June 2018

# Is good news bad?

Late May and early June saw the intensification of a thematic that global financial markets have been wrestling with for much of 2018; namely, the tension between positive growth news (particularly out of the US) and rising geopolitical concerns. While it appears that any assessment about how markets evolve from here is likely to require some apportionment of the relative influence of these factors, for the time being I want to review some recent developments in the fundamentals.

## Global growth momentum is picking up

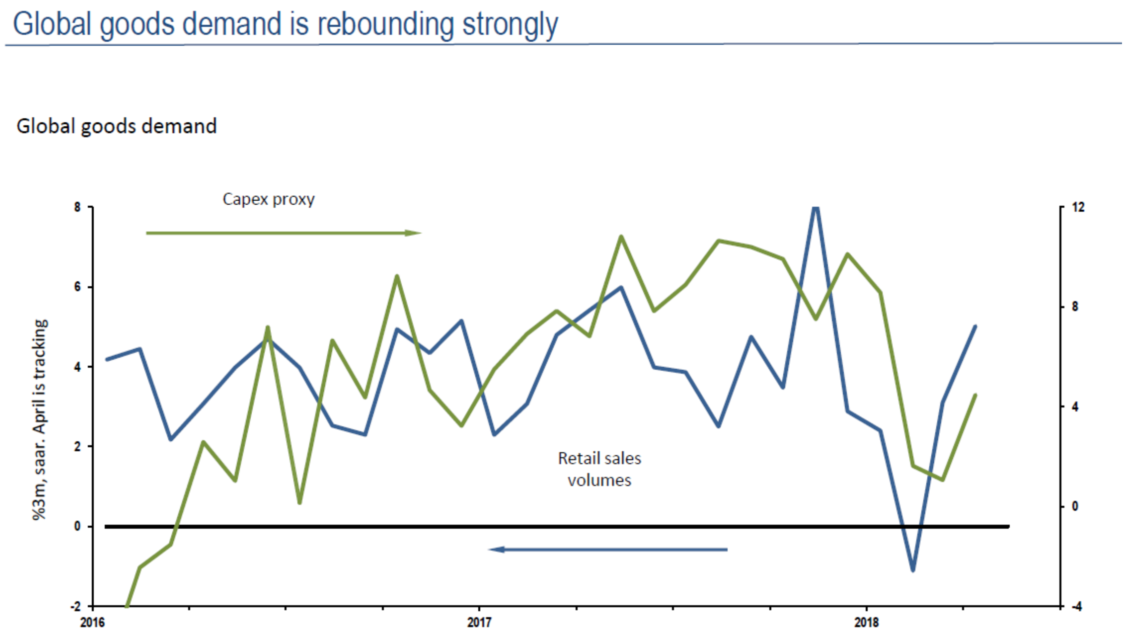
First to global growth where, by and large, the strength in global economic activity is being led by the two largest economies, the US and China. This comes after an apparent 'pause' in global growth momentum earlier in the year. However, the May US payrolls report showed a healthy gain of 223k while the unemployment rate came in at 3.8%, the lowest recorded since April 2000 when it also registered 3.8%. That April 2000 number was itself the lowest since December 1969.

So, even acknowledging some measurement issues around 'under-employment', the US labour market is by any measure a picture of health. JP Morgan economists note too that European GDP is expected to pick up to a still strong 2.5% (annual rate) this quarter, albeit revised downwards from previous forecasts. And with growth bouncing back from weak 1Q outcomes to 2% or faster in Canada, the UK, and Japan, growth in developed markets is poised to pick up smartly this quarter.

For emerging markets (at least those outside Asia) the picture is a little more challenging, although Gavyn Davies, writing in the *Financial Times*, notes a sharp pick-up in 'nowcasts' of Chinese growth.

So, the good news is that the slight slowdown in global growth after the major spurt at the end of 2017 appears to be reversing and the global economy retains considerable positive (above trend) growth momentum. This is shown in the JP Morgan measures of global goods demand momentum shown in chart one.

