GONET MARKET OUTLOOK
BANQUIERS 1845 QUARTERLY ▪ JULY 2017

EBB AND FLOW

IN A NUTSHELL

Major equity indices seem to be maintaining their steadily bullish trend, driven further by easing bond yields, rather than by earnings momentum. The current sense of serenity may be undermined however, not by a major downturn in economic activity, but by central banks starting to withdraw the excess liquidity they so generously supplied.

SERENE EUPHORIA?

At the half-year stage, global financial markets are characterised by two dominant themes. Volatility has fallen to extreme lows in most asset classes, while the majority of investors remain optimistic, with the notable exception of certain professionals.

Despite a series of episodic spikes, volatility has fallen steadily. New significant lows have been hit since we analysed this trend closely six months ago. In May, realised volatility stood at only half of its historical average, among government and corporate bonds, and at only one third of the average among equity indices.[1]

The current calm in the markets contrasts with the instability of the global political backdrop. Although several key elections are now behind us, every major European issue remains open. While the legal and media battle between Donald Trump and the Democrats has paralysed the US, the level of tension has increased in the Middle East and friction with China and its neighbours has not abated.

The macroeconomic climate now at least appears more reassuring. The US economy has stabilised, after its recent downturn, along with the Chinese economy, which had also decelerated for different reasons. Meanwhile, the long-awaited economic pick-up in the Eurozone is finally underway, while growth has been satisfactory in Japan, etc. However, a number of disconcerting indicators have appeared in the US, as we shall analyse further on in the text. The case of China also requires further discussion, from a financial perspective rather than in strictly macroeconomic terms.

The slump in volatility is largely attributable to the accommodating policies adopted by the central banks. Having maintained interest rates at excessively low levels, compared to the pace of economic activity, and also having absorbed a good part of the public debt issued, central banks have promoted risk-taking in general and encouraged financial leverage in particular.

Low volatility leads to a concentration of risks. The most striking example of this factor can be seen among US equities, where five stocks out of 500 contributed over 50% of the year-to-date

— S&P 500 Index
— Citi US Economic Surprises Index
Source: Bloomberg

[1] Realised 30-day volatility: 5.4% vs 17.4% for the S&P 500 index; 8.7% vs 22.2% for the EuroStoxx 50. Source: Goldman Sachs Investment Research.

OUR STRATEGY

On 24 April, we completely scaled-back our equity overweight (initiated on 16 November 2016) and resumed a neutral weighting. As a result, our net cash position increased.

We have otherwise made no key changes, remaining significantly underweight in bonds.

Our equity positions are limited to our core markets, whereas the fixed-income portfolio is heavily weighted in favour of investment-grade government and corporate debt securities.

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gains in the S&P index.[2] It is a less well-known fact that half of the gains recorded by the emerging markets index,[3] which has returned doubled the performance of Wall Street, were attributable to tech stocks alone.

The S&P 500 index appears to have completely ignored the collapse in the reflation theme, which we predicted last quarter, and also a series of negative macroeconomic surprises and the sharp decline in inflationary expectations. However, if we exclude FAANG and a few others, it is clear that most stocks have indeed weakened.[4] ■

[2] Apple, Alphabet (Google), Amazon, Facebook and Netflix, referred to collectively as FAANG.
[3] UBS Investment Research, 10 May 2017.
[4] Over 10 weeks from March until early May, according to macrocharting.com, the FAANG stocks had gained 260 billion in market cap, whereas the other 495 securities in the index had lost as much.

GOLDILOCKS, PICTURED ON SNAPCHAT OR FILMED ON YOUTUBE

The combination of moderate growth and low inflation is another reason often evoked to explain the serenity among equity markets, despite disappointing macroeconomic indicators. The economic climate, which is neither too hot nor too cold, is just right, like the bowl of porridge in the Goldilocks story. The analogy, which was all the rage during the mid-90s, is now fashionable once again. Although this is a convincing explanation, we believe it to be misleading.

