FUNDS ON FRIDAY
by Glacier Research

glacier
by Sanlam

03 February 2017
Volume 895

# US politics to change the shape of global growth? The outlook for asset markets…

By Sean Ashton, Chief Investment Officer and Portfolio Manager and Blake Allen, Global Strategist, both of Anchor Capital Asset Management

The current moment in global markets is rather historic and appears to be marked by significant ‘signposts’: the Dow Jones broke through the 20,000 mark for the first time; inflation seems to be making a long-awaited comeback, and the world is experiencing extraordinary political change (Brexit, Trump, escalating Euroscepticism). It is also now about eight years since the global financial crisis (GFC); an important milestone at which, historically, economies that have experienced a significant financial crisis regain their pre-crisis lustre. We have also seen a continuation of the global political drift towards nationalism and anti-globalisation. The election of Donald Trump catalysed many economic developments that were previously unfolding gradually, and introduced further new and potentially drastic possibilities.

We see increasing evidence that the global growth environment is improving, as well as a modest rise in inflation expectations. Both developments are associated with a much-needed shift from monetary to fiscal stimulus, which now appears to be in the offing. The “Trump trade” saw an equity rally late in the year, as markets priced in an improved growth outlook, and a return of inflation; global bonds sold off for similar reasons, and a large shift in capital flows from emerging markets (EMs) to developed markets (DMs) also took place. This global development rippled through the domestic market, as high levels of foreign selling weighed heavily on certain key sectors.

Domestically, despite a rally in domestic markets since late December, earnings multiples appear more attractive in aggregate than a year ago (currently ~14x forward P/E) and earnings momentum should improve, albeit largely driven by a very strong rebound in resource sector earnings. There are some lingering concerns about the key drivers of most commodity prices, most notably an oversupplied Chinese real estate market, but diversified miners’ valuations appear to be discounting much lower commodity prices at spot P/E multiples of as low as 5x. We are constructive on domestic equities for the coming twelve months.

Globally, while equity markets are indeed already discounting a fair amount of good news, there are a number of optimistic developments taking place for global equity valuations. These include the waning of significant and enduring headwinds associated with weak commodity prices and legacies of the financial crisis. There is a frequently expressed concern that the current equity bull market is getting “long in the tooth,” and indeed the returns have been eye-watering, when measured from the lows of the financial crisis. From a longer-term perspective, however, we have had something of a ‘dismal decade’ in equity markets, indeed EMs have gone nowhere for a decade. This should, in addition to below average valuation multiples, temper worries that equity markets have simply run too far ahead of fundamentals.

As many of the changes in outlook over the last quarter can in some way be connected to President Trump, **US politics makes a good starting point for the current narrative.** Trump, very significantly, represents the easing of two important ‘gridlocks’ that have characterised the US political-economic situation for much of the past eight years.

### Gridlock 1: The political system

The first gridlock has been within the political system, more specifically between Congress and the White House. This has resulted in much political ineffectiveness, seen, for example, in the inability to act decisively when fiscal spending was required. Following Trump’s election, however, the Republicans control both the White House and Congress, thus significantly easing this first gridlock, and consequently improving the likely effectiveness of the political system.

### Gridlock 2: Poor government / private sector relations

The second gridlock was expressed by high degrees of suspicion between business and government (Elizabeth Warren is for some the mascot of political suspicion of business). This is probably part of the reason investment spending has been disappointing for some time. With many of Trump’s appointments being highly credentialed businesspeople, the probable easing of this gridlock is extremely good news for strategic decision making within the state, and for the all-important “animal spirits” in the private sector. Economic ‘bears’ have however noted that Trump’s fiscal spending policies will only affect the government spending component of GDP in about a year from now, by which time the economy may well have slowed in response to higher interest rates. This is indeed a risk we are monitoring - but this bearish view seems to underestimate the importance of confidence. Indeed, the expectation that the economy will improve, in response to a much more pro-business government, will probably be self-fulfilling, and should lead to improved business investment in the short to medium term.

