The Great Monetary Transition is …. risky

Why it is better to be prudent than sorry

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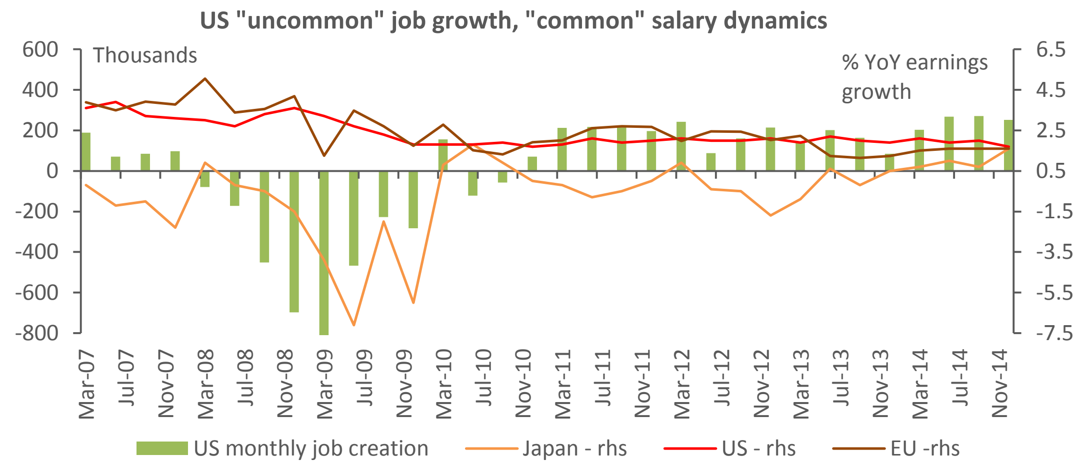
Throughout my first nine months at ADCB I have maintained a positive stance on global equities and US Treasuries combined with a negative stance on commodity-related markets and currencies. This stance has so far played out positively. In view of the significant appreciation of the US dollar, it is now time to change our view on equities, in particular US equities.

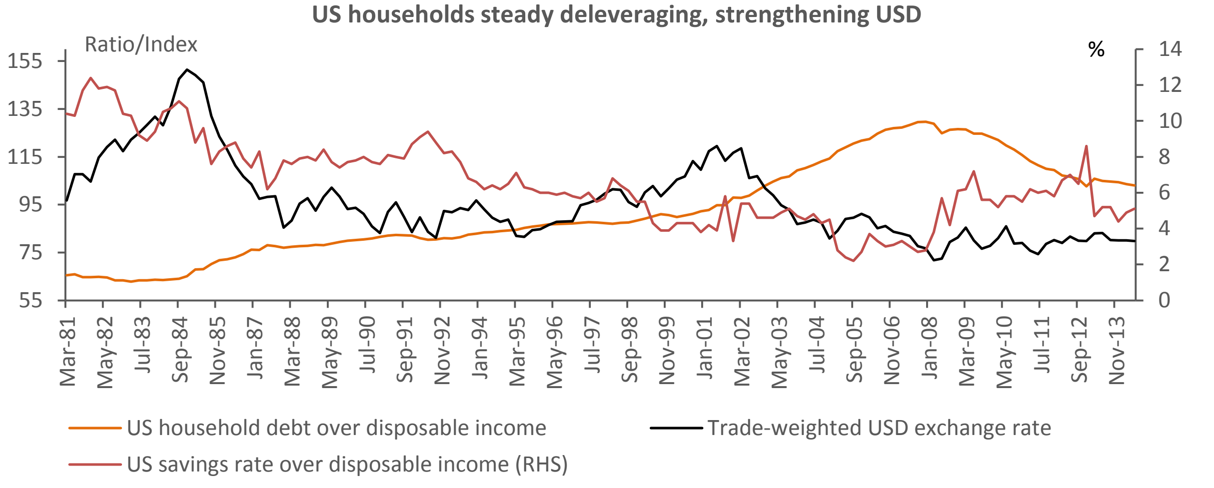
Secular deflationary forces to be long lasting

The recent correction of the oil price has to be seen in the context of a larger and structural deflationary trend that has already affected other commodity prices and is now also threatening consumption goods and services. It would be imprudent to a priori exclude that this trend can yet hit asset prices. Structural and non-transitory trends are such because they have deep roots. The deeper root behind the deflation of our times is an ageing – and therefore more frugal – population in advanced economies. A too long period of leveraged consumption, housing and financial assets had distracted us from that reality. When the bubble finally burst the overhang of those non-productive investments – historically high debt levels – could not but further exacerbate the deflationary pressures. Massive liquidity injections have not been able to revert this trend. Even in the United States, where we have seen a steady pace of job creation, job insecurity seems to prevail. It might be more appropriate to talk about income insecurity, rather than job insecurity.



