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The era of economic slowbalisation

Sisyphus was punished by the gods by having to repeatedly roll a boulder up a hill after it rolled back down each time he reached the summit. Today, markets are subjecting the world's central bankers to the same punishment. Each time central banks attempt to normalise monetary policy, the “market gods” compel them to revert to easing mode and lower rates. The result is we are living in an era of economic slowbalisation.

SISYPHUS AND THE MARKETS



CÉSAR PÉREZ RUIZ

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“The global economy is flying on one engine, with manufacturing in recession and services keeping the economy airborne.”

Sisyphus was punished by the gods by having to repeatedly roll a boulder up a hill after it rolled back down each time he reached the summit. Today, markets are subjecting the world’s central bankers to the same punishment. Each time central banks attempt to normalise monetary policy, the “market gods” compel them to revert to easing mode and lower rates. This is a result of the era of economic *slowbalisation* that we are now living in.

The global economy is flying on one engine, with manufacturing in recession and services keeping the economy airborne. Populism-driven fiscal stimulus is keeping services afloat for now and central banks are doing everything possible to support their economies. While the risks of an economic recession are low, an earnings recession could end up happening if economic activity does not pick up in the second half of this year or a trade deal is not reached. This is because the fate of equity markets tends to be linked to the manufacturing sector, while the strength of the economy is more closely tied to services. Therefore as far as global growth is concerned, we are still comfortable for the time being, although we may see equities struggle as multiples are difficult to expand in a low earnings growth environment. Central banks will try to bring confidence back to consumers in an effort to prolong the cycle but equities may not do as well as in the recent past. For markets, the key factor in their favour is the absence of exuberance. Indeed, this rally is unique in that equity markets have reached new all-time highs at the same time as USD 150bn have flowed out of equity funds.

Monetary policy looks trapped in a looser for longer cycle, making credits look more attractive, especially on a risk-adjusted basis. The Federal Reserve has more room for manoeuvre than the European Central Bank and the Bank of Japan, who have fewer effective tools left in their monetary policy toolkits. Because of this, the dollar might end up weakening, which would continue to support gold prices and emerging-market currencies. We doubt that the “market gods” will relieve the central bank Sisyphuses in the end and allow monetary policy to normalise. Should this fail to translate into positive economic growth, we could eventually see more direct fiscal easing from more populist governments. Of interest as the US presidential election season kicks off is who the Democratic nominee will be and what his or her proposed policies are, particularly as we could see Modern Monetary Theory discussions take centre stage.

In a nutshell

Central banks – today's global markets orchestra conductor

Since the beginning of the year, global yields (unhedged) have declined strongly, dropping from 2.3% in November to 1.5% today. One direct consequence of central banks going into reverse gear has been that global debt with negative yields has risen from 12% of the total in October to almost 24% today, a level not seen since end-2016.

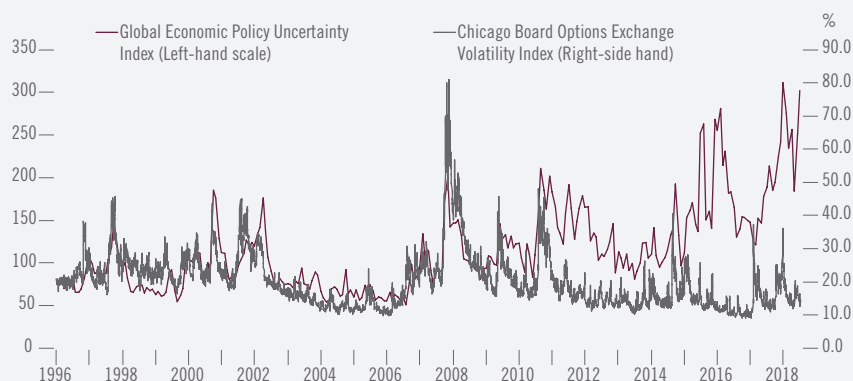
AS RATES HAVE COME DOWN, BONDS WITH NEGATIVE YIELDS HAVE RISEN



Source: Pictet - WM CIO Office, Bloomberg, July 2019

In an environment of escalating tensions between the US and China, markets seem oddly insouciant, as the VIX level (14.5%) for US equities shows. Volatility has decoupled from global economic policy uncertainty since 2009, possibly because of massive central bank support since then. With too much complacency in the market, we remain underweight equities in portfolios.

EQUITY VOLATILITY DOES NOT MIRROR POLICY UNCERTAINTY



Source: Pictet - WM CIO Office, Bloomberg, July 2019



CHRISTOPHE DONAY

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INVESTMENT STRATEGY

Markets face a tug of war

With a lot of good news already priced in, but technicals painting a less rosy picture, equities could struggle to make headway in the short term.