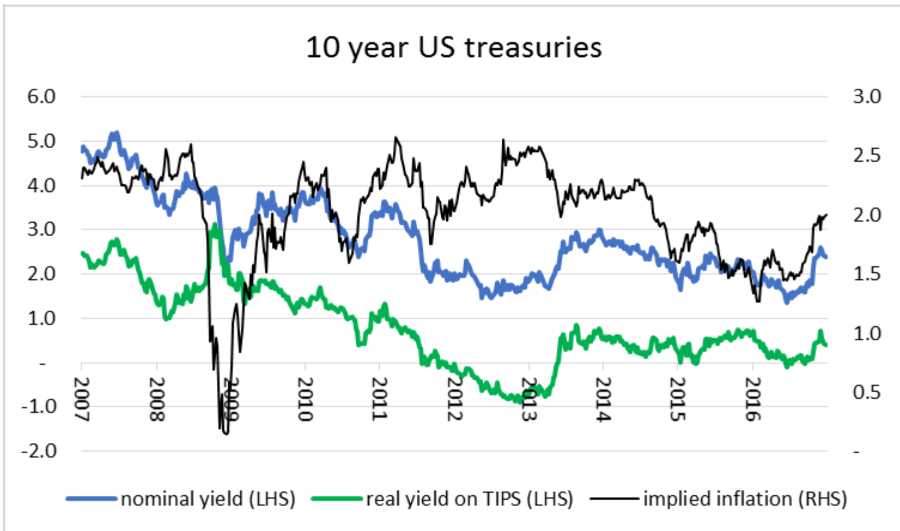
One could rebut this view (noting that the US is really a consumer economy), that investment spending is a rather small component of US GDP (c. 20%), and therefore is unlikely to “move the needle” on growth. But this criticism is problematic, for the main hindrance to real wage growth in the US is weak productivity growth – Alan Greenspan’s long-time bugbear. **This is, in turn, connected to weak investment spending, as a higher capital: labour ratio tends to improve productivity. Thus, investment spending and business confidence ultimately underpin growth prospects for consumption expenditure.** Trump’s election is also associated with an important shift in the global policy landscape. For roughly the past 12 months, the major tension in markets was that monetary policy globally was reaching the end of its effectiveness in stimulating economies, and the baton needed to be passed on to fiscal policy and structural reform. There was, however, little sign that the latter were forthcoming, particularly due to the political gridlock in Washington. With Trump’s very significant fiscal stimulus plans, the baton seems to be in the process of being passed. Consequently, this raises new questions which represent the crucial judgements that need to be made in financial markets. These include:

- Is fiscal stimulus likely to be effective in raising GDP growth?
- Will US inflation move significantly higher, in response to these developments?

Details on Trump's fiscal and structural reform plans are still lacking, and will take some time to emerge. At this early stage, though, reforms evidently include: lower corporate taxes, an infrastructure spending plan, a repatriation deal (US Corporates have significant offshore cash balances – some $2.6trn), and deregulation in the banking and energy sectors. However, there is still much uncertainty as to what degree some other campaign promises will be enacted, such as trade protectionism (a significant risk to the global growth outlook), and repealing Obamacare. Importantly, the actual implementation of such plans can be difficult – and the market seems to have discounted quite a high degree of success already.

Given Trump's policy stance, his election success suddenly introduced much higher inflation expectations into US financial markets. To say that these "rippled" through markets would be an understatement: rather, the bond market saw a significant downward correction, as did any "bond proxy" in the equity space; while assets positively correlated to interest rates, particularly US banks, surged in value. These moves were a dramatic display of the ubiquity of interest rate sensitivity.