**Chart one: Global goods demand rebounding**



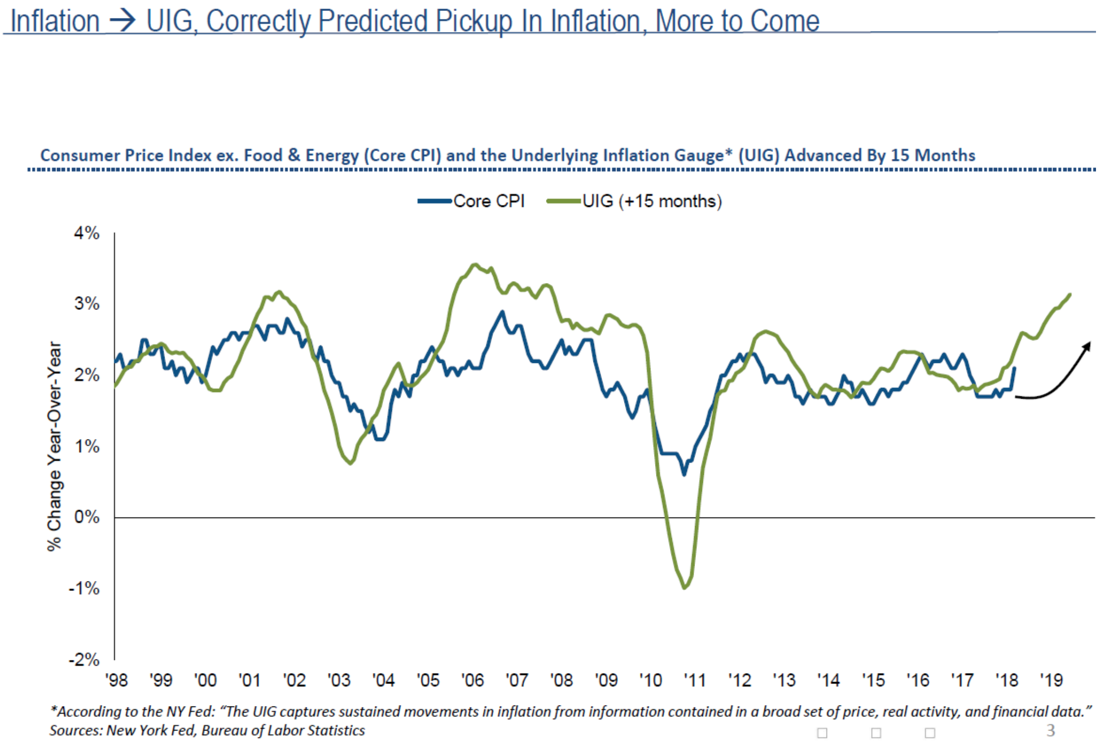

*Source: JP Morgan*

## US inflation may accelerate by more than anticipated

On the price front too, there are promising signs that the risk of deflation in developed markets is receding. Again, this is most evident in the US where there are strong signs of continued acceleration in inflation.

Payden & Rygel point to measures of the New York Fed's "Underlying Inflation Gauge" (UIG) as indicating that there is more inflation to come in the US and a very real prospect of inflation noticeably exceeding the Fed's 'soft target' of 2% (see chart two).

**Chart two: UIG and inflation**




The Fed has recently indicated it is somewhat relaxed about this eventuality but the extent of that relaxation may still mean four policy rate hikes of 25 basis points (bps) each in 2018. Remember, the US is expected to be running a budget deficit of close enough to 5% of GDP next year and the renewed confidence in global growth momentum has come before the effects of that stimulus have hit the US economy. With the US at full employment, demand could well spill over to imports (ironic, given President Trump's protectionist crusade) and / or higher inflation (also excacerbated by protectionist measures).

The challenges to inflation getting to more comforting levels in Europe and Japan are a little more enduring, but recent developments with respect to both prices and wages data do contain some encouragement.