The world economy and financial markets are being influenced by two opposing forces engaged in a tug of war. On one side are trade tensions and an ageing economic cycle, factors that are eroding business confidence and holding back corporate investment, raising questions about an impending recession. On the other are central banks, which are pulling out all the stops to prolong the expansion.

After cutting rates at the end of July, the Federal Reserve (Fed) could decree a second 25-basis point rate cut before the year is out. Similarly, we expect the European Central Bank to deliver a comprehensive easing package in September, with the possibility of another round of quantitative easing. Dovish central banks have led to a drop in rates across the yield curve and a record volume of negative-yielding bonds. Core government bonds continue to provide protection to portfolios, but with low interest rates seemingly here to stay, declining (and even negative) yields mean their cost to investors is increasing.

However, central banks' capacity to prolong the current expansion is limited, given low nominal and real rates and central banks' already bloated balance sheets. We also believe massive asset purchases could soon show their limits, leaving policy makers to thrash around for a new approach to economic policy (see article '*New monetary policies for new challenges*').

Other factors could prove even more decisive for assets over the coming months. In particular, how the current US-China 'trade truce' pans

out remains to be seen. We see a 60% probability that the fragile truce holds for a while, but with periodic flare-ups as the US presidential elections approach and the possibility of some extra tariffs. We see a lesser probability (35%) of a definitive breakdown in trade relations, but an even smaller one (5%) that all trade tariffs and restrictions on Chinese tech are lifted.

Continued trade concerns, which are contributing to the ongoing slowdown in global economic momentum, have hurt business sentiment. We do

"It is unlikely that a status quo on trade tariffs will be enough to revive world growth in the coming months."

not see the risk of a global recession in the next 12 months (wages and commodities remain under control), but global manufacturing activity is contracting, and with it corporate investment. International trade is also stumbling. It is unlikely that a status quo on trade tariffs will be enough to revive world growth in the coming months.

A jaundiced view of equities also seems appropriate on technical grounds, especially as the recent share rally has been led by a relatively narrow range of stocks and sectors. Analysis shows that US equities are sensitive to changes in Treasury yields. The spread between S&P 500 earnings yields and 10-year US Treasuries has been in a relatively narrow range since 2009, but this equilibrium is being

threatened by the fall in bond yields. For it to hold, either earnings will need to go up or prices down. Given subdued earnings guidance (a record 75% of S&P 500 companies have been giving negative guidance) and 'top-pish' valuations, the risk is that the movement comes on prices.

Overall, we remain cautious on equities, believing a lot of good news has been already baked into prices. Indeed, market expectations for Fed rate cuts have been excessive and the earnings-bond yield shows that valuations are stretched. Continued lack of visibility could leave stocks range bound, with markets having already pushed equities to the top of that range. ■



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INVESTMENT INSIGHTS

US-Iran – a geopolitical headache

In this interview, our in-house expert discusses the prospect of an outright conflict between Iran and the US. While it still seems some way off, there is an ever-present risk of miscalculation on both sides.

Is it too late to save the 2015 Joint Comprehensive Plan of Action (JCPOA)?

Donald Trump pulled the US out of the treaty unilaterally in May 2018. Afterwards, the US set out 12 stringent preconditions for returning to the negotiating table in a move that to some resembled a diktat. By achieving an extra-territorial application for its decisions and sanctions, the US has succeeded in neutering an agreement that had the backing of the international community. The deal could still be revived, but only if the Trump administration gives itself space to bring it out of limbo. The US is actually trying to reverse the gains made by Iran and its allies since the US pulled out of Iraq (2011) and since Syria's civil war. The Trump administration also wants to deprive Iran of ballistic missiles, which it sees as a way for the regime in Tehran to advance its geostrategic interests in the region (but Iran sees as a deterrent against aggression).

In any event, Iran has forfeited the benefits of the JCPOA deal and lost all incentive to abide by its terms. Iran's leaders recently started renegeing on their commitments (albeit gradually with the ability to back-pedal), given that the other signatories were not standing by theirs. Iran may even be tempted to see nuclearisation as a kind of insurance policy or a significant bargaining chip in any future talks with the US.

How far could the current crisis escalate?

By threatening a partial, gradual and reversible withdrawal if the five other signatories fail to uphold their end

of the bargain (i.e. the lifting of sanctions), the Iranian authorities will try to push them into a corner. If that fails, Iran could start on a course to obtain nuclear power. But if Iran does that, it could find itself at odds with the IAEA and run the risk of the Security Council ruling against it, which would then leave the Trump administration more leeway to proceed with air strikes. Policy hawks in the US would conceivably stop at nothing to cripple Iran's ability to restart its nuclear programme. Such a prospect is a long way off, but it could involve intense air raids and missile strikes against Iran's nuclear installations. The US might even go as far as using a tactical nuclear weapon to target underground facilities, should its 'mother of all bombs' (used in Afghanistan in 2017) prove insufficiently powerful.