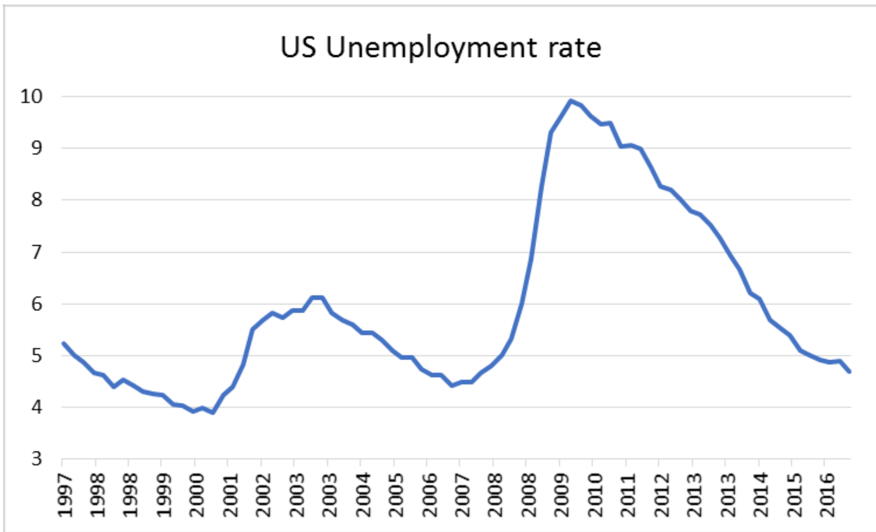
**Figure 1: Real and nominal changes in US interest rates** (note the spike in implied inflation)




Source: Bloomberg

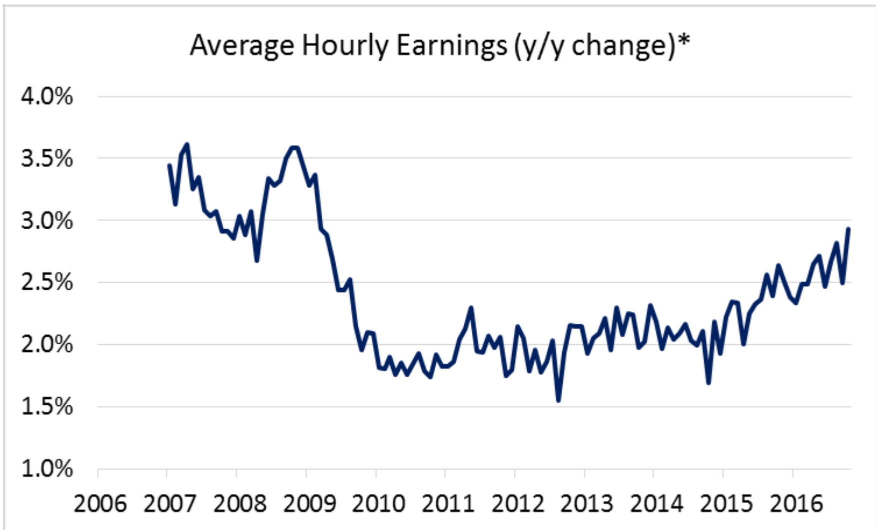
This development introduces what is now **the most important question facing investors at present:** will the rise in US rates continue, or will it peter out and perhaps reverse? Our view, in short, is that rates will struggle to rise materially from current levels, in spite of building inflation pressures globally. The key source of inflation pressure at present is the US labour market. With this market effectively at full employment (Figure 2), and 2017 likely to deliver above-trend GDP growth, further tightness in this market should spur yet further wage increases. Indeed, we are already seeing rather strong increases in hourly wages in the US (Figure 3). Importantly, this wage pressure indicates a risk of an inflation overshoot, which may even push US bonds up to a 4% yield (particularly if growth is also strong). The historical relationship between such wage pressures and core PCE is however not strong enough to justify this view as our base case. Rather, we think some significant mitigating factors will ultimately keep US inflation from surprising meaningfully to the upside.