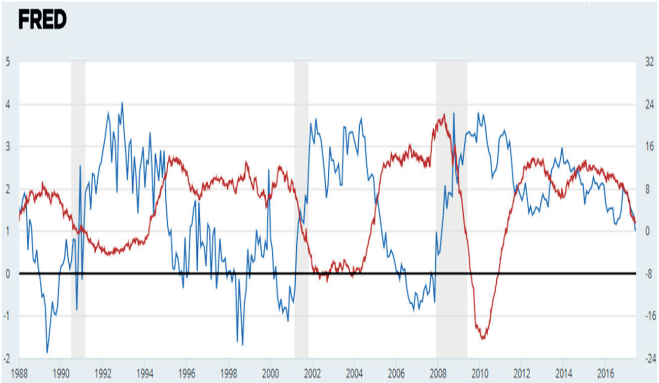
Today, conditions appear to be “just right” but only for the time being, like on Snapchat we might say. But the longer film which is going to be played out (on YouTube?) is sending out a different message, suggesting that the porridge will go cold.

In the US, after a particularly sluggish 1st quarter, consensus among economists and investors is banking on the pace of growth accelerating once again. However, all hopes in this sense have been systematically disappointed. The Citigroup Economic Surprise Index has collapsed as much as it did in 2011, which was not a great year for the US and the global economy.

If all of the indicators turned green and even if they were now to beat expectations, the uptick would be only temporary. The most optimistic forecasts are effectively predicting a deceleration in the second half of this year and in 2018. Last quarter, we analysed the forces at work, notably the top in the employment market and the absence of productivity gains.

Two trends require close surveillance. The slope of the yield curve is key, as it has a determining influence on corporate financing decisions and commercial banking policy. In the US, each inversion the yield curve, i.e. when 10-year yields fall below 2-year rates, has always been followed by a peak in the equity market and then a recession. Although the yield curve is currently still a long way from being inverted, it has nonetheless reached its lowest point since 2008. Even though the Fed asset purchase programme has created an imbalance between supply and demand, which we shall cover further on in the text, the Treasuries market is one of the most diversified and efficient markets in the world. Its message cannot be ignored.

The sharp slowdown in the banking loans market, excluding mortgages, is another disconcerting factor. It should not be forgotten that the aim of quantitative easing measures, whether in the US or elsewhere, is always to stimulate the credit market. In the Eurozone, take-off in the loans market has rekindled optimism and has been cited by Mario Draghi ever since. In the US on the other hand, domestic sectors are clearly losing momentum.



— 10-Year Treasury Constant Maturity Minus Federal Funds Rate (left)
— Commercial and Industrial Loans, All Commercial Bank (right)
Source: Federal Reserve Bank of St. Louis. Shaded areas indicate recessions.

So what has happened to the reflation theme that emerged with the election of Donald Trump? We still believe that a cut in the corporate tax rate and particularly in household income taxes would have the greatest impact. Although Trump’s campaign promises were effectively highly ambitious, the political stalemate in Washington has already delayed by 6 months the start of what promises to be a very lengthy debate. It should be noted that the reform initiated by Ronald Reagan only became fully effective after five years. A recovery in fixed investment appears illusory without fiscal measures. Although confidence indicators are certainly at all-time highs, intentions are not necessarily followed by actions. Why should companies invest more heavily when final demand is decelerating and their financial charges are increasing?

Although the uptick in the Eurozone economy is clearly good news, growth has now reached its medium-term potential and will not continue to accelerate indefinitely. Stabilisation at the current level would already represent a step forward in the region. Two obstacles are looming on the horizon however, in the form of a stronger euro and, more significantly, the impact that a slowdown in the US engine will have on the global economy. ■

WHAT WILL DRIVE EQUITIES FURTHER?