## The investment consequences may not be benign

In terms of a high-level investment thesis, the forgoing probably translates into higher interest rates (bond yields) in the US as the Fed continues to hike policy rates and the budget deficit expands to close enough to 5% of GDP (despite full employment). Above trend growth momentum likely means that corporate earnings provide US equities with some reasonable tailwinds but there are also reasonable headwinds from higher bond yields, particularly if the growing US budget deficit causes exaggerated upward moves in bond yields and complicates the Fed's calibration task with respect to policy rates (not to mention the impact of Fed balance sheet reduction), and particularly if one accepts the view that US equities (in aggregate) are fairly valued.

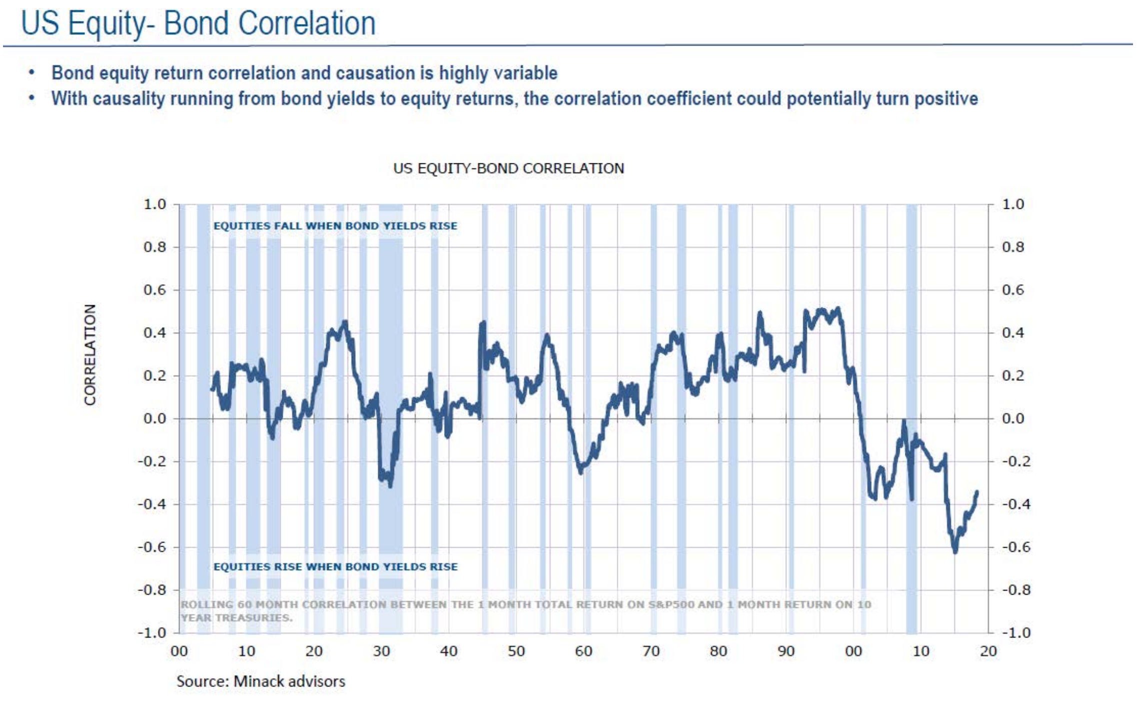
The opposite seems the case in other developed markets, with growth (and earnings) impetus having room for a greater degree of support (through upside surprise) and where there is less likelihood of being upset by rising bond yields and valuations are probably a little more attractive. I think such a thesis probably involves continuing strength in the USD at least in the short term: there is a compelling cocktail of higher policy rates and higher bond yields (through fiscal stimulus and Fed balance sheet reduction) that makes the yield support for the USD the overarching factor in currency markets. That does, however, increase the prospect that an unfortunate cocktail of higher rates and a higher USD creates a ‘tipping point’ for US equities.

The latter is an important consideration for investors. Chart three reveals that the negative correlation between bond and equity returns that has characterised this century was not the norm for most of the last (twentieth) century. This, in my view, reflects an unstable causal relationship.

During much of the twentieth century, higher (lower) bond yields presaged lower (higher) growth and earnings, so that bond and equity returns were positively correlated. Higher bond yields (negative bond returns) were associated with negative equity returns and lower bond yields (positive bond returns) with positive equity returns. Why?