**Figure 2: The US is now very close to full employment**




Source: Bloomberg

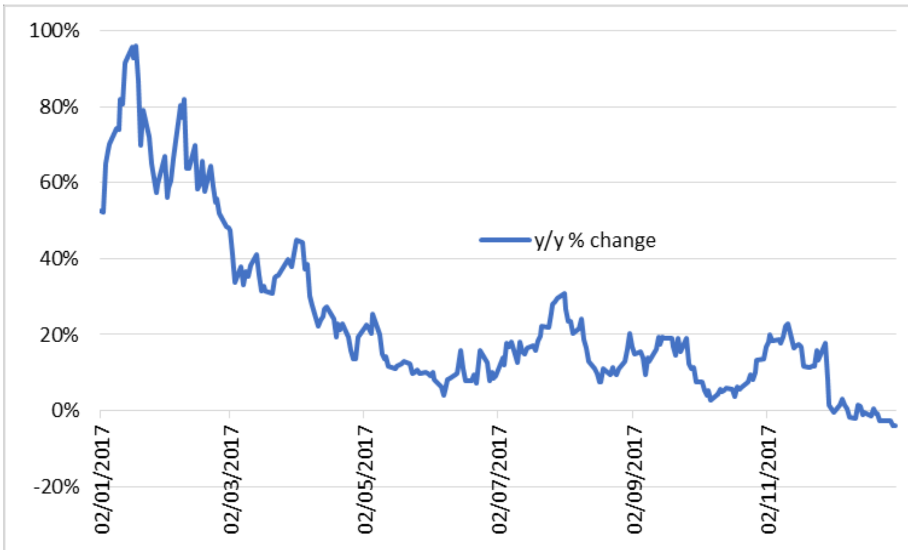
**Figure 3: US wages already registering a tighter labour market**




Source: Fed (St Louis); Average Hourly Earnings of All Employees: Total Private, Dollars per Hour, Monthly, Seasonally Adjusted

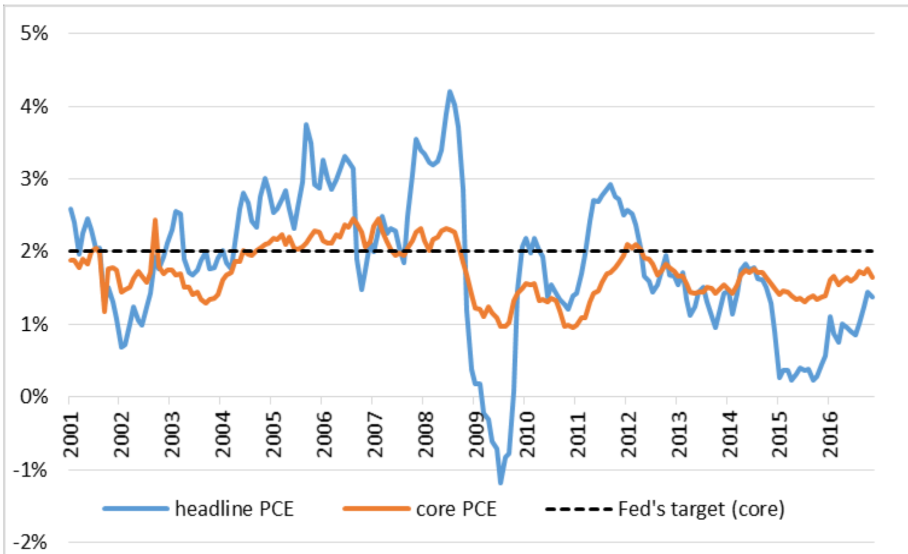
In addition to wage price inflation, the rebound in commodity prices could generate a sizeable upward swing in headline inflation. Such pressures do eventually flow through into core inflation (the focus of the US Fed), but with a lag. Note, for example, that if Brent oil prices remain at current levels for the remainder of the year, the year-on-year price increases would be extremely high (Figure 4). We think this development in the oil market, when seen in a longer-term context, should be read as the removal of an inflation dampener (which oil has been for the past two years), as opposed to the introduction of significant new inflationary pressure.

