Issue 84 | June 2016

Market Perspective

The caravan moves on | Western decadence – or progress?

foreword

"*A plague o' both your houses*" – Romeo and Juliet

We take little credit for suggesting in December 2015 that the Brexit debate would not be edifying: it was an easy call. We are surely at "peak referendum" now, and both sides are proclaiming "stuff that just ain't so" from the rooftops. Apparently the UK is damned economically if it leaves, and damned if it doesn't.

Soundbites were always going to dominate, and bad news makes the best soundbite. The easiest way to get quoted as a City economist – more of a PR role than practitioners realise or like to acknowledge – is to be quick on the draw with a gloomy bullet point. Even the academic community is not immune: few professors can resist colouring their views in response to the siren calls of the media.

Scary news sells best because of loss aversion (pain caused by loss outweighs the pleasure caused by a comparably sized gain) and the human condition more widely (nobody lives forever). For pundits seeking that PR opportunity, the naïve pragmatist suggesting tomorrow may be pretty much like today is a less telegenic proposal than the world-weary wit asserting that disaster is just around the corner.

We judge Brexit would be bad news for business and investments, but not in a game-changing way. We think the UK – and the City, and indeed Europe – can prosper whether the UK stays or leaves. We'd prefer not to find out, however; and our best guess is still that we won't have to.

Meanwhile, we note below that US interest rate risk is still alive and well, and may be something to be embraced rather than feared. We also offer a few more illustrations of "stuff that just ain't so" – including the notions that corporate top lines don't grow and "we don't make anything anymore".

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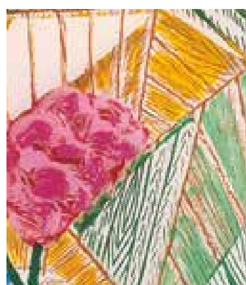

Cover: Walking Past Two Chairs – detail (lithograph and screenprint) by David Hockney © 2008. David Hockney.

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The caravan moves on

"The dogs may bark, but the caravan moves on"
– proverb

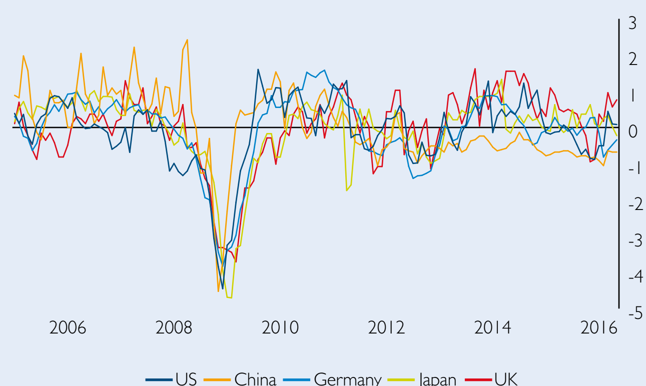
Global economy still exceeds stall speed…

Fears of US recession and a hard landing in China have faded further, commodity prices seem to have stabilised, and stock market volatility has fallen back to low levels. There are some big issues still on the horizon – higher US interest rates, the Brexit vote and widening geopolitical concerns (including the looming US election, the reviving refugee crisis and the labour relations impasse in France) to name just a few. But our muddle-through scenario seems to have survived its latest test, and has been shuffling in its understated way towards the summer. The caravan moves on.

The eurozone's table-topping first quarter GDP result is unlikely to be replicated, but the US seems to have rebounded as expected from its (upwardly revised) first-quarter disappointment. Global growth remains lacklustre, but seems still to be exceeding stall speed. Fears of another 1997-type Asian crisis in particular have subsided: they always looked overstated, and leading indicators suggest that the regional economy may be bottoming. (This does not mean China's slowdown is complete, simply that its wider impact may not be traumatic.) Forward-looking cyclical indicators generally remain clustered close to trend (figure 1).

Figure 1: Key cyclical indicators close to trend

Manufacturing surveys, forward-looking components: standard deviations from trend



source: Datastream, Rothschild

… and profits set to stabilise

Bellwether US corporate profits fell by roughly an eighth in 2015. This is bad news in itself for stock investors, but for many pundits a harbinger of recession. We have taken a different view. More than all of the profits decline was driven by weakness in oil and mining sectors, and lower commodity prices are not necessarily a harbinger of anything (other than added spending power for consumers). If commodity prices stop falling and the US economy continues to grow, so will corporate revenues, and operational gearing – the dilution of fixed costs as turnover rises – will support margins too.

