

10 Seconds Into The Future

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The consensus amongst investors is the following:

The US is still a good place to invest because the economy is strong, inflation is under control, and policy is accommodative despite the Democrats winning the House and potentially stopping further shots of performance enhancing substances, the Fed is raising rates reassuringly and gradually, and finally, there are few alternatives as attractive once the risks are accounted for.

China is a risky investment because growth is slowing, there is a credit bubble, policy is hawkish as the government tries to deflate the credit bubble, and there is a trade war with America which China will lose.

Europe is a basket case where growth is already slowing, policy is behind the curve and hasn't normalized when the going was good, Brexit is a distraction and a material loss of an important partner, Italy is misbehaving fiscally, and populism threatens from the extreme right and left.

Here's what I think.

With Democrats in the House the political and regulatory risk has risen. It's going to be difficult to analyse policies on their merits and along conventional lines because even tangential matters can be used as bargaining chips or hostages.

Expect a standstill in tax cuts. The negatives are of course that the equity and credit markets have been counting on further tax cuts and deregulation. In the short to medium term, this will reduce the momentum in earnings. Deregulation is also likely to be set back.

In some areas, Democrats and Republicans agree, such as infrastructure investment and containing China. Even here, there is uncertainty as each piece of legislation becomes a potential pawn in a larger conflict between the two parties. Anything is possible.

The US has prolonged its prosperity by cutting taxes, which essentially borrows from its future. Were these borrowings spent on investment in future growth and capacity it might be

positive for risky assets but instead a significant portion has been spent on share buybacks, thus inflating asset prices. Eventually this debt needs to be refinanced or repaid. Rates are rising and spreads have been kept artificially low by QE and policy. The future cycle could be deeper than previously thought.

China is slowing down and directly as a result of the campaign to deleverage the economy. The effort has been turbulent as the speed of deleveraging has surprised the regulators as they shifted leverage from the shadow banks to the regulated banking system. This type of contraction is the price for a worthwhile cause, a safer credit system.

Trade has already had some impact on the economy but mostly through sentiment. China's export reliance has fallen steadily over the last 10 years as part of a deliberate policy to balance the economy. China has the domestic demand to support its economic growth. Exports account for 10% of economic growth of which a third is to the US. Europe is China's largest trading partner, which brings with it its own set of problems as Europe reverts to moribund trend growth. But tariffs on goods headed to the US penalize Americans as much as they do China.

Between a market trading at 19X (S&P500) and yet to slow down, and a market trading at 11X (Shanghai Comp) which is already in a slowdown, it really depends on whether you prefer the game of chicken to being too early into a trade. China slowing from 7% to 6% growth still generates a comparable incremental nominal output as the US growing at 3.5%.

Europe is a trading bloc, which explains much of its attitude towards trade policy. Europe has an ageing population, is most lately averse to immigration, and has relied most heavily on international trade for growth. Without miscreants weakening its currency (2008 – 2016, and most recently 2018), the EUR would have been too strong for the Eurozone's business model. Trade has been good to the Eurozone and exports to GDP have risen steadily from 40% of GDP in 2008 to 46%, almost monotonically. China, has been an avid buyer of European brands and intellectual property. Some would say, thief, not buyer, but this is an exaggeration from extrapolation in certain sectors. The Chinese have been heavy buyers of high tech and industrial products to supply its growing economy.

Europe's problems would fill volumes, but the complicated mess that is Europe provides a lot of stock picking opportunities. At 12X – 13X earnings, Europe is not expensive, and contains pockets of opportunity. European luxury brands demand by an increasingly rich populace in

China is a durable theme. The broad brush approach of macro investors to Europe create opportunities even in the European banking sector where healthy banks have to pay over 7% for tier 1 capital. The simple refinancing of bank liabilities would improve margins even if the ECB maintains negative interest rates.

The consensus view on Europe is, however, accurate, and a broad exposure based approach to invest in Europe is inadvisable. The ECB is in a corner, not entirely of its own doing. Growth rose sharply in 2017 but did not last long enough for the ECB to raise rates. Its compromise of backing away from QE is not really viable without replacing it with some other accommodation. The ECB will almost certainly have to resume its LTROs, if nothing than to refinance the old ones. Any dreams of ECB rate hikes will have to be preceded by large scale LTROs.

The political landscape in Europe is highly uncertain. 13% of the Bundestag is with the AfD. Italy is run by a coalition of two populist parties bent on challenging the fiscal discipline of Brussels. Brexit will at the very least distract and would remove the most pro-business lobby within the EU.

And, Europe is slowing down again, off its 2017 trade infused high. Manufacturing PMIs are flagging, declining in 8 of the last 10 monthly readings. Service PMIs are a little bit better but the overall picture is down. Other economic indicators corroborate the slowdown. Some of this is the slowdown in China, and some of it is the trade war between China and the US which introduces some very complicated problems. The European auto industry, as an example, produces in the US to serve Asia and Europe, Asia to serve America and Europe, and Europe to serve America and Asia, often within the same car company. (Generally, SUVs are made in America, compacts are made in Asia and America, and flagships are made in Europe.)