**Figure 4: Hypothetical YoY increases in the Brent oil price** (assuming prices remain at current spot price)




Source: Bloomberg; Anchor Estimates

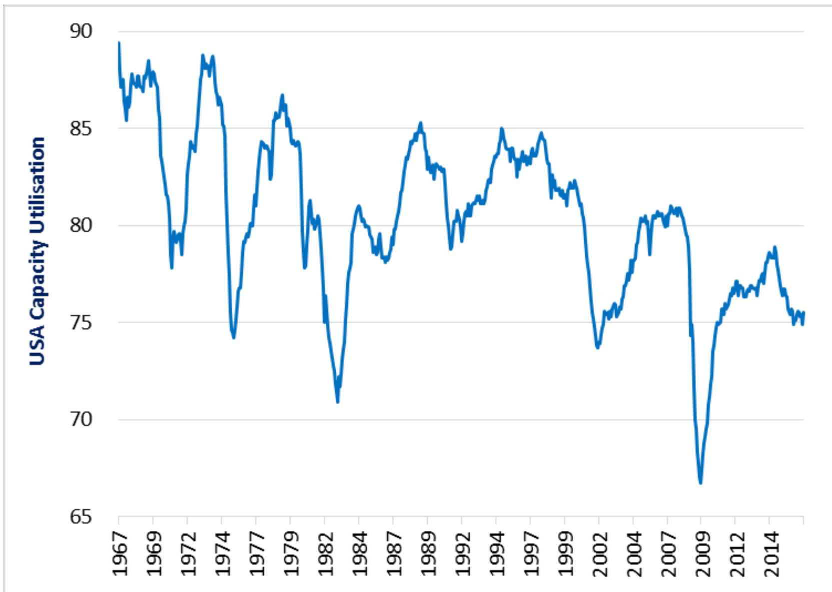
**Figure 5: Core PCE is rising** (expected to be above the Fed's target by EOY 2017)




Source: St Louis Fed

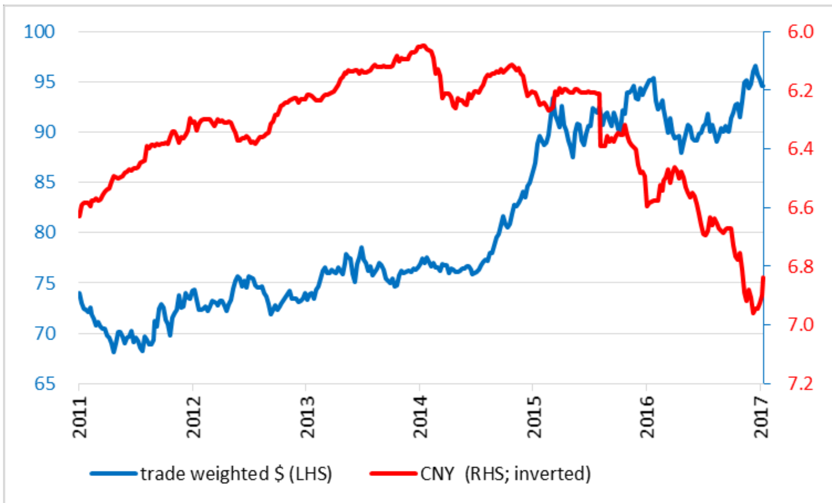
There are, however, very powerful factors which mitigate these inflation pressures. Principal amongst these is the still very low capacity utilisation levels (Figure 6). These reflect, amongst other things, the unintended consequences of almost a decade of 'Abnormal Monetary Policy' (quantitative easing [QE] and ultra-low interest rates). The flow of causality is something like: ultra-low rates → prevents 'creative destruction' ("Zombie" corporations are kept on life-support) → excess capacity → disinflationary pressures → ultra-low rates; etc. Further, US dollar strength should dampen domestic inflation pressures; and the meaningful weakness we have seen in the Chinese yuan will dampen global inflation pressures.