Top lines can grow…

The possibility of revenue growth in the current climate may seem surprising. It shouldn't: one of the many mistaken tenets of received wisdom is that there has been no top-line growth in the post-crisis period, and profits have all been driven by cost-cutting. This idea was always questionable in theory, and wrong in practice.

Revenue has grown as the US economy has expanded – and so have costs. S&P 500 Index data shows sales growing at an annualised pace of 3.8% since 2009's low – a period that includes the recent hit to commodity revenues (figure 2). Excluding oil and mining, the growth rate has been 4.9%. The growth in US nominal GDP over the same period has been 3.4%. (US Inc receives a growing portion of its income from overseas, but its home market remains more important.)

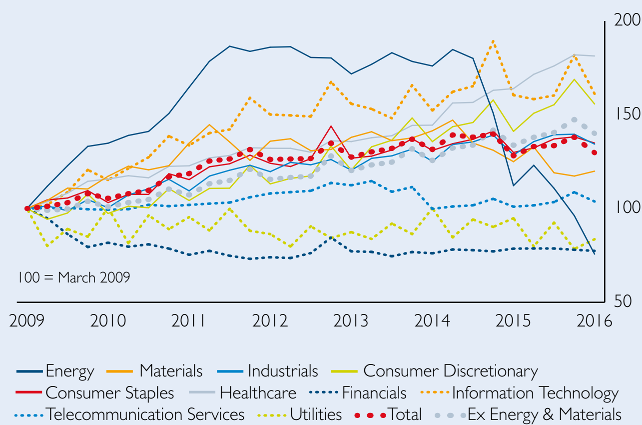
… and costs have risen too

Individual companies can boost profits by cutting costs, but it is highly unlikely that business in aggregate could ever do so. Workers are its biggest cost, but collectively are also the biggest buyers of its output. As Henry Ford remarked, it's not good for business to sack its customers – and it hasn't been doing so. The aggregate payroll has expanded steadily alongside GDP since the crisis.

On a related theme – the idea that something other than business as usual has driven US corporate performance – stock buybacks can also be misinterpreted. They have been around

Figure 2: US corporate revenues have grown

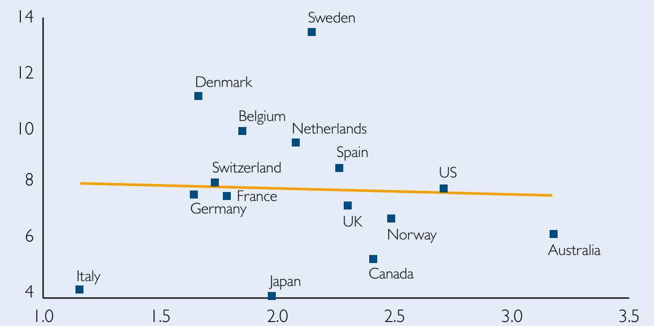
S&P 500 Index revenues, indexed



source: S&P, Rothschild

Figure 3: Don't overdo the connection

GDP growth (horizontal scale) and stock returns 1980-2015, annualised, %



source: MSCI, Datastream, Rothschild

for many years, are usually covered by operating profits and cashflow, and as we noted last month do not seem to have restricted business investment.

GDP matters – but loosely…

This is not the place to ask why people are quick to believe so much "stuff that just ain't so". Instead, having suggested that a growing economy will allow revenues, and in turn profits, to grow alongside it, let's row back a little and caution against translating that GDP growth mechanically and precisely into a specified investment return. Economic growth matters, but it is not sufficient – and sometimes not even necessary – for a successful investment in stocks. It matters in a regime-setting, facilitating sort of way, not in a mechanistic one.

Figure 3 reminds us that real GDP growth is not a good guide to ranking likely investment returns across countries. China has been by a mile the fastest-growing big economy in more recent years, but a relatively poor investment. Sometimes, US GDP growth itself seems to matter more to other countries' stock markets – perhaps because it determines global risk appetite.

This doesn't mean there is no link at all. The relative performance of the eurozone and US stock markets is often correlated with relative GDP growth. But the link is not as reliable as we'd like, not least because so many different things affect stock markets in addition to GDP – or revenue – growth.

… and not in isolation

One obvious candidate currently is monetary policy. Decent US GDP growth is quite likely to result in a further normalisation of interest rates soon, even as inflation remains relatively subdued. Federal Reserve officials have clearly warned us, but a move could still unsettle markets. It could also underpin the dollar, amplifying the resultant tightening of US monetary conditions.

Fed up – again?

As we see it, rising interest rates currently would signal greater confidence at the Fed in the ability of the US economy to stand on its own two feet (as we've long argued it can). Markets are likely eventually to share this view (a stronger dollar would be one manifestation of that). At some stage an incremental tightening of monetary conditions could prove the straw that breaks the camel's back. But currently, we think renewed market volatility on this score might be short-lived.

Other central banks continue mostly to face the other way. Indeed, the ominous whuppa-whuppa of approaching "helicopter money" – the direct printing of circulating money, as opposed to quantitative easing – has if anything got louder in the last few weeks. We doubt such drastic action is needed, and of all the uncertainties facing us, this man-made risk may be the most troubling. Groupthink in media and policy circles is intense, and memories of the damage done by overly ambitious counter-cyclical policies in the past are fading. For now, however, we continue to draw reassurance from the fact that even in the US and UK, where labour markets are historically tight, inflation remains quiescent.

Brexit: update and implications

President Obama's intervention in April felt like a game changer, as we noted last month. Official commentators – including the UK Treasury (again), the Bank of England, the

IMF and various EU partners – have subsequently echoed his caution, and the "leave" campaign has shown signs of fragmenting as freetraders and those in favour of tighter border controls have clashed.

You don't have to admire the government's "fear" campaign to recognise that most independent studies of the economics of Brexit (as we noted back in December) suggest it would on balance be bad for business. We are no fans of received wisdom but it can sometimes be right.

Some economists have gone as far as to argue that there can be no economic case for Brexit. This is an exaggeration. The available statistics, and our collective analysis of them, are not capable of supporting such a strong conclusion (not least because of the impossibility of knowing what else might have shaped the trajectory of the UK and EU economies these last 43 years). It also overlooks the reality that economics does not have the clear edges and logical foundations to support such a strong assertion. But to make a case that the UK could be better off by leaving the EU is to argue uphill.

The campaign may at least have demonstrated that if we want to try in this way to restrict immigration, or to achieve some other political aim, we have to be prepared to pay for doing so. The opinion polls have mostly moved a bit closer to the bookmakers' odds in the last few weeks, and our best guess remains that the status quo will prevail.

At this late stage, a quick recap we see it:

- Leaving would likely worsen the UK's position with the EU (the country's biggest market and co-investor), but not necessarily improve it vis-a-vis the rest of the world. Clarity would take many months, and the uncertainty itself could affect spending.
- Initially, stocks and the pound would likely be hit by a Brexit vote as the markets price in the possibility of weaker growth. Short-term interest rates might be loosened by a nervous Bank of England, however, and gilt yields would likely fall too as a result of risk aversion.
- Longer-term, we believe the impact on the UK's trend growth and financial services would be manageable, and it would likely remain the most dynamic (or least sluggish) big European economy. Talk of being "shackled" to the slow-growing Continent is mistaken: outside agriculture, the UK's efforts elsewhere are not thwarted by EU membership.
- We have not advised restructuring even UK-based long-term portfolios with a possible Brexit in mind, because: (1) the lasting impact may not be big; (2) UK markets and investments are largely shaped by global trends; and (3) our portfolio managers invest in many global franchises, and hold some protection against short-term volatility.

A cautious "happy birthday"

We don't make formal predictions: forecasts are spuriously precise, and can foster overconfidence. We know that the current US expansion – the most important driver of the global business cycle – is relatively mature (seven years old this month), and that there will inevitably be another recession and financial crisis at some stage (not necessarily at the same time). But we continue to think that neither is yet at hand, not least because US consumers have yet to misbehave financially in the way that they often have done before downturns in the past. They are still running a cashflow surplus – their savings exceed their investment spending – and instead of borrowing, they are effectively net suppliers of liquidity to the wider economy.

Investment conclusion

Our working assumption – as opposed to detailed forecast –is that the global economy will continue to grow for a while longer at a non-recessionary pace, with the US and Europe making trend-like contributions; inflation and US interest rates will firm up, but only slowly; and corporate profits will stabilise and start growing again.

As noted, the cyclical clock is ticking – but the long expansion should not have come as a surprise, and has no fixed limit (the 1990s expansion lasted a full decade). It can be costly to focus too soon on that next recession or crisis: having moved on, the caravan may not return.

This leaves us continuing to advise that medium and long-term investment returns may best be obtained from business ownership – stocks – rather than government or corporate bonds. Valuations also still point in the same direction, though fears of a collapse in (expensive) bond prices are likely overstated.

Within global stock markets, as of April we no longer prefer developed to emerging markets, or non-resources (oil and mining) sectors to resources, but we do still prefer the US (despite its less dovish monetary outlook) and continental Europe (despite its slower growth) to most other regions. In particular, we continue to sit firmly on the fence with respect to Japan (the jury is still out on structural reform) and think the UK may continue to lag for a while, even when the referendum noise subsides (its sector mix can still be a drag). Asia remains our preferred emerging region on a long-term view. Generally we prefer a mix of cyclical and secular growth, with some bond-like and defensive sectors bringing up the rear.

Western decadence – or progress?

"And not by eastern windows only, When daylight comes, comes in the light;
In front the sun climbs slow, how slowly! But westward, look, the land is bright!"
– Arthur Hugh Clough

One of the by-products of the Brexit debate has been a renewed focus on international trade. An unspoken assumption is that the UK, and perhaps the wider West, is doomed to underperform in that arena.

The most ardent advocates of leaving the EU do not propose an increase in trade tariffs (duties levied on imports), even as they urge tighter controls on the movement of labour (and their immigration worries are often practical, related to the availability of UK infrastructure, not ideological). Yet the UK's trade deficit with the EU and the wider world is widely seen as a competitive failing, and the EU is often seen by its critics as a besieged fortress (or, less kindly, a theme park), surrounded by a common external tariff sheltering its weak and decadent inhabitants from marauding competitors. Nobody wants increased protection – but the pace of further reduction is frustratingly slow.

Most international trade is in manufactured products. We are told often that "we just don't make stuff anymore" in the UK or the wider Western world, and that our economies need to be "rebalanced" in favour of manufacturing. But as we have noted in these pages before, the idea that developed world manufacturing is finished, and that all such value added will inevitably gravitate to China and the emerging world, is (yet) another caricature in the current affairs cartoon. Western manufacturing can be successful; and when it comes to rebalancing, we should be careful what we wish for.

Worries about UK "deindustrialisation" for example have been with us for the last half century or so at least, and for most of this period the UK has been running trade and current account deficits, mostly in manufactured goods. But over the period as a whole, real GDP per capita has risen by more than 150% (2% per annum), and the UK's net international investment position has mostly been stable, those deficits notwithstanding.

More recently, at end-2014, the UK's foreign liabilities exceeded its assets by roughly £450bn, which sounds daunting. But both sides of the balance sheet are big, at close to £10 trillion (five times GDP), and changes in their valuation are much more important than annual flows on current account. (At 5% of GDP recently, the current account deficit has been historically large – partly down to the sudden loss of UK oil companies' overseas earnings – and if we thought it would stay this big we'd be a bit more concerned.) A similar story could be told for the US: cumulative current account deficits have not prevented real per capita incomes from growing steadily, nor – yet – been responsible for financial crisis.

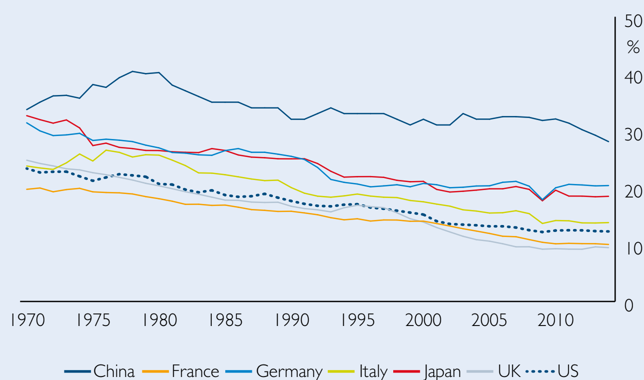
Where products are easily compared, and labour costs are important, production in an increasingly open world will tend to shift to low-cost suppliers. The possible closure of a large steel manufacturing plant in Port Talbot, Wales is understandably arousing strong feelings: sadly this has been a relatively common occurrence in this sector (andindeed in this region – declaration of interest). But steel is a commoditised product, and not all manufacturing is as price sensitive.

Products that are more differentiated – whether by technology, such as aerospace, top-end automotive or pharmaceutical products, and/or by design and branding, such as processed food and drink, or household products – are less price sensitive. And the constant evolution of technology and the product cycle, and of fashions in industrial organisation (to offshoring, joint ventures and vertical integration and back again) mean that Western producers have a good chance of sustaining some manufacturing capacity for the foreseeable future. In the UK, despite that ongoing trade deficit, there are successful, globally competitive businesses spread across many sub-sectors, including aerospace, automotive engineering, pharmaceutical, processed food and drink, and household goods industries.

Whether that capacity is adequate to balance trade will partly depend on other factors too – most importantly the relative strength of local demand, which tends to suck in imports at any given level of competitiveness. It is no coincidence that the UK's last balance of payments surplus occurred shortly after a major (manufacturing-led) recession, when domestic consumer and capital spending were subdued. Even if trade doesn't balance, as the long-term experience in the UK and US shows, the economy is not doomed to stagnation (though that does not mean we are indifferent to the scale of the UK's current deficit).

Figure 4: Decline or progress?

Manufacturing as a percentage of GDP



source: United Nations, Rothschild

Equally, Germany's current surplus would shrink, even without its manufacturers becoming any less competitive, if German consumers were to let their hair down and spend more. That said, to criticise their parsimony – as some do – for contributing to a global "savings glut" may be a bit harsh. Failing to spend the results of hard work and competitive success is an enviable charge sheet – particularly if that success owes less to a cheap euro than is popularly assumed. (Daimler and Siemens, for example, do not exactly compete on a "pile 'em high and sell 'em cheap" business model – the model so often advocated naively to British policymakers.)

Even as most of the world's most successful manufacturing businesses continue to be based in the developed world, however, the proportion of the major developed economies accounted for by manufacturing production has been falling steadily (figure 4). Is this shrinkage in the size of the traditionally tradeable sector a concern?

The sheer ubiquity of the trend suggests that it might not be: arguably it is as much a sign of progress as of decadence.

The level of manufacturing output is not falling on a trend basis. It does shrink in recessions, and in the UK there have been prolonged periods when it has failed to grow: it is still roughly 10% lower than before the crisis, for example. But what has mostly been happening across the developed world – and what will happen at some stage in the emerging world too – is that other sectors' output has been growing faster, and manufacturing's share of total output, GDP, has fallen as a result.

The sectors that have gained share are mostly services (where the UK has a surplus), and include some that didn't exist 30 years ago, such as mobile communications and digital media for example. They have been gaining share not because manufacturers in aggregate have been disappointing their customers, but because services have also been innovating – and, more prosaically, because there are only so many manufactured products that customers can consume.

As people become wealthier, and their tangible needs are met, they naturally tend to spend more on relative luxuries. Many of these are intangible, and found in the services sector – such as leisure, entertainment, communication, travel, higher education, healthcare, even finance.

This is why the idea of "rebalancing" an economy in favour of manufacturing may be misplaced. Individual sectors can certainly be transformed – the UK's ability to support mass car production being a very visible success story, with output seemingly poised soon to overtake its 1970s peak (a key difference being that most of the cars made these days are exported, further testimony to improved competitiveness). Until a bigger portion of services output becomes internationally tradeable, a core manufacturing capability helps restrain trade imbalances. But a sustained, material increase in the aggregate share of manufacturing in the economy – like that of commodities – is unlikely to occur unless we all become suddenly poorer and spend less on intangibles.

In the meantime, the viability of Western manufacturing has not been missed by the stock market. Even as the share of manufacturing in local economies has been falling, the value of quoted manufacturers has been rising: the proportion of developed world market capitalisation accounted for by broadly-defined manufacturing currently is around 47% (with the narrower "industrial" sub-sector at 13%). Thirty years ago it was 33% (10%). At these levels it of course dwarfs the market capitalisation of emerging world manufacturers.

There are several possible explanations for this apparent rise in the worth of Western manufacturing even as its share in local GDP has been falling. Changes in stock market listings, in valuation multiples, and in profitability will all have played a role. But so too has the response of developed world manufacturers to those shrinking domestic market shares: they have expanded into the faster-growing emerging world, to the extent (for example) that US and European companies have been the biggest producers of cars in China (thanks to joint ventures with local producers – a reminder that there is more to international trade than head-to-head competition).

So: be sceptical when you next hear talk of "rebalancing" Western economies. And in debating Brexit, don't sell UK or EU manufacturing short.

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