

A Midsummer Night's Illusion

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From May to the end of June, many investors appeared to have fallen under a spell. It was reminiscent of Titania, who – in Shakespeare's *A Midsummer Night's Dream* – fell in love with Bottom, a comic character with the head of an ass.

In this case, investors fell in love with the bond market, causing yields to fall and triggering a sell-off in the equity market. Near the end of June, the spell broke, sending yields sharply higher as investors realised that Bottom (the bond market) was not quite as attractive as they thought (*Display 1*).

The magic potion: Missing inflation

Despite a whole slew of positive economic statistics, such as improving economic growth in most regions, the enchantment with bonds coincided with a technology-led sell-off in equities. Considering that we are in a low-volatility environment, underpinned by a broad-based global recovery, we view investors' brief love affair with bonds as a temporary delirium. The tech sell-off was also short-lived, with the sector's stocks rallying shortly after the sell-off and volatility on the whole subdued.

If put in perspective, the VIX's index's average during the period was 11¹ – well below the long term average. In Shakespeare's drama, Titania's bout of midsummer madness was caused by a magical potion applied to her eyelids. The potion that confused investors in June seems to be that, after an initial increase in inflation earlier in 2017, it has since softened and this triggered

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¹ As measured by the Chicago Board Options Exchange (CBOE) VIX Index, data from 7 June 2017 to 7 July 2017.

concerns that it will not pick up again. Just after the European Central Bank (ECB) expressed its support for higher interest rates, investors seemed to reawaken to the reality that – despite the low inflation readings – the ECB is hawkish and the economy is still growing. As they shook off the illusion that inflation was forever dead, they sold bonds.

In the context of a stronger global economy, led by the U.S., the Federal Reserve appears to be undeterred by the weaker than expected U.S. inflation. This is reflected in the Fed's continued resolve to increase interest rates, announcing a further quarter-point increase in June and continuing to outline plans to reduce its \$4.5 trillion balance sheet, anticipated to begin in September.

However, we believe that the Fed's confidence is not misplaced. Various areas of the economy indicate a strong foundation and even if seeming to lag now, the potential for growth should feed through in the future.

Old equipment

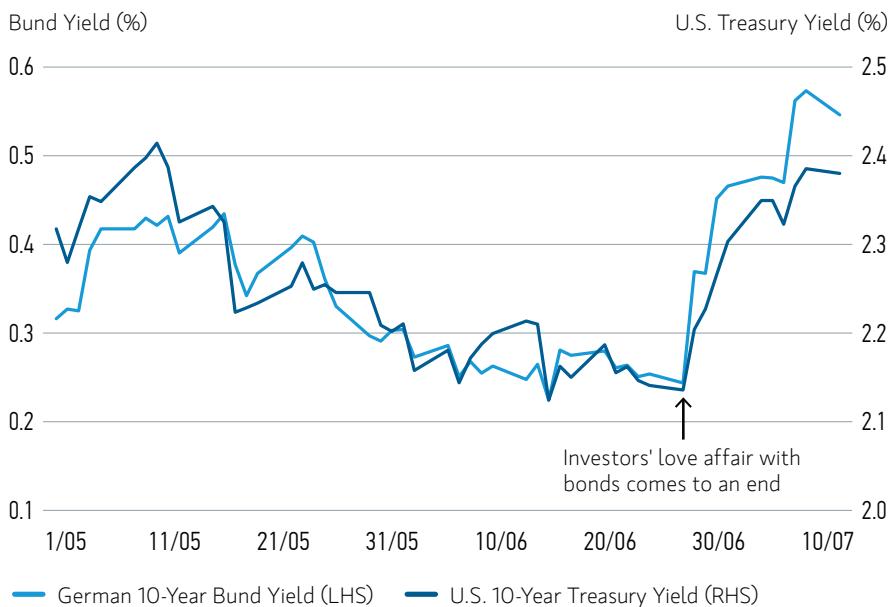
As we have noted recently, we consider the economy to be at a turning point: Business fixed investment is starting to come back into play as a result of increased economic growth, demand for products and the need to tackle low productivity. When businesses start to experience higher demand, they initially hire more labour.

Business fixed investment has been low for many years, indicating that companies have been holding back on investing in upgrading their old machinery and systems. In light of this, it may initially make sense to hire more workers when demand ticks up. Eventually, though, increased hiring puts upward pressure on wages. At some point, rising wages will incentivise management to invest in new and more efficient equipment, which will increase productivity per employee. Management can subsequently justify and afford to pay them a higher wage. *The moral of the story:* Capital investment improves productivity, which drives wage growth.

Currently, the average age of capital stock underscores the degree to which such investment has been postponed. In the U.S., it is currently 21.75 years, whereas in the mid-80s it was below 19 years (Display 2).

DISPLAY 1

Midsummer illusion... the bond spell breaks

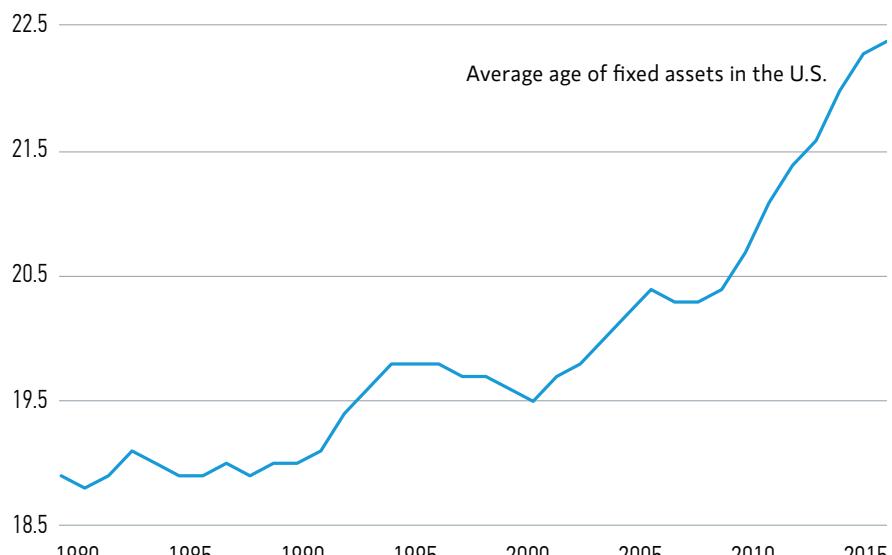


Source: Bloomberg. Data as of 10 July 2017. Performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results.

DISPLAY 2

Old and creaky

Number of years



Source: U.S. Bureau of Economic Analysis (BEA), www.bea.gov.

Table 6.9. Current-cost average age at year end of private fixed assets (accessed 19 July 2017).

Assets and equipment are growing old because companies have not been investing, which in turn explains today's low productivity.

The five-quarter lag

One of the illusions in June seems to have been investors' expectation that wage rates would go up immediately as economic recovery took hold. Clearly, the lack of wage growth is one of the factors keeping inflation down, and many investors have been under the misapprehension that this is a sign of economic malaise. This, in turn, made bonds *appear* attractive.

But it was an illusion. The Federal Reserve confirms our view that the economy is indeed growing. Central banks, in our view, are correctly anticipating increased capital investment and are now either raising rates or giving some indication of future rate rises, in anticipation of the eventual pickup in inflation. Only once investments in fixed assets are fully operational, will we see productivity rise and following that, wages. How long does that take for this initial investment to filter through to wages? The evidence points to about five quarters.

The correlation between investment and wage growth is 24% (with no time lag). With a five-quarter lag, it strengthens to about 53%. Basically, it has taken just over a year for investment-led growth to translate into higher wages and subsequent inflation (*Display 3*).

Low oil prices: Adding to the illusion

Low oil prices are also adding to the illusion of potential economic weakness. As we have written in earlier pieces, however, lower energy prices are currently stimulating the economy. The initial negative phase of falling oil prices weakens the earnings of energy firms and causes them to curtail their investments. The contribution of the energy sector to global GDP has dropped significantly over the past few years. Whilst this is negative, that phase has already taken its toll. Consequently, this negative side of

DISPLAY 3 Wage growth follows investment



Source: U.S. Non-Residential Fixed Investment quarter-on-quarter change data is provided by U.S. Bureau of Economic Analysis (BEA), www.bea.gov. U.S. hourly wage data is provided by the Federal Reserve Bank of Atlanta, Wage Growth Tracker, www.frbatlanta.org/chcs.wage-growth-tracker. Data as of 31 March 2017.

weakness in oil prices is now much less prominent. At this stage, energy users are benefiting from lower energy costs in what amounts to a significant transfer of wealth and a stimulus to the overall economy.

Our assessment of current conditions

The persistence of low volatility is yet another factor that is mystifying investors. In our view, however, the mystery is why they would expect volatility to be high in this environment. Even if interest rates are rising, they are still at historically low levels amid a backdrop of stable, global economic growth.

Volatility has also been dampened by reduced correlations between asset classes. We have seen the banking sector, for example, rising sharply while the technology sector has traded lower. This divergence is in contrast to recent history when most sectors have risen or fallen together, colloquially known as the "risk-on, risk-off" trade. Decreased correlations and normalising interest

rates signal a return to a normal, pre-crisis economic environment. These conditions also suggest that investment managers should see more opportunities to add value through sector selection and active management.

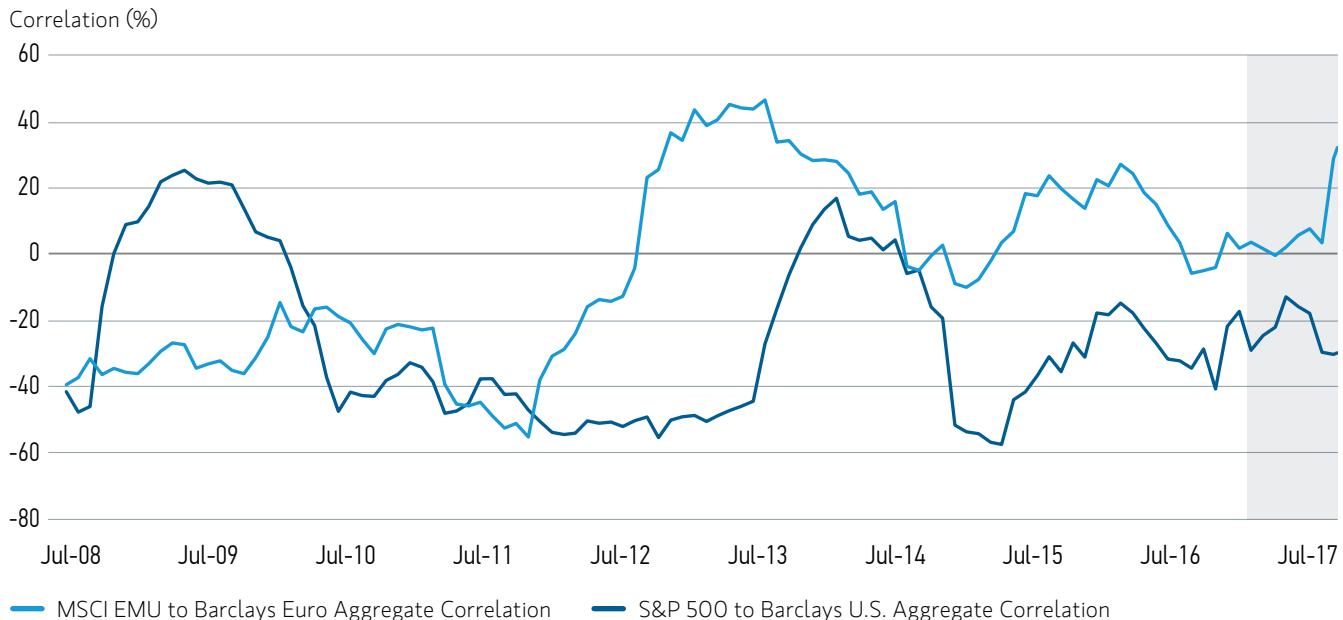
Different parts of the world have reacted in slightly different ways to the normalisation of interest rates, now underway. In addition to the expectation for an investment-driven recovery, we see many reasons to be optimistic across regions.

Europe: Still in the early stage of recovery

Historically, correlations between U.S. equity and bond indices and those of the Eurozone have tended to move together, but rolling one-year correlations of weekly returns between stocks and bonds in the two markets have recently diverged. The correlation fell in the U.S. as Fed rate increases were met with positive equity performance. But correlations between equities and bonds rose in the Eurozone, coinciding with negative equity performance

DISPLAY 4

Diverging correlations indicate the U.S. and Europe are at different stages



The performance of these indices is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results. See disclosure section for index definitions. Source: Bloomberg, data as of 10 July 2017. The S&P 500 Index, Bloomberg Barclays U.S. Aggregate Bond Index, MSCI EMU (European Economic and Monetary Union) Index and the Bloomberg Barclays Euro Aggregate Bond Index.

and concerns about the potential for tighter monetary policy from the ECB (*Display 4*).

The difference is due to the health of the underlying economies. In a healthy economy, stocks will be expected to continue to climb in the face of rising interest rates. Europe, however, is earlier in its recovery than the U.S.; as we wrote a couple of months ago, it is still being weaned off of stimulus, but we believe that this is a temporary state. As a surging U.S. economy ignites growth throughout the rest of the world, we believe that correlations between stocks and bonds will fall. In the meantime, Europe's nascent recovery implies opportunities in European risk assets may now be relatively more attractive. Europe is also in a position to benefit from what seems to be a very strong relationship between France's president Emmanuel Macron and Germany's Chancellor Angela Merkel, who appear

to be determined to rekindle European integration and growth with business-friendly policies.

Japan: Keeping rates low

The outlook for both Japan and the EU is strengthened by their recent trade deal, which includes a major reduction in tariffs through the EU-Japan Free Trade Agreement. As one of the largest export economies in the world, this is a substantial, positive deal for Japan, with one of their largest trade partners.

Japan is still keeping interest rates very low, restraining bond yields from rising more. If U.S. or European rates were to go up, investors would likely switch from Japanese bonds, thus keeping rates in the U.S. and Europe from going too high. On the other hand, if Japan were to stop quantitative easing, then we might see interest rates rise enough to upset the apple cart.

Emerging markets: Unlikely to derail

The trend of lower inflation in developed markets has also been felt in emerging economies. Lower energy prices are good news for many of these markets because the effect on inflation provides these central banks the capacity to reduce interest rates and through this, provide a boost to economic recovery. This reinforces our generally positive view of emerging markets.

China: Stable

China still appears to be growing at a decent pace. We do not foresee significant political risk arising from any new appointments during the 19th National Congress of the Communist Party of China in November. China's President Xi Jinping continues to strengthen his position, which in turn diminishes the likelihood of economic derailment.

² Source: Ministry of Statistics and Programme Implementation. <http://www.mospi.gov.in/>. India's Annual GDP growth rate Q1 2017.

India: Promises kept

Besides benefitting from lower energy prices, which has helped bring inflation under control, India is also poised to gain from significant tax reforms that the government has passed in the form of the new Goods and Services tax (GST). This should reduce bureaucracy, standardise tax rules across provinces and finally create a unified market. The anti-corruption measure of removing high-denomination currencies had a temporary negative impact on India's GDP, but seems to have been accomplished quite efficiently. Liquidity has returned to the markets, and the latest GDP numbers are back on track

at about 6.1%², in line with what was expected before demonetisation. Modi seems to be delivering on his promises to make the economy more efficient and transparent, which should translate into improved productivity and economic growth.

Illusions come and go

As the period of midsummer madness wears off, we expect to return to a normalised markets where investors realise that the underlying economy is strong. The key drivers are consumer spending and business investment, which will likely boost productivity and ultimately wages. Inflation is likely

to stabilise at a healthy level as the economy recovers.

There are always risks, of course. Political factors such as the U.S. debt ceiling negotiations or the standoff between the U.S and North Korea could destabilise markets and create potential headwinds. But these remain low-probability events in the near term. As for illusions, markets will always be vulnerable to human misperceptions. Experienced investors learn to discern between fantasy and reality and, most importantly, manage risks and seize opportunities along the way.

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