**Figure 6: US capacity utilisation**




Source: St Louis Fed

**Figure 7: Chinese yuan weakness and US dollar strength**




Source: Bloomberg

While the Fed has only hiked rates twice, it is important to note that US financial conditions have tightened far more significantly than suggested by these hikes. The US monetary base has declined materially in the past year, as has the excess reserves of depository institutions – both developments represent monetary tightening not immediately evident in apparently paltry rate hikes. Further, rising oil prices and a stronger US dollar represent additional financial tightening. Lastly, only marginally higher interest rates result in a significantly higher interest expense when debt levels are at extremely high levels, as is currently the case around the world. We expect US inflation (core PCE) to average about 1.9% for the 2017 year, but to breach the Fed's 2% target by year end. This is, in our view, already largely reflected in the bond market, and consequently our forecast US bond yield is only marginally higher than current levels. The risk skew around this inflation forecast is however crucial to appreciate: in our view, there is a low probability of an upside spike in inflation; and a high probability of a relatively small inflation undershoot, versus what is already priced into bond markets. The main risks associated with rising rates is that they overshoot, precipitate a recession, and tempt the Fed to implement a (destructive, in our view) 'negative rates' policy. We think this outcome is unlikely, mainly because we think inflation pressures will be contained. In addition, a return to more "normal" bond market conditions (implying much higher term premium and US long rates >3%) is in our view only consistent with an environment where QE is largely removed from the global monetary system.

## Growth prospects outside of the US

Turning to Europe, continued above-trend GDP growth, which should be further boosted by the euro's recent weakness, has started to feed through into price pressures. The early signs of this are showing up in inflation measures such as the Eurozone PPI, which turned positive YoY for the first time since 2013. This is a very positive development, as it means the European Central Bank (ECB) can more easily escape the destructive situation of negative interest rates. Further, euro weakness reduces the probability of (or defers the inevitable) Eurozone fragmentation, as the region's weakest members have a currency that is closer to where their national currency would be, were they not inside the currency union. We think however, that it is premature to assume that monetary easing is removed in its entirety on the above developments.

**Figure 8: Eurozone PPI inflation turns positive**


Source: Bloomberg; (Eurozone PPI, excl. construction)

Moving on from inflation to consider the global growth outlook, it is evident that **economic growth** is generally improving around the world. This can be seen both in DMs (European growth continues to gain momentum; and Japan is expected to deliver much improved GDP growth this year) and EMs (Brazil, for example, should return to growth in 2017, after the worst recession in multiple decades). China is an exception – though it is still by far the largest contributor to global growth, its GDP growth rate continues to slow down, while remaining at a high level (Figure 9).