But overall, both sides are for now behaving rationally, clearly aware of the potential consequences of their actions. The Iranians have upped the ante slightly, but recent incidents in the Gulf have been small scale. An important mitigating factor is the collegial system of decision-making in Iran, made up of institutions and persons with considerable experience in international relations.

There are also checks and balances wired into America's political (and military) complex that can be expected to kick in when the occupant of the White House tries to push his presidential powers to the limit. In any case, at this stage, i.e. late June 2019, Trump has been relatively cautious. Granted, the president's coterie includes figures who are in favour of using the military option against Iran,

“...both sides are for now behaving rationally, clearly aware of the potential consequences of their actions.”

but the closer we get to the US presidential elections, the less likely it is that a large-scale military campaign will be on Trump's agenda.

However, there is a risk the opposing parties could stumble into direct military confrontation. That could arise from a skirmish (in the Gulf or in Iraq) between US and Iranian (or pro-Iranian) forces that would then degenerate into full-scale hostilities. What marginally mitigates this risk is that both sides are aware of the danger and have professional command and control structures.

Escalation could also result from a miscalculation, as has often happened in the Middle East's chequered history. The US could overestimate the power of sanctions to subjugate Iran into doing America's bidding, tempting it to wade in militarily, possibly through air strikes (to start with at least).

For their part, the Iranians could underestimate Trump's ability or willingness to wage war as a last resort, despite the risks involved. Saddam Hussein made the same error of judgement in 1990 when he invaded Kuwait.

How long can the Iranian regime survive the current sanctions? Could one envisage a Venezuela-type situation?

The state of decay of the Iranian economy and regime is still light years away from Venezuela, and the prospect of regime change by way of a popular uprising, backed by token

support from the US, seems implausible at this stage. To bring about such a change, the US would probably have to cross a red line by taking out all of Iran's top political leaders, or by sending hundreds of thousands of soldiers into Iran's vastness. This could eventually involve the appearance of a 'failed state', as in Iraq in the years following the 2003 US invasion (although Iranian institutions are far more robust).

If a *coup d'état* did take place in Iran, it would more likely be the hardliners trying to force out a president and government that they see as too soft towards the Americans. However, the president – who in the past has shown signs of moderation – has given pledges to the hardliners in recent months, which has mitigated this risk for the time being.

China and Europe seem to be content to stay on the sidelines. Are they that afraid of antagonising the US?

European leaders have reacted haphazardly and on the whole unenthusiastically, clearly so as not to strain an already troubled transatlantic relationship. More surprisingly, while they have given vocal support to Iran, both Moscow and Beijing have avoided circumventing US sanctions too overtly. Most likely, Beijing has enough on its plate with the trade spat with Washington.

Where should investors turn at a time like this?

So far, neither the price of crude nor financial markets have been shaken by the rising tensions in the Gulf, even though 30% of the world's seaborne crude-oil purchases pass through the Strait of Hormuz. There are two possible explanations.

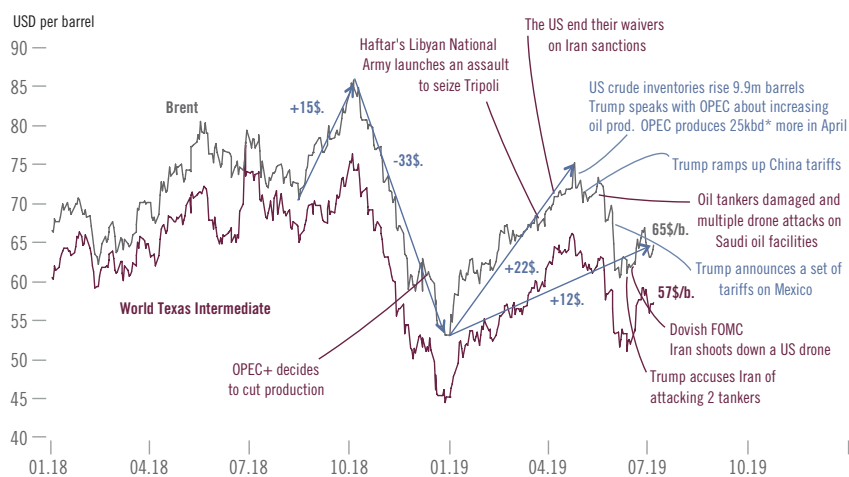
“...there is a risk the opposing parties could stumble into direct military confrontation.”

One is that market participants are complacent and focused instead on positive fundamentals such as economic growth and, perhaps even more so, the continuation of looser monetary policies by central banks. Consequently, risks that are not strictly economic, such as geopolitical risk (always hard to assess), are ignored.

Conversely, we may be witnessing a fair appreciation of geopolitical events. Ultimately, neither the US nor Iran wants war. Investors correctly surmise that the war of words and the isolated incidents are merely gesticulating and do not risk spoiling the global economic or financial backdrop.