Well, looking at the period from the mid-1960s when inflation started to take off as higher budget deficits and a reversal of (temporarily) loose monetary policy signalled higher bond yields and therefore lower economic and earnings growth ahead, both bonds and equities responded negatively (returns were positively correlated). From about the mid-1980s, when structurally lower inflation looked to be in prospect and budget deficits began to be meaningfully reduced and a reversal of (temporarily) tight monetary policy signalled lower bond yields and therefore higher economic and earnings growth ahead, both bonds and equities reacted positively (returns were again positively correlated).

**Chart three: US equity bond correlation**




However, with the pricking of the ‘tech bubble’ in 2000 and again with the onset of the Global Financial Crisis toward the end of 2007, causality appeared to reverse. With inflation quiescent, stress in risk markets heightened perceptions of sustained monetary policy support. Therefore, declines in equity markets (negative equity returns) saw bond markets embrace sustained periods of monetary support resulting in lower bond yields (positive bond returns). When equity markets exhibited some capacity for upside (positive equity returns), bond markets reassessed the prospect of sustained monetary support resulting in higher bond yields (negative bond returns). So, throughout these periods bond and equity returns were negatively correlated.

What sort of world are we in now?

It is difficult to tell. In the US, if we do get higher inflation, we may well be migrating back to a period of positively correlated bond and equity returns. This, unfortunately in the near-term probably manifests itself first as negative bond and equity returns: inflation, spurred on by a misplaced fiscal stimulus, surprises on the upside leading to an exaggerated increase in bond yields that derails equity markets.

It is admittedly harder to entertain such a scenario in in Europe and Japan. On a global scale, therefore, projections of how that return correlation unfolds is difficult. Suffice to say, however, that the commonly held assumption of negative correlation is certainly not inviolable.

As was starkly evident last week, markets don't react solely to fundamentals. The geopolitical news flow in 2018 has come thick and fast and on occasions has upset the investment theses offered up by a focus on the fundamentals, such as with sharply lower US bond yields in the last week of May (and arguably on occasions reinforced them as with the sharply lower Euro in the last week of May).

Critically, growth momentum is currently moving along nicely (after a 'pause') and that supports corporate earnings. However, looming policy challenges, particularly in the US, presage a challenging 2019 that could see it all end in tears.

Arguably, the outlook for both equity and bond beta is challenging and investors need to incorporate this eventuality into their thinking about portfolios through the incorporation of less (both equity and bond) beta sensitive strategies.

This is another way of saying that ***at the margin*** bond investors need to contemplate portfolios that are more flexible and access diverse sources of risk and not be tied to durations of particular indices. Obtaining beta exposure through, say an ETF, may not be sufficient going forward.

Similarly, equity investors, ***at the margin***, need to contemplate portfolios that can benefit from 'stock-picking' acumen and / or the ability to offset 'long' exposures with 'short' exposures and so reduce exposure to equity beta.

That markets may discount the eventuality of poorly performed bond and equity beta argues for moving sooner rather than later.

**For more information about GSFM's investment strategies, please contact:**


Damien McIntyre • dmcintyre@gsfm.com.au • (03) 9949 8852 • 0407 266 999

Stephen Fletcher • sfletcher@gsfm.com.au • (03) 9949 8828 • 0400 559 118

Shaun Thomas • sthomas@gsfm.com.au • (02) 9324 4355 • 0450 157 588

Steve Taylor • staylor@gsfm.com.au • (07) 3012 6159 • 0404 092 635

Huw O'Grady • hogrady@gsfm.com.au • (03) 9949 8825 • 0419 200 052

David Blair • dblair@gsfm.com.au • (02) 9324 4352 • 0410 484 389

Stephen Higgins • shiggins@gsfm.com.au • (02) 9324 4330 • 0407 094 707

Zane Leyden • zleyden@gsfm.com.au • (03) 9949 8860 • 0419 116 626

Matthew Ferguson • mferguson@gsfm.com.au • (02) 9324 4342 • 0449 103 640

gsfm.com.au