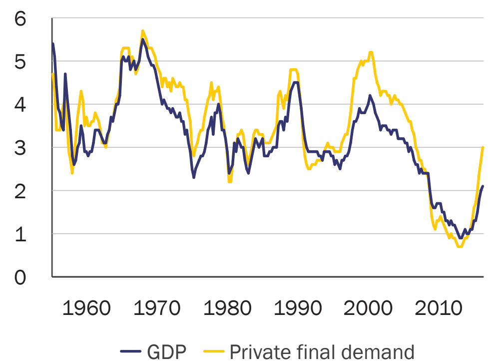
In the UK, the more emotional business surveys have rebounded sharply, as we thought they might, after referendum-related swoons. Hard post-referendum data are still patchy: retail spending was robust in July, but manufacturing faltered.

We do think that Brexit will be bad news for business and for UK trend growth: some slowing in inward investment at least seems likely. But an imminent recession is far from certain.

The Bank of England has done its bit by cutting rates and announcing (modest) new bond purchases in August, but the cheapened currency has likely done more. Indeed, we suspect that the Bank and sterling both have over-reacted: the fact that the pound did not dip to new lows on the Bank's move perhaps hints as much. One year out we would not be surprised to see sterling and rates rebound somewhat.

Figure 2: Secular revival?

US real GDP and private final demand growth, 7-year moving averages, annualised %



Source: Datastream, Rothschild & Co

The eurozone economy has been growing in line with its traditionally-subdued trend, but with no noticeable inflation. The ECB continues to buy large quantities of bonds in an attempt to force the pace. Negative yields have spread further, as more and more bonds have seen their prices squeezed higher, but despite our misgivings the practical impact outside the bond market has been limited. Even the euro seems unfazed, and unlike the pound it is not noticeably cheap.

There may be little immediate economic tension, with even the banking sector relatively quiet of late, but political stresses in Europe may be rising again. The refugee crisis is still very visible. General elections loom in France, Germany and the Netherlands in 2017, and protest parties have been doing well (part of that grass roots revolt identified by many commentators, noted earlier). Spain remains without a government.

Most importantly, Italy faces a constitutional referendum towards year-end. It is designed to facilitate more stable government – and hence structural reform. In practice, the prime minister initially allowed it to be seen as a pending vote of confidence on his government and the wider status quo – including, some argue, Italy's participation in the EU. After our collective failure to guess the Brexit result, "Quitaly" must be a real risk.

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The chain of events needed for Italy to leave the euro and the EU would be lengthy, complicated and slow. We doubt it will happen. But it would be a much bigger blow to the EU (and markets) than the UK's departure: Italy is a founder member of the EU and euro.

Switzerland continues to grow a little more healthily even than we'd dared assume. The franc is very slowly returning to earth, but remains expensive, and the post-January 2015 episode (when the Swiss National Bank removed its cap) serves as a neat illustration that there is more to competitiveness than low prices.

Elsewhere, it looks as if emerging Asia may have passed the point of maximum cyclical risk. Some indicators from China suggest not just steady deceleration but even an uptick in growth (which, if it were to materialise across the wider economy, would be a big surprise, even to us). The chances of another 1997-type crisis, always overstated in our view, may not revive even when/if the Federal Reserve does raise US rates further.

Debate about the Japanese economy continues to revolve around yet another mooted quick fix, with predictions of helicopter money and resumed yen weakness. We continue to think the focus should instead be on the labour market, corporate governance and liberalisation generally.

Markets are not cheap, but in many cases they are not expensive either.

Investment conclusion?
As we've argued before, ongoing growth, little inflation and ample liquidity is not that bad an investment climate. Markets are not cheap, but in many cases they are not expensive either.

Our main concern is still that secular stagflation groupthink is encouraging mission creep at the central banks: if the global economy is less fragile than feared, monetary policy may not need to be this generous. But again, this doesn't yet seem to be a clear and present danger.

Government bonds look very expensive: negative yields are alarming. But valuations may not be quite as wild as they seem. Inflation is low, and central bank buying is unlikely to be reversed, or even switched off, soon.