But while we can currently assume that Iranian and US leaders are thinking rationally, and large-scale military conflict is not the most likely outcome, a dangerous chain reaction cannot be ruled out. Investors need to keep a close watch on this complex game of chess in which the pieces are constantly moving. A diversified portfolio that has a fair but not excessive share of risk assets equipped with mechanisms to cushion against sudden negative events is the most suitable response to the situation in the Gulf and elsewhere. ■

OIL PRICE IN WAKE OF US WITHDRAWAL FROM THE IRANIAN NUCLEAR AGREEMENT



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Chinese bond market: Too big to ignore

Attractive yields and low correlation with other bond segments are just two reasons why investors should consider Chinese local-currency debt.

The size of the Chinese debt market (including all debt securities denominated in renminbi and hard currency) rose by 479% in the 10 years to December 2018, making it the world's second largest after the US, where total debt grew by a more modest 36% over the same period (see *Chart 1*). The rise of China's bond market parallels that of its economy, which surpassed Japan's to become the second largest in the world in 2010. However, until very recently, renminbi-denominated Chinese bonds have been absent from the main local-currency bond indices, and hence from most foreign investors' portfolios.

Unsurprisingly, this absence is largely due to regulatory reasons, as the Chinese authorities have taken their time opening up the country's financial markets to foreign investors. However, while capital controls remain in place, over the past year the Chinese authorities have taken steps to guarantee relatively smooth access for off-shore investors, paving the way for the inclusion of renminbi-denominated bonds in the main bond indices. They have been included in the Bloomberg Barclays Global Aggregate Index since

1 April (with their share of the index to increase progressively until end-2020) and are under consideration for inclusion in the JP Morgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified. Chinese bonds' inclusion will likely attract significant inflows from fund managers who track these indices, making it imperative for international investors to grasp the dynamics of this new market.

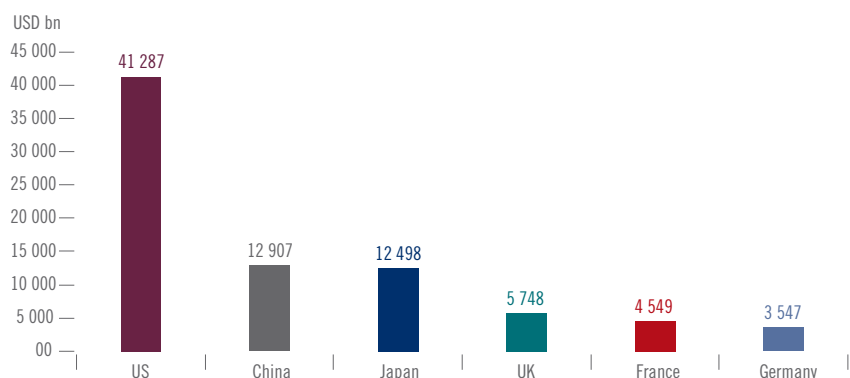
Commitment to market opening

There are good reasons behind the Chinese government's push to open its capital markets to foreign investors.

The structural shift in China's balance of payment makes portfolio investment inflows increasingly important. In the decade before 2014, China was mostly able to maintain a twin surplus in both its current account and the capital and financial account (which measures cross-border investments in financial instruments and changes in central bank reserves). However, since 2014 there have been major changes.

First, China's capital and financial account has swung into deficit as

CHART 1: TOTAL DEBT SECURITIES OUTSTANDING



Source: Pictet WM – AA&MR, BIS, 31.12.2018

outward investment has picked up. The deficit widened sharply in 2015 due to capital outflows following devaluation of the renminbi. While the deficit has narrowed as the Chinese authorities have tightened capital controls, the balance has remained in negative territory. In Q1 2019, China ran a capital and financial account deficit of USD 39bn. Second, the Chinese current account surplus is shrinking due to the declining surplus in merchandise trade and rising deficit in services. The Chinese current account fell into deficit in Q1 2018 for the first time since 2001. While it managed to show a small surplus at the end of 2018, the days when China ran large current account surpluses are likely behind us.

This structural shift in China's balance of payments implies that to maintain the current level of foreign reserves (roughly USD 3.1tn), which serve as an important buffer against external risks, China will increasingly rely on foreign capital inflows, through either foreign direct investment (FDI) or portfolio investment.

The opening of China's onshore bond market is a natural extension of earlier policy moves that opened its equity markets, with both initiatives aimed at attracting portfolio inflows. Opening up the capital markets is also an integral part of the Chinese government's push to internationalise the renminbi. Effective 1 October 2016, the International Monetary Fund added the renminbi to its Special Drawing Rights basket of currencies. While this was a milestone for the renminbi, in order for it to become a truly international currency (and eventually a major reserve currency), the Chinese government

must make it more attractive to global investors, including central banks. Opening up the onshore capital markets is essential for this purpose.