Source: Bloomberg

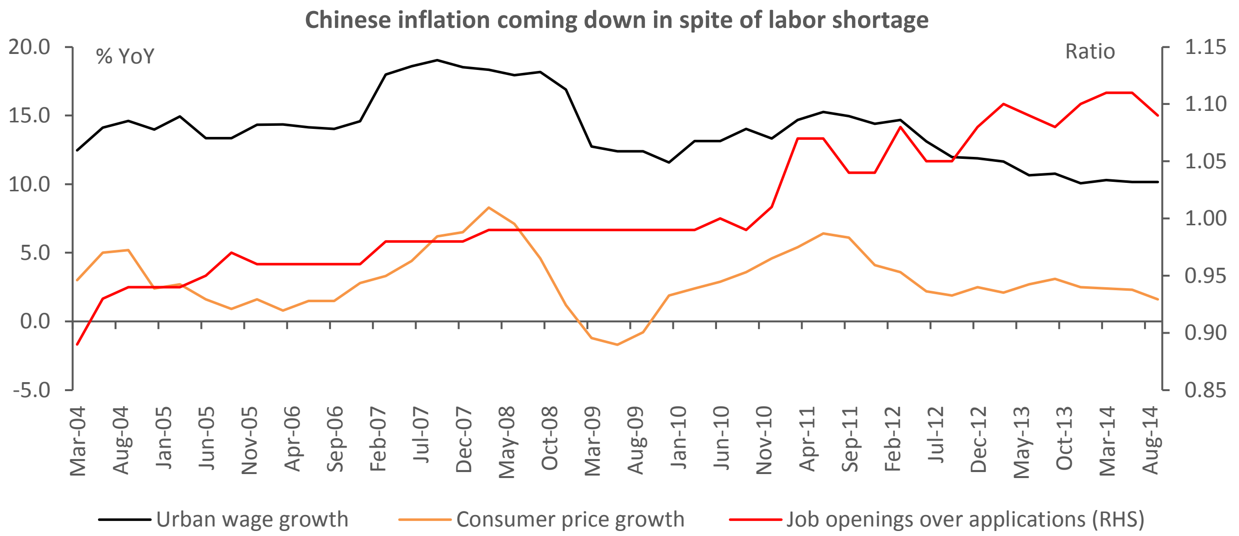
This insecurity combined with increasing equity price volatility, and a housing market that is unlikely to take off, should continue to favor savings over consumption. Higher US household savings are the most important long-term driver of US dollar strength.



Source: Bloomberg

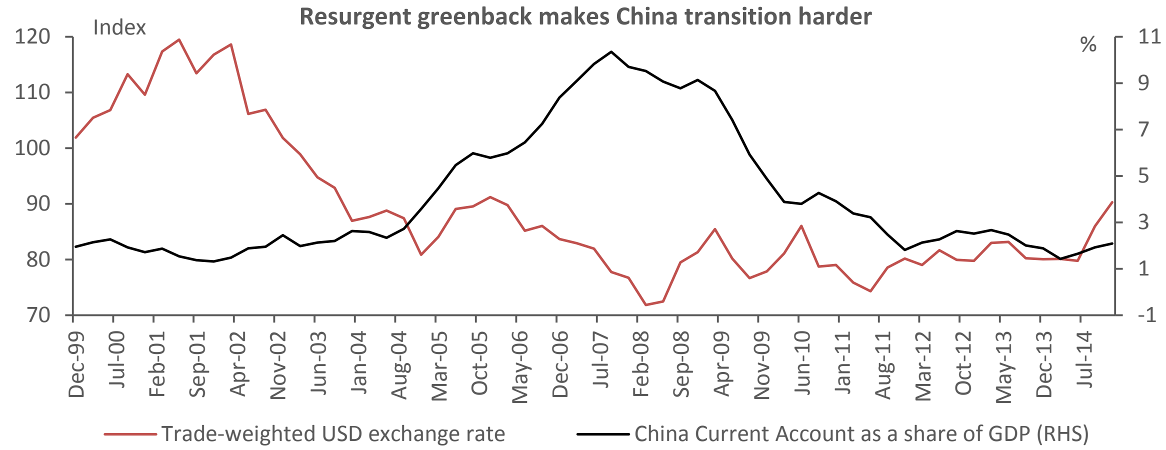
Secular deflationary forces catching up with China

Lower inflation is now spreading from advanced to emerging economies. China is an eloquent example and – given its weight in the global economy – an important one too. With apparently still high GDP growth rates, and the shrinking availability of workers, one might expect continuing upward pressure on the wage and price dynamics. Instead both wage- and price growth are receding in China. In China, as in the US, wages are not rising as a result of increasing labor demand. Rather, it looks like companies are demanding more labor because – and as long as – wage growth will remain contained.



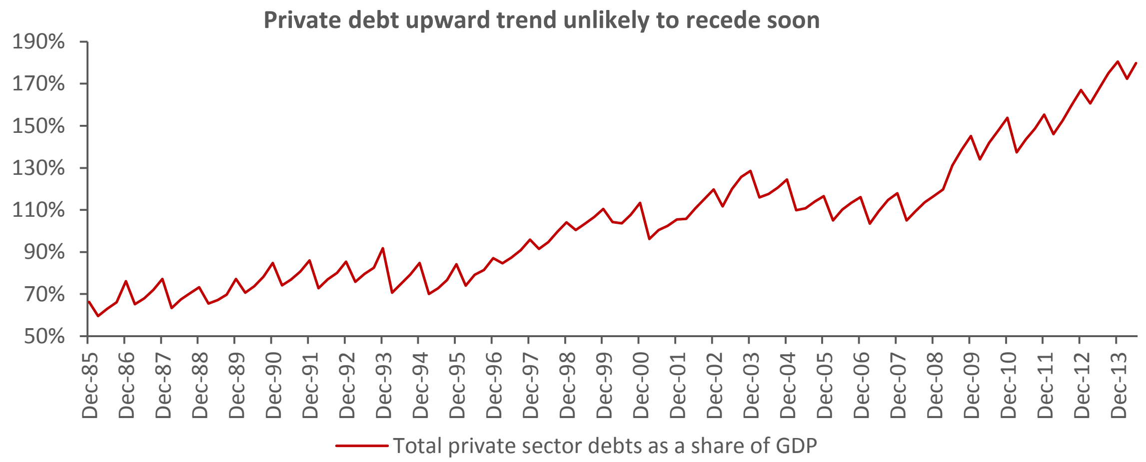
Source: Bloomberg

China's low inflation is of course to some extent the result of the stronger US dollar. The stronger greenback is also an increasing source of concern as China's economy tries to stabilize at a "new normal" growth rate. China, in fact, is the only country that since the 2008 Global Financial Crisis – because of its soft peg to the US dollar – has born the full brunt of continuing US dollar strength.



Source: Bloomberg

In the presence of higher debt levels and excess capacity, China's soft peg to the US dollar will become only more challenging. The domestic debt share of GDP is likely to continue creeping up because the further slowdown in investments will inevitably exercise significant downward pressure on growth, simply because investments constitute around 50% of total spending.



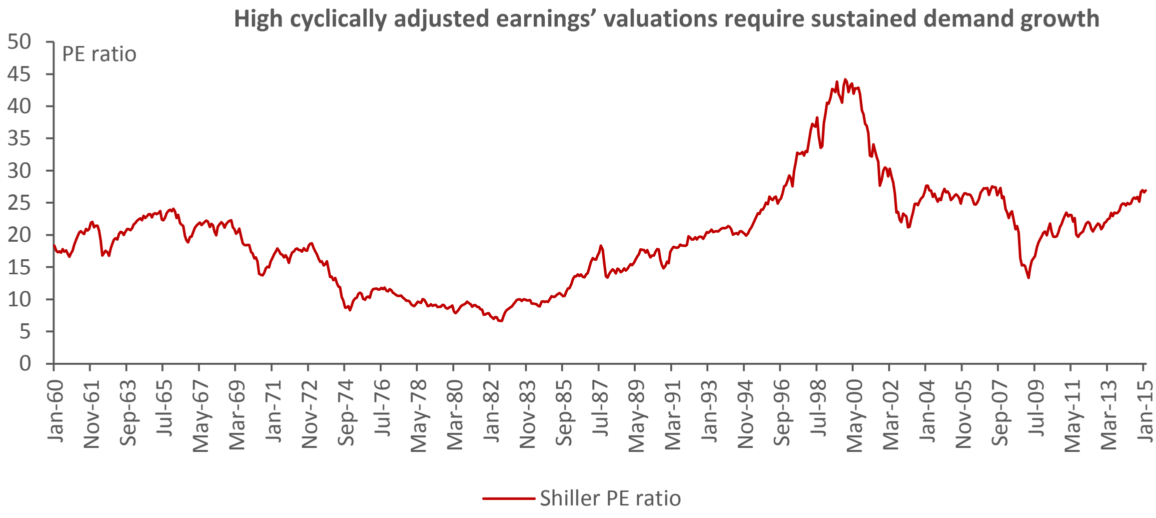
Source: Bloomberg

Of course, China could partly reduce excess capacity by reducing the global price of its output, specifically through a weaker currency. Might we expect the un-expected, i.e. the renminbi joining the club of currencies devaluing against the US dollar? There are of course very good reasons for China not to devalue, even now that the containment of necessary import costs has become less of an issue following the heavy erosion of commodity and energy prices. The fear of financial stability is probably most critical as China's companies' external debt is to a large extent US dollar-denominated. Then again, China has close to four trillion US dollar reserves and its capital markets are still relatively segregated from the global circuits, making an "orderly" devaluation manageable. A meaningful devaluation, however, would put renminbi internationalization on a slower track, thereby compromising the country's geopolitical ambitions. Most importantly, from my point of view, any meaningful reduction of the external value of the currency would also reduce households' purchasing power and thus dent confidence in the country's most existential economic project, its transformation in a domestically driven consumer economy.

Bright spots?

If China manages to pursue its “new normal” growth rate, at say 6%, solely through domestic stimulus measures and without resorting to a meaningful currency depreciation, its contribution to global growth would remain unequivocally positive and significant. Unlike QE, which redistributes wealth from the poor to the rich, the lower oil price provides a stimulus that mainly favors leveraged and battered low-income consumers in the United States and Europe, but also in many emerging economies. Indeed, lower energy costs should facilitate fiscal consolidation that is non-contractionary, in both the periphery of the Euro-zone and emerging giants such as India, Indonesia, Turkey as well as China itself.

Such scenario should thus, at least in theory, see a more substantial increase in companies’ earnings through the top line, rather than by mainly squeezing costs. That would then justify continuing equity exposure, even in the context of high cyclically adjusted price-earnings.



Source: Bloomberg

Better prudent than sorry

If over-invested China continues to meaningfully contribute to global growth….. If the lower oil price will stimulate global demand notwithstanding the globally deflationary context ……. If global company earnings will show substantial improvement through the top-, rather than the bottom line …. It appears to me that the “ifs” are non-trivial. Certainly not trivial enough not to reduce global equity exposure. It makes most sense to do that in US equity markets which – even in a relatively benign scenario – will suffer more as the greenback is likely to strengthen further. We will, however, not relocate the proceeds from that reduction in our favored equity markets (a.o. Euro-zone, Switzerland, Indonesia, India). Rather we place them in US Treasuries which should remain well-behaved in the context of continuing US dollar strength. A small part will be allocated in precious metals. So far I have not looked favorably at gold, because low inflation typically reduces its allure. Yet, with increasingly low interest rates across the globe – and negative ones in safe haven currencies such as the Swiss franc and the Japanese yen – the opportunity cost of holding it have come down significantly. After all, if things would turn out very ugly – at this stage not our base case scenario – that would certify the failure of a global non-conventional monetary experiment with few historical precedents. In such circumstances gold – the anti-money par excellence – should somehow limit investors’ damage. It is better to be prudent than sorry.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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