The excellent performance returned by global equities since the election of Donald Trump, or since the beginning of the year, is often explained by stronger earnings momentum. It is true that Q1 earnings per share within the S&P index have increased by 14.5% over 12 months, which is the strongest increase since 2011, and by 26% in the Stoxx 600. Cyclicals logically outperformed at the start of the year. However, with the first signs of a shift in this trend becoming visible from March-April onwards, we entitled our previous issue of this review *A Change of Leadership*. The situation is now even clearer, with value stocks and most cyclical sectors underperforming, whereas the global indices are driven by stocks trading on high multiples, or even, as we stated before, by a sub-group composed of FAANG etc. Earnings momentum is expected to level off in Europe and decline in the US due to sluggish nominal GDP growth, as margins peak, along with a reduction in share buybacks and the forex impact.

Is the long-awaited outperformance staged by Europe, after lagging throughout 2011–2015, already over? With earnings in the MSCI Eurozone index having returned only to 2006 levels, it would appear that there is further leeway for improvement. However, if banks, utilities, telecoms and commodities are excluded from the calculation, i.e. if we focus solely on global players, earnings are actually 30% above their previous cyclical peak, i.e. exactly the same as in the US.

With indices remaining bullish while growth has stopped accelerating, valuation multiples have expanded in the US and in Europe. Robert Shiller's cyclically-adjusted P/E ratio (CAPE) has risen far beyond the previous cycle peak and has now matched the 1999 level. Meanwhile, the MSCI Europe index has reverted to its historical mean vs the US in terms of valuation, while most manufacturing companies are overvalued compared to their US or Asian peers.

Multiples would of course not have expanded if bond yields had not eased. Growth in excess liquidity, resulting from central bank securities purchases, have been the main driver however. Over the first four months of the year, the aggregate balance sheet for the 5 major central banks, i.e. the Fed, ECB, Bank of Japan, Bank of England and the SNB, increased by USD 1,100 billion. There is a very close correlation between central bank balance sheets and equity and corporate bonds prices. At the current levels, risky assets are pricing-in an indefinite supply of excess liquidity from the central banks. A major shift in this policy is due however within a few months. ■

GLOBAL LIQUIDITY EXPECTED TO EBB FOR THE FIRST TIME SINCE 2008

Will the dip in US inflation prove temporary? The Fed, at least, believes so and did not hesitate in hiking its base rates for the 4th time. Although inflation remains muted in several European countries, this is far from the case in Germany. ECB rates, which are adapted to the weaker economies, are extremely negative in real terms from a German perspective. This tension can only increase, making the ECB position with regard to its largest shareholder increasingly fragile.

In his latest declarations, although Mario Draghi has carefully avoided guiding one way or the other, we remain convinced that the ECB is planning to taper its asset repurchase programme from early 2018 onwards and that it may also make an announcement to this effect relatively soon, for example on 7 September.

In parallel, the Fed has recently provided further detail regarding the reduction of its balance sheet, i.e. refraining from renewing its bond holdings. The start date remains uncertain however, with the latest declarations implying September, although December is still more likely.

Why does the Fed want to reverse QE and hike its rates further while growth is slowing down? Although this debate could fill thousands of pages, we shall give a brief reply to the question. The Fed wishes to avoid a bubble in the equity markets and among other risky assets. On 14 June, the FOMC press release referred for the first time to a notable easing of "financial conditions" in the equity and credit markets, asset management and shadow banking.[5] The New York Fed president was even more explicit, stating that easier financial conditions provide "additional impetus for the decision to continue to remove monetary policy accommodation".[6] We have now been warned.

Within six months at the most, the Fed will no longer replace maturing bonds in its balance sheet and the ECB will buy fewer bonds than currently. In other words, the central banks' aggregate balance sheet will begin to shrink for the first time since the launch of the various QE programmes across the globe.

Central bank asset purchases are not the only component of global liquidity however. Currency reserves must also be taken into account. China has consumed part of its reserves in defending the renminbi against the dollar. Although the radical measures implemented at the beginning of June, in practice freezing the limited convertibility of the renminbi, temporarily halted the heavy outflow, observations on financial centres abroad imply that outflow has begun again.

Although they will be acting for different reasons, the Fed, the ECB and the People's Bank of China shall all be stemming their global liquidity flows. ■

[5] As measured by the Chicago Fed's *National Financial Conditions Index*.
[6] William Dudley, Panel remarks at the BIS Annual General Meeting, Basle, 25 June 2017.

A QUEST FOR YIELD – OR FOR SECURITY?

Balance sheet reduction by the Fed and tapering by the ECB will of course lead to lower total demand for bonds in the market. Although government security yields will inevitably rise, we believe that the ensuing increase will be limited, at least in the short term, firstly for macroeconomic reasons. Growth in major developed countries, particularly in the US, will not accelerate. Core inflation is present, but showing no sign of surging, other than the case of Germany referred to above. Secondly, both the Fed and the ECB plan to intervene progressively over several years, in order to avoid spooking the markets. Lastly, the central banks are not the only buyers of government securities. Major Japanese institutions still have a keen appetite for US Treasuries for example.

Although most advisors constantly evoke the quest for yield as a justification for risk-taking, the quest for security is equally worth mentioning, as liquidity has dried up among government securities in the market. This observation may be surprising, given the persistently deep budget deficits in most countries, which inevitably give rise to an ocean of public debt. However, in parallel, other fixed-income market segments have surged. For example, during this cycle, the USD high-yield market cap has more than doubled. All of these segments are not only structurally riskier than government securities, but they are also historically overvalued, while liquidity among the most recent segments has never been tested in a more challenging market phase.

Demand will of course remain strong for government securities, led by US Treasuries, among major institutions, such as insurance companies and retirement pension funds, and also among investors implementing risk arbitrage strategies, including hedge funds, investment bank proprietary trading desks and many other investors who are increasingly active across all markets.

We are maintaining our 12-month 10-year US Treasury yield target of 2.75%. Although this objective implies a sizeable rise from current levels, it would not be catastrophic.[7] For the time being, yields may steepen on less disappointing macroeconomic news, although we are not expecting an increase beyond 2.40% in the immediate future. ■

[7] Having stabilised at this average level from mid-2013 to mid-2014, following the Fed's surprise announcement of plans to reduce its asset purchases, or "taper tantrum".

A BRIEF SURGE IN THE DOLLAR

Our comments on FX markets will be brief, as our analysis outlined last quarter remains largely valid. We believe that the euro will continue to rally for fundamental reasons, including the current account balance surplus, and its relative valuation, notably given the slight tightening of the yield spread between US Treasuries and the German Bund. Our euro/dollar target of 1.14 has been reached already. However, gyrations may be triggered by political issues in Washington, coupled with the German elections and a time lag between decisions from the Fed and the ECB. Over the next few months, the euro/dollar rate could therefore ease back towards 1.10 before resuming strength. ■

INVESTMENT CONCLUSIONS

Although our core scenario remains broadly bullish, we are becoming increasingly cautious regarding equities and high-yield bonds given the collapse in volatility and the euphoria among investors. Markets across the board have become overvalued. Our price targets for the year, which previously appeared optimistic, have almost been reached in the US and have been surpassed in Europe. In other words, upside potential is now particularly limited, whereas the risk of a correction is increasing.

The term "correction" implies a salutary swing, resorbing excess valuations and putting the market on a stronger footing. Under normal circumstances, we would not be concerned by a correction of this nature, although we fear that the extreme positioning among many investors, having sold volatility short, may temporarily exacerbate downside.

We are therefore no longer recommending an overweight positioning in equities, having resumed a neutral weighting. Equity markets have been driven by a restricted number of increasingly fragile stocks. In these conditions, our tactical preferences may shift very rapidly.

We maintain our recommendation for a highly selective approach to corporate bonds, while maintaining limited positions in US Treasuries, hedged against currency risk.

We believe it is essential to reconstitute cash reserves, in order to reduce overall portfolio risk, and in order to maintain firepower to intervene in the markets which are bound to become more volatile. ■

Patrizio Merciai, Chief Strategist
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