Some key characteristics of renminbi-denominated bonds

Chinese sovereign bonds (i.e. those issued by the central government) represent one of the safest, biggest and most liquid segments of the Chinese bond market, along with local government bonds and bonds issued by policy banks.

Distinctive characteristics of Chinese local-currency sovereign bonds include their high rating, attractive yields and the risks attached.

Among the highest EM credit ratings

Total Chinese sovereign bonds outstanding amount to USD 2.18tn, roughly 50% of Chinese GDP. China accounts for 36% of total EM sovereign bonds in local currency outstanding, although the Chinese market remains much smaller than the US Treasury equivalent (USD 15.9tn)¹. The low central government debt-to-GDP ratio, stable governance and robust economic growth mean that the overall rating for Chinese sovereign debt in local currency (A+ on average) is the highest in the EM universe and close to that of developed-market issuers such as Ireland. Investors assign a relatively low default risk to Chinese government debt compared with other EM issuers, as can be seen in the credit default swap spread (see Chart 2).

Attractive yields

Today, Chinese real yields are relatively lower than their EM peers', but fare

fairly well compared to developed-market counterparts': low inflation means that the real yield on Chinese sovereign bonds stood at 0.6% at the end of June, higher than the real yield on US Treasury bonds, which has fallen to 0.1%. Chinese sovereign yields tend to be influenced by both the PBoC's monetary policy and the direction of US Treasury yields (due to the loose CNY/USD peg). We expect Chinese sovereign yields to fall this year as the PBoC continues to ease policy to sustain Chinese growth. This would mean a reversal of their recent rise stemming from downward pressure on the renminbi.

Three main risks to monitor

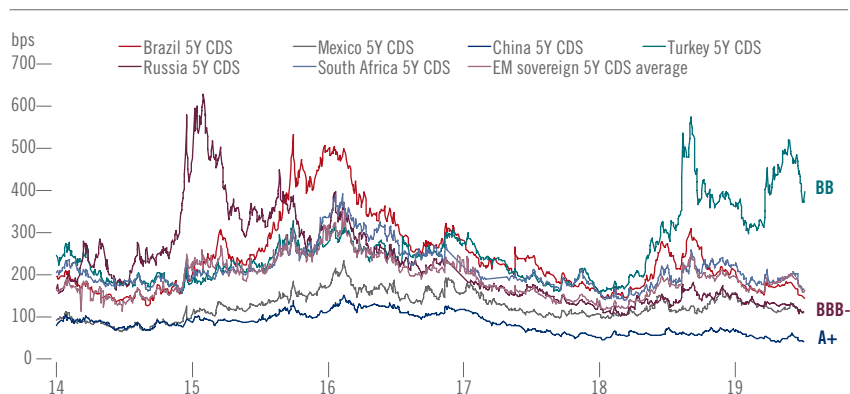
The main risk investors must monitor is further renminbi depreciation against the US dollar. However, we believe that the Chinese authorities will continue to tightly manage the renminbi. Although it could remain subject to downward pressure in coming months, for now we believe the USD 1/CNY 7 level is a line in the sand.

Nonetheless, should downward pressure increase drastically, the Chinese authorities could resort to tighter capital controls as they did back in 2015-2016. Despite reassurances that they would allow foreign investors to repatriate their money and convert it back into their reference currency, the risk nevertheless exists that the Chinese renege on their commitments, leaving foreign investors stuck with renminbi in China. Finally, a look at quarterly turn-over data suggests the Chinese sovereign bond market is relatively liquid, although less so than its US Treasury counterpart. Chinese liquidity will face a critical test as the market opens up to foreign investors, especially to fund managers who sometimes place large tickets.

Overall, however, we believe the opening-up of the renminbi-denominated bond market represents an opportunity. Sovereign Chinese bonds have a place in investors' portfolios, as they offer attractive yields for relatively limited risk. ■

¹ Bloomberg 6 June 2019

CHART 2: EM SOVEREIGN 5-YEAR CDS SPREADS AND LOCAL CURRENCY RATING



Source: Pictet WM - AA&MR, Bloomberg, 06.07.2019



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REGIONAL FOCUS

Democrats bet that leftward shift will pay off in America's Rust Belt

If there were any remaining doubts about the Democratic party's direction of travel, they were dispelled by the first TV debates among its leading presidential candidates for the primary race: the Democratic party's ideological centre of gravity has clearly shifted leftward.