**Figure 9: Global GDP growth**

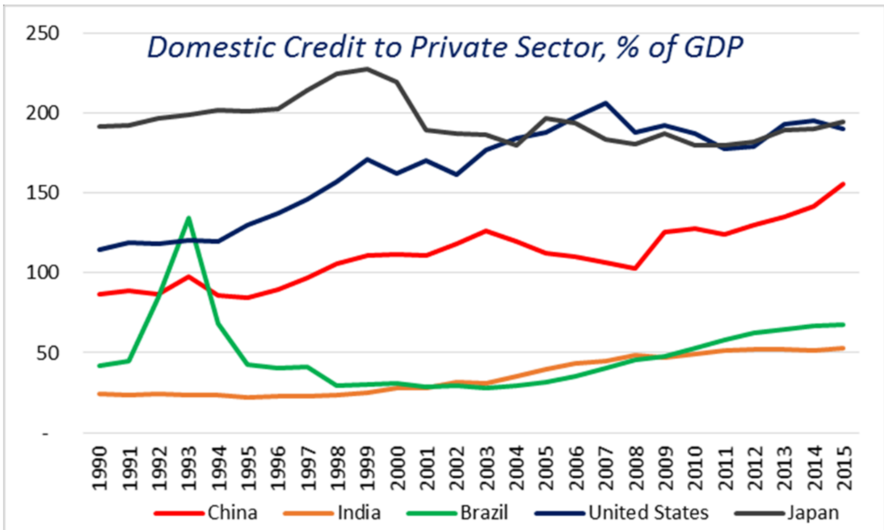
| Country | GDP (2016; $Bn) | % of total GDP | 2017 GDP growth | % of total growth | Popln (mil; Jul 2016) | GDP/ Cap |
|---|---|---|---|---|---|---|
| USA | 18,562 | 25% | 2.20% | 16% | 324 | 57,269 |
| EU | 17,111 | 23% | 1.60% | 11% | 743 | 23,026 |
| China | 11,392 | 15% | 6.20% | 28% | 1,382 | 8,241 |
| India | 2,251 | 3% | 7.60% | 7% | 1,327 | 1,697 |
| Brazil | 1,770 | 2% | 0.50% | 0.3% | 210 | 8,444 |
| Rest of World | 23,497 | 32% | 4.12% | 38% | 4,190 | 5,608 |
| World | 74,582 | 100% | 3.40% | 100% | 7,433 | 10,034 |

Source: IMF; Anchor Capital estimates

The short-term global growth outlook is significantly affected by the anticipated increase in **fiscal spending.** But such policies have been criticised due to their eerie resemblance to Japanese fiscal policy in the nineties. The spectre of 'Japanisation' still lingers behind Trump euphoria. On a theoretical level, econometric research, for example, has indicated that fiscal spending has a negative GDP growth multiplier and it is often concluded that such spending, therefore, tends to stifle growth. This is based on the view that the private sector can invest better than the state and capital should be left in its hand, not invested by government. In our view, the fiscal spending drive should boost short to medium-term GDP growth, but probably does have negative long-term consequences.

The longer-term global growth outlook still faces the same enduring concerns of excess debt and poor demographics. While these concerns are very significant, it is important to remember that they are slow-moving, and that an investment stance overly driven by them can miss out on good short- to medium-term returns. Further, it is very significant that not all regions are equally affected by these difficulties. If one compares China and India, for example, it is evident that while Chinese debt burdens have been skyrocketing (with GDP growth simultaneously slowing), Indian debt has remained very low, accompanied by falling fiscal deficits (while GDP growth has actually been rising).

**Figure 10: Radically divergent debt profiles**




Source: World Bank

## Conclusion

It remains early days in Trump’s presidency and this regime has already begun to signal more protectionist policies for the US, for which the longer-term implication for global growth is unclear. However, in the short term we see evidence of growth lifting, as well as inflation, albeit with some counterbalancing forces to the latter. This places a negative risk-reward skew on global fixed income assets, which are coming off historically low yields, while we believe risk assets such as equities should, on balance, benefit over our forecast horizon.

*Glacier Research would like to thank Sean Ashton and Blake Allen for their contribution to this week's Funds on Friday.*

**Sean Ashton, Bcom (hons), CFA**

Sean has a B Com Honours and is a CFA charter holder. He has 13 years' experience in the financial markets, having worked as a highly rated sell-side analyst as well as a fund manager, holding positions at Nedbank, Deutsche Bank and Investec prior to joining Anchor Capital in early 2013. Sean is responsible for the investment process at Anchor Capital as well as managing the Anchor BCI Equity Fund.

**Blake Allen, CA (SA)**

Blake is a CA (SA), having completed his articles at Investec. He holds a B.Com (Hons) and a MA degree. Blake has nine years' experience in financial markets, predominantly in equity research. This began with a focus on the resources sector, and has developed more in the direction of global strategy. He is currently based in the UK. Outside of the traditional CA route, he has also studied philosophy, economics and literature.