How does one make money under these conditions?

US earnings growth is still strong and theoretically, one could just invest in US companies. Market prices are, however, driven by more than just earnings. They are impacted by valuations and by expectations of future earnings. If investors think that future earnings growth may not live up to expectations, they may value companies less and prices would fall even if current earnings were robust. Expectations about future earnings are impacted by fiscal and monetary policy, domestic and foreign demand, costs of credit and input costs, among other things.

Companies in China are cheap but the economy is slowing and while earnings are still growing,

they too will slow with the general economy. India is growing strongly and earnings are highly correlated to growth but the risk of higher oil prices and a strong USD threaten inflation and diminished returns in USD. Japan is a bright spot with growth just accelerating and disinflation reversing. But global sentiment on equity risk typically drives equities of all nations in the same direction with dispersion mostly in magnitude.

Credit markets also struggle. The Fed raising rates makes duration unattractive. Credit risks correlate with equity risks, so as a bundle, the outlook for traditional bonds is not great. There are pockets of value and returns in the more esoteric corners of the bond market but they tend to be accessed by institutional investors and unavailable to private investors.

Trading FX is an adventure fraught with risks as currencies can decouple from fundamentals for a long time. In the meantime, short term variation is explained more by capital flows, sentiment and news.

For the next year at least, a couple of possible investments suggest themselves.

- Italy's bond yields are some 3% higher than German bund yields. If one believes that Italy will not exit the Euro currency mechanism then odds are the difference between BTP and bund yields will fall. (Buy the Italian bond and sell short the German one.) An additional catalyst is that the ECB revives the LTROs. It almost has to just to refinance the expiring LTROs to avoid a liquidity crisis (not a solvency one) for Europe's banks. And given the latterly soft economic data from Europe, it may have to expand its LTRO sizes to replace the expiring QE program. The risks to this trade are that Italy's two co-ruling parties decide to amplify their defiance of EU rules thus widening the budget deficit and further growing the national debt. Even so, it may make sense to stick two fingers at the Italian government and make the trade. If Italy tries to exit the Eurozone it will wind a 480 billion EUR (25% of GDP) debt obligation from the conversion of its TARGET2 net balance, into a bona fide debt. A similar trade with less risk can be attempted between Spanish and German bonds that doesn't involve staring down sovereign governments.
- The US treasury curve had been flattening for the past seven years and has reached an extreme level of flatness. It has only been this flat in 2005/2006, 2000, 1989/1990, mostly leading up to recession years. The US is unlikely to sink into recession. The current flatness was born from technical issues to do with QE, notably the extension of the Fed's SOMA holdings. At peak, the Fed owned some 30%-40% of the market in

short and intermediate maturities. It owned 56% of the 30 year treasury market. Just as QE in its latter stages was meant to flatten the curve, to cap long term borrowing costs, so the withdrawal of QE is bound to reverse it. On a duration neutral basis, the trade has generous carry, precisely because the curve is so flat. That the curve is steep at shorter maturities provides a positive roll down for the trade. The risks to the trade are that inflation falls or that the US enters into a recession and the Fed resumes QE.

- European bank capital is attractive because it is mispriced. European banks have seen two years of improved earnings and beating forecasts. More recently bank capital buffers continue to improve and banks are meeting ECB stress tests under the most stressful conditions. Despite these improvements, the bank capital market has sold off in sympathy with bank equities, which had in turn sold off in sympathy with increasing sovereign default risk.
- European banks may not be in the best of shape even after all the recapitalization exercises, but, if the ECB does go ahead with LTR0s, it presents European banks with a capital free (or at least very low capital consumption) way to make money. We know also that the ECB cannot raise rates before embarking on large scale LTR0s as they would be punishing the banks whom they needed to do their dirty work for them. The first ECB rate hike would lift the banks as it would aid their profitability.
- 2 vs 10 year bund flattener. This is a more risky trade. The economics are sound. The ECB will unlikely revert to QE for fear of signalling that Europe was back in intensive care. LTR0s are less glitzy steroids. However, it is likely to lift the benchmark deposit facility rate from -0.4% towards zero to take pressure off European banks and insurers. Raising the short rates and operating 3 year repos will put flattening pressure on the EUR sovereign curve. Being long the 10 year pays 0.4 and being short the 2 year pays (yes, pays, not costs) -0.6 X 5 (duration hedged) for an all in carry of 0.7% in EUR. This is a risky trade because if the moderate slowdown in Europe becomes a recession, and the stock market crashes, the risk aversion trade will likely steepen the curve from 1% to 2% for a 5% loss on an unlevered basis, and you're not going to do this without leverage are you?