During the debates, former vice president Joe Biden, a centrist who embodies continuity with former president Obama, appeared surprised by being outflanked on his leftist credentials by other leading candidates. Significantly, the idea of 'Medicare for all' (a federal insurance to replace private health insurance) is now becoming mainstream among Democrats, having previously been considered a fringe theme. Biden's moderation now seems to be a burden in a party where 'progressive' ideas, including environmental concerns, have risen swiftly to the fore, including environmental concerns (see chart). Recent opinion polls show that this trend is encroaching on Biden's support among Democrats, with the gap between him and Bertie Sanders, Kamala Harris and Elizabeth Warren narrowing. Policy agendas underpinned by ideological depth seem to have become more important than personality and mere opposition to Trump, so it is quite possible that Biden will continue to lose ground, paralleling Hillary Clinton's decline against Obama in the 2008 Democratic primary.

Political commentators across the board are puzzled by the party's leftward move, which they see as complicating its fight against President Trump in November 2020. But these commentators may under-appreciate the ever-present 'anti-establishment' forces prevalent across the US, and especially in the crucial Rust Belt. Trump himself, whose own presidential campaign was astutely based on

a close reading of the electoral college map, seems more anxious about left-leaning opponents than political commentators are.

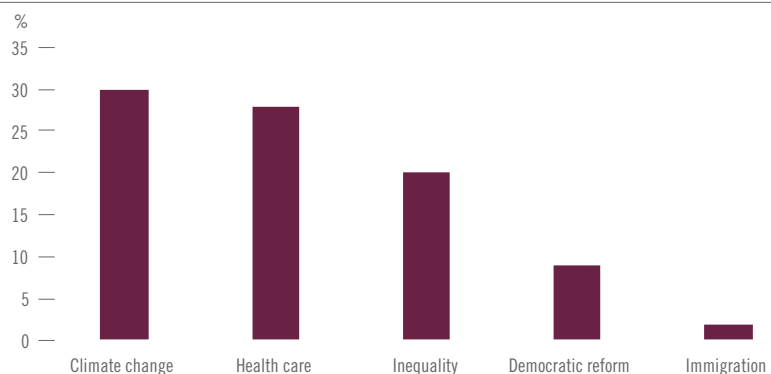
Indeed, a correlation between the positions of these left-leaning Democrats and some of Trump's recent postures is visible. Interestingly, Bernie Sanders, the self-proclaimed Democratic Socialist, called Donald Trump "the worst kind of socialist" in a 27 June op-ed in *The Wall Street Journal*. Sanders claimed his vision was better than Trump's "corporate socialism", while also implicitly acknowledging some parallels with his own brand of socialism – especially in their appeal to the lower middle class.

Some other Democratic candidates, for instance Elizabeth Warren, are also emphasising their sense of 'patriotism', a theme dear to Trump's heart. In particular, Warren has called for an "economic patriotism" that would use US trade policy more prominently in safeguarding US workers'

interests — not that far off from President Trump's stance on trade. There is also some surprising confluence between Trump and the Democrats on trust busting. Warren has been the most forceful of Democrats on this theme, urging the end of 'Gilded Age 2.0' (a reference to the cartels that led to the emergence of 'Robber Barons' in the early 20th century). For his part, Trump has also taken an aggressive stance on the big internet companies, in a break with the Republican party's traditional line.

Meanwhile, worries about the ongoing deterioration in US finances and the growing federal budget deficit seem to be dropping even further down the list of politicians' worries, whether Trump's or the Democrats'. None of the Democrats are calling for a cut in government spending, and nobody dares call for a rise in interest rates. Possibly the most pioneering ideas come from Bernie Sanders. He has high-profile economists on his

POLL OF PARTY DONORS: TOP PRIORITY



Source: New York Times, July 2019

team who are proponents of Modern Monetary Theory (MMT), arguing that constraints, including inflation, on budget spending and money printing are not as serious as is commonly thought. But again, could the relentless pressure that Trump has put on the Fed to lower rates make him an MMT proponent as well?

The Democrats' stance, particularly on trade, may mean that Trump sees that there is little political gain to be had from reaching a

broad, all-encompassing deal with China before the 2020 election. With the political stakes so high, he might continue to adopt a hard line, possibly through a further layer of tariffs on Chinese goods and increased attention to European imports as well. His focus on imports of automobiles (a product key for the US manufacturing base) might persist, as might his focus on currency exchange. This tension is likely to keep markets on tenterhooks, especially if market participants

realise that import tariffs will remain an issue, whether Trump or a Democrat wins the 2020 election.

The ongoing deterioration in US public finances and federal debt metrics might be nullified by ever-looser monetary policy for now. Fundamentally, however, the Fed's ammunition to fight the next recession is deteriorating. No one, including the Democratic party, seems to be willing to fix the roof while the sun still shines. ■

REGIONAL FOCUS

UK politics: Boris Johnson vs Parliament

The ongoing Brexit uncertainty is taking its toll on the British economy, which could curb the appetite for exiting the European Union without a deal. New elections are the most likely way to break the current gridlock. This may necessitate another extension of the Brexit deadline.