We prefer corporate securities. But corporate bonds are also expensive, and as investors we mostly prefer to own a stake in business than to lend to it. We see global stock markets as still reasonably priced, and advise using renewed volatility to build or add to positions.

We still favour both US and continental European stock indices most, and in August restored emerging Asia to the list (trimming our conviction on the US to do so). We remain least positive on the UK and developed Asia ex-Japan. We also continue to favour a mix of structural (technology) and cyclical (financials, energy) growth ahead of most defensive sectors.

Our conviction on currencies is even lower than usual. The pound looks oversold, as noted, and on a one-year view we would now place it towards the top of the ranking, just ahead of the dollar. Next would come the yen, and the euro, with the Swiss franc and renminbi still our least favoured currencies.

The US election

Politics is not always the main driver of investment returns

This is already the noisiest presidential campaign in recent memory. Nonetheless, the outcome may not have a big impact on portfolios.

Democrat Clinton seems to be slightly ahead of Republican Trump, but polls (and betting odds) are fluid and fallible. Investors should be wary, however, of translating a shock result into a dramatic investment conclusion. As we suggested about Brexit, seemingly profound political developments can sometimes have relatively muted economic and financial effects, at least for a while.

Obviously, the occupant of the White House matters: the POTUS is still the most powerful person on the planet. But campaign policies do not always make it onto the Oval Room agenda; the President's power is limited by the "checks and balances" of the US constitution; and, most importantly, capital markets have many moving parts – lots of other things matter too.

The historical record
The centre of gravity of the US debate usually lies firmly on the (economically) liberal side of that in Europe: most Democrats would feel at home in European conservative parties, for example. That said, the Republican party is usually closer to business, believes in smaller government, and might be thought of as likely to preside over more investment-friendly outcomes.

Historically, this has not been the case. Since 1945, growth has been stronger, unemployment lower, and real stock market returns materially higher, under Democrat Presidents (figures 3–5). This is possibly because Republican presidents have often faced a Democrat-controlled Congress, and may not have been able to make a difference; much more likely, it reflects the reality that even the strongest president cannot shelter the US from the cyclical and secular forces shaping the economy and markets.

For example, presidents Nixon and Ford are unlikely to have been the main cause of poor performance in the 1970s, when economies globally were increasingly sclerotic and inflationary (inflation then was recognised as a bad thing). More recently, George W Bush had the misfortune to win in 2000 after the excesses of the "new economy" boom in 2000, while President Obama won amidst the depths of the 2008/9 maelstrom, when things could only get better.

This is of course simplistic. It assumes a president's impact is confined to their term of office, and ignores the possibility that a good outcome under one party might have been even better under the other. But the President's political complexion has not been a visibly dominant driver of investment returns. We made the same point about the UK governing party ahead of last year's general election.

Trump needn't mean slump

The assumption that a Republican victory has been best for portfolios has been historically mistaken, then. And Trump's idiosyncracies make it doubly questionable.

A Clinton victory would effectively be "business as usual": it would not alter the macro climate. Some industries might face headwinds – healthcare, financials – and some fiscal expansion seems likely, but these are not game-changers for the sectors or for bond yields.

A Trump victory seems a dramatically different prospect – but in practice, it might not be.

His policies are fluid – to be fair, so are many candidates' at this stage – and he would surely face moderating advice from colleagues and cabinet, and from the legislature and the judiciary (those checks and balances). His marketing ability is less often questioned than his business record: having made a sale, he would not be the first salesman to underdeliver.

Most visibly and unattractively, Trump favours protection and a bellicose isolationism. This would be bad for US and global business, and lowered international liquidity might drag capital costs higher. His browbeating of the Federal Reserve might push bond yields up. Borrowing costs might also rise if global capital markets were to take fright at a perceived quantum jump in geopolitical instability.

However, Trump says he will reduce personal and corporate taxes substantially, and boost infrastructure spending. Much as we would worry about the long-term consequences of protection, this fiscal expansion might be potent.

A big increase in US government borrowing could encourage the Fed to raise rates, and the bond markets might take fright even if it doesn't. A surge in interest rates is one of the reasons why some commentators think an immediate slump is likely.

But in the current climate, we're sceptical such a surge would happen. The US's balance sheet is not as fragile as it is often made out to be, a point we've long been making, and the global hunt for yield currently might be sufficiently strong to offset many investors' scruples at lending to a Trump administration.

Fiscal expansion unaccompanied by materially higher rates might give the economy a net near-term boost – and with so many moving parts, by the time protection does bite, there might be other factors uppermost in the markets' minds.

Similarly, the dollar need not be a one-way bet downwards under Trump.

Much as we would worry about the long-term consequences of protection, fiscal expansion might be potent.

Protectionism is the economic equivalent of shooting oneself in the foot – but a weakened and misguided US would lead to a more unstable world, and the dollar is still capable of being viewed as a safe haven currency. And if the short-term impact of that fiscal expansion is potent, then (as often happens) investors are quite capable of refocusing from the dollar's safe haven status to its cyclical attractions, even without a surge in interest rates.

Conclusion? Trump may not win. If he does, he will have to decide what he really wants to do; his advisers may challenge him; the resultant policies may be muted by Congress and the judiciary; and the global economy will not be standing still in the meantime.

Despite the obvious risks, then, investors should keep an open mind about the narrow economic and financial implications of a Republican win on 8th November. A fear-induced sell-off in stocks could start at a higher level than today's, and might be limited in scale.

Figure 3: S&P 500 real returns (%) sorted by US President (1945-2016)

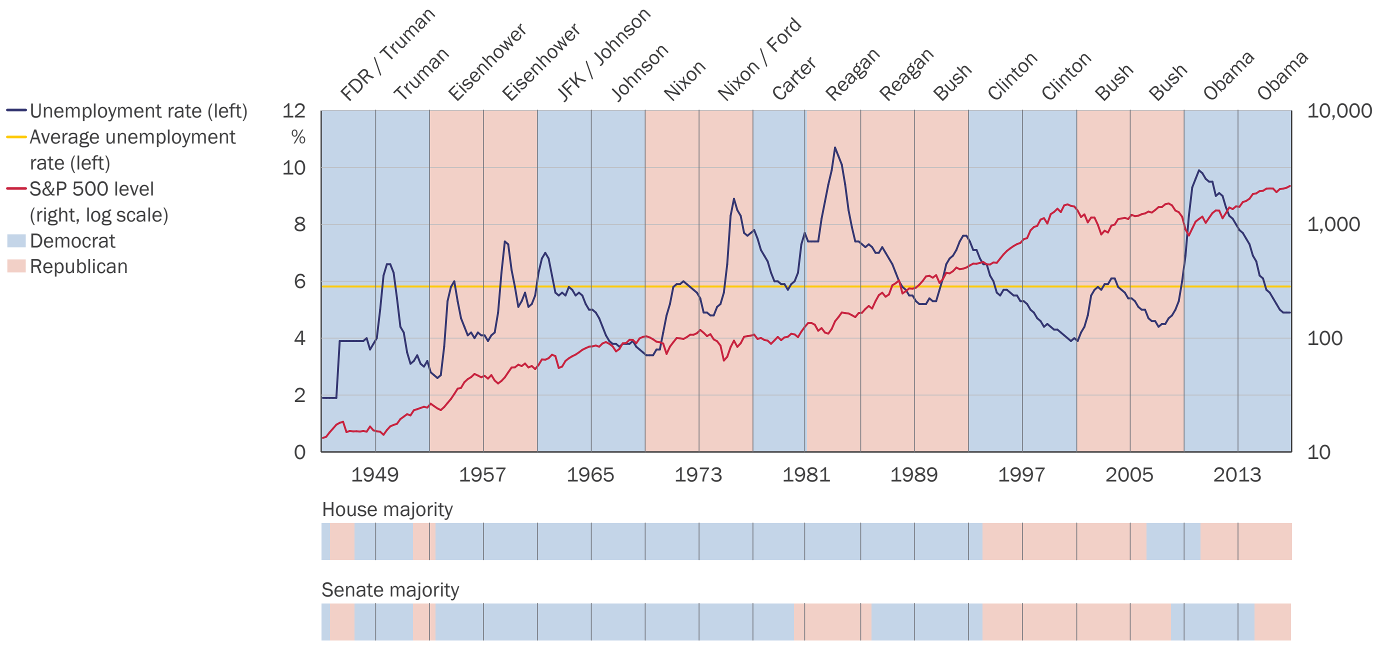
House of Representatives / Senate Majority	
Blue	Democrat
Red	Republican
Blue/Red	Democrat/ Republican
Red/Blue	Republican/ Democrat

President	Political Party	Inauguration	Year 1	Year 2	Year 3	Year 4	Whole term	Annualised
FDR / Truman	Democrat	Jan 1945	34.1	-26.2	-3.2	2.4	-1.9	-0.5
Truman	Democrat	Jan 1949	25.7	26.7	17.8	16.9	119.3	21.7
Eisenhower	Republican	Jan 1953	-1.8	52.9	31.0	4.0	104.6	19.6
Eisenhower	Republican	Jan 1957	-13.7	41.2	10.3	-0.9	33.1	7.4
JFK / Johnson	Democrat	Jan 1961	26.2	-10.0	21.3	15.3	59.0	12.3
Johnson	Democrat	Jan 1961	10.6	-13.7	21.2	6.3	23.0	5.3
Nixon	Republican	Jan 1969	-14.3	-1.7	10.8	15.5	7.8	1.9
Nixon / Ford	Republican	Jan 1973	-22.9	-38.7	30.0	18.9	-27.0	-7.6
Carter	Democrat	Jan 1977	-13.8	-2.4	5.9	19.9	6.9	1.7
Reagan	Republican	Jan 1981	-14.5	17.0	19.3	2.2	22.0	5.1
Reagan	Republican	Jan 1985	28.2	17.4	0.8	12.3	70.3	14.2
Bush	Republican	Jan 1989	27.1	-9.4	27.4	4.6	53.4	11.3
Clinton	Democrat	Jan 1993	7.3	-1.3	34.9	19.7	71.0	14.4
Clinton	Democrat	Jan 1997	31.5	27.0	18.4	-12.5	72.9	14.7
Bush	Republican	Jan 2001	-13.7	-24.3	26.8	7.6	-11.0	-2.9
Bush	Republican	Jan 2005	1.2	13.8	1.6	-38.6	-28.2	-7.9
Obama	Democrat	Jan 2009	25.0	13.8	-1.2	14.1	60.4	12.5
Obama	Democrat	Jan 2013	31.1	12.4	0.9	-	48.8	14.2

Figure 4: Summary data (1945-2016), %

		Year 1	Year 2	Year 3	Year 4	Whole term	Annualised
Republican	S&P 500 real return	-2.7	7.6	17.6	2.8	25.0	4.6
	Real GDP growth	2.1	1.1	4.2	3.1	10.9	2.6
	Inflation (CPI)	4.6	3.9	3.3	3.2	16.1	3.7
	Unemployment rate	5.3	6.4	6.2	6.2	6.1	6.1
Democrat	S&P 500 real return	19.8	2.9	12.9	10.3	51.0	10.7
	Real GDP growth	3.0	3.5	2.8	3.5	13.1	3.1
	Inflation (CPI)	1.8	5.0	4.5	3.9	16.1	3.7
	Unemployment rate	6.0	5.4	5.1	5.0	5.4	5.4
Entire period	S&P 500 real return	8.5	5.3	15.2	6.3	38.0	7.6
	Real GDP growth	2.5	2.3	3.5	3.3	12.0	2.9
	Inflation (CPI)	3.2	4.4	3.9	3.5	16.1	3.7
	Unemployment rate	5.7	5.9	5.7	5.6	5.7	5.7

Figure 5: US Presidents, unemployment (%) and S&P 500 level (1945-2016)



Source for figures 3-5: Datastream, BLS, Rothschild & Co

Notes

At Rothschild Private Wealth we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation-first is the right approach to managing wealth.

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