Thomas Costerg, *Senior Economist, Pictet Wealth Management*

Boris Johnson, who, at the time of writing, seems likely to succeed Theresa May as prime minister, wants to play hardball with the EU, proposing either to renegotiate the withdrawal agreement May brought back from Brussels, or exit without a deal on 31 October. Knowing that the EU has said that it will not reopen negotiations, the scenario is quite simple: we go straight to a no-deal Brexit on 31 October. While this is indeed a likely possibility, it still forgets another key player in the story: the British parliament.

Boris Johnson has only a fragile hold on parliament, with the minority Conservative government propped up only by support from Northern Ireland's Democratic Unionist Party. Importantly, several Tories have said publicly that they would not support a slide towards a no-deal Brexit at end-October—even though that's the default option if nothing else happens. It is true that some Labour members of parliament (MPs) who are disgruntled with the EU may help the arithmetic for Johnson. However, our base case scenario is that, while conflicted,

parliament still wants to avoid 'no deal' and its dire economic consequences. We believe that despite Johnson's rhetoric, another extension of the deadline is still the most likely outcome.

Having already granted two extensions (both for flimsy reasons), we do not see the EU standing in the way of another one. So, in essence, our base case scenario hinges on a 'wake up call' from Parliament, with members deploying the threat of snap elections if necessary to avoid the no-deal Brexit outcome. Now, Johnson and some allies hinted during the Tory leadership campaign that he would not exclude shutting parliament altogether to avoid precisely such an eventuality. But the Speaker of the House of Commons, John Bercow, has vowed to use all possible tactics to avoid parliament being sidelined; he is himself probably against a no-deal Brexit.

Meanwhile, the UK economy is now really feeling the heat of Brexit uncertainty. The composite PMI survey, a bellwether for the UK's economy, dropped below 50 in June, suggesting 'contraction' in economic activity (*see*

chart). True, this could persuade some MPs already tired of the Brexit saga to 'pull the plug' once and for all, even if it means a no-deal Brexit, just to avoid the further pain that another extension would entail. But the decline in business activity will also put the focus back on the economic cost of Brexit, which has tended to be downplayed by hardcore Brexiteers. The recent slowdown could be just a taste of more to come in case of no deal. Meanwhile, the ongoing trade scuffles between the US and China have shone a light on the EU's role as a relatively smooth-running, integrated free-trade area in an unsettled world. Some Tory MPs may not fear threatening snap elections because the Labour party is declining in opinion polls, and it is now officially calling for 'Remain' in a new referendum.

True, Johnson's acceptance of another extension of the Brexit deadline could be seen as a betrayal of his initial promise. But Theresa May also broke promises. Johnson is pragmatic, and the promise of new elections down the line might provide him

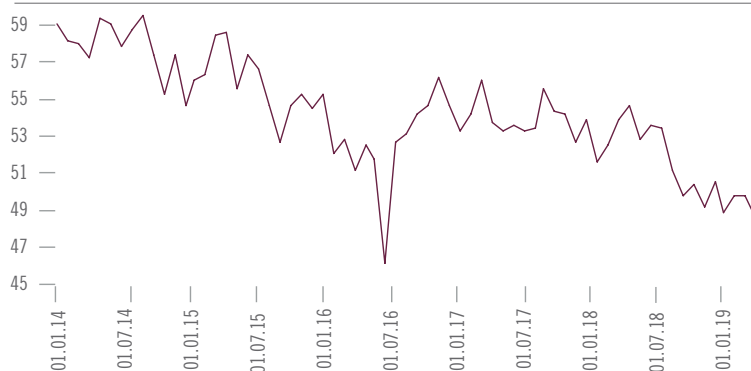
with an easy excuse. Alternatively, Johnson could be toppled before the October deadline, leaving a government of national unity to call for the extension instead. Another alternative is that UK constitutional lawyers' imagination helps parliament find the power to bypass the prime minister for such an extension. Further arguments against a no-deal Brexit on 31 October include the civil service's unpreparedness for such an outcome, as well as the electric situation with regard to the Irish border. Still, we reckon the uncertainty is very high and it is difficult to really call Johnson's bluff.

In the longer run, our base scenario is that, after several attempts, the UK will end up leaving the EU, but will remain in close association with

it. More than Brexit itself, we remain anxious about the deeper issues that Brexit has brought out into the open, including the territorial integrity of the UK and the deep economic and social divisions between

its globally connected capital and less affluent regions. ■

UK COMPOSITE PMI INDEX



Source: Pictet WM – AA&MR, European Central Bank, Federal Reserve, Bank of Japan, January 2019



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ASSET CLASS FOCUS

The relevance of private equity

The role of private equity in a strategic asset allocation.

The dispersion between top-tier and bottom-tier private equity (PE) managers is higher than in other asset class, making selection of top managers paramount for alpha generation. PE firms that have continuously deployed capital and avoided crowded playing fields by targeting specific sectors, untapped segments or unique strategies are best positioned to continue generating above-average returns.

Expected returns for private equity have gone down, but remain above those for public equities

Internal rates of return for private equity are lower than in the previous

decade but the premium over liquid equities should remain. Value creation in private markets is skill based and difficult to automate or replicate through cheap passive strategies. While today's private equity valuations are high, they also reinforce why professionals are needed to select and access sound PE investment opportunities for alpha generation. Public equities are expensive today as well. Indeed, valuation spreads between the two universes have converged at high levels, with private equity valuations only slightly more expensive than public equities.

PE deals are often structured as leveraged buyouts. The cost of debt,

“The best PE managers differentiate themselves through optimal timing of capital deployment, as well as their skill in keeping powder dry when the timing is sub-optimal.”

i.e. the interest rate paid to finance leveraged buyouts, has been exceptionally low since the 2008 financial crisis. Given that central banks will unlikely be able to fully normalise rates over the next decade, corporate financing conditions are expected to remain supportive. Furthermore, as opposed to the period before 2008, a majority of today's PE deals involve covenant-lite loans. This reduces the potential financial damage PE investors face in a business cycle downturn. In contrast with the high floating rates prevalent before the financial crisis, approximately 70% of loans are now concluded at a low fixed rate, protecting investors from rate increases.

While transaction prices for large-cap buyout deals in the US are close to their all-time highs and the average leverage for the same transactions is also close to its previous peak, the cost of debt remains significantly below the levels seen in the last cycle. Therefore, interest coverage is not an issue today and, given the outlook for interest rates, should not be an issue over the medium term either.

In absolute terms, dry powder, or the capital PE funds have available and ready to be deployed, is at an all-time high (USD 1.2tn according to Preqin, *see chart*). However, the PE market has grown significantly in recent years, with the number of private companies trending up as the proportion of

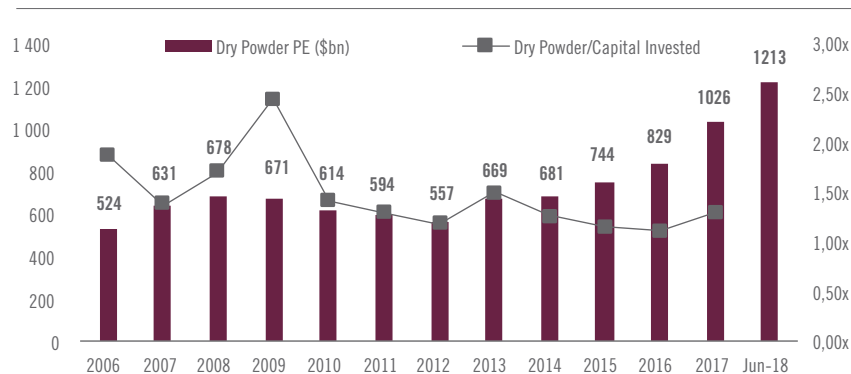
public companies has gone down, in particular in the technology sector, where companies stay private much longer than in the past. Therefore, many opportunities are only accessible through private markets.

Time horizon and timing changes in the cycle

Unlike traditional equity management, PE management entails a time lag between asset raising and asset investment. The best PE managers differentiate themselves through optimal timing of capital deployment, as well as their skill in keeping powder dry when the timing is sub-optimal. As a result, even though certain vintages may provide lower returns than others, we still expect carefully-selected PE managers to continue to generate alpha.

Deploying PE capital and harvesting returns follows a J-curve, with four-to-five years needed to deploy capital and eight years to reach break-even. Cash flows are typically paid out to investors after 10-12 years. Consequently, investors should target PE exposure in terms of net asset value and commitments that they can fund in all circumstances and diversify across PE vintages. An investment today could turn into a bumper vintage if there is a significant correction in the equity market tomorrow. ■

GLOBAL PRIVATE EQUITY DRY POWDER



Source: Preqin as of March 2019

New monetary policies for new challenges

As central banks try (yet again) to bolster faltering growth and inflation, it is important to grasp how the 'style' and aims of monetary policy-making have changed over time and how they need to evolve in the future.

Christophe Donay, *Chief Strategist, Head of Asset Allocation & Macroeconomic Research, Pictet Wealth Management*

The world is being disrupted by structural trends such as populism, demographic and climate change and technological innovation. Likewise, with previous approaches producing fewer results, we believe it is time to envisage monetary policies that address these sources of disruption more directly.

We observe five different phases of monetary policy making since 1980.

1. Combatting inflation (1980-2008)

By far the longest phase saw the Fed push through large, swift increases in the federal funds rate under Paul Volcker. The policy was a success on its own terms, with US inflation dropping from almost 15% in the spring of 1980 to 4-5% by the mid-1980s. In 1990, the Reserve Bank of New Zealand was the first central bank to adopt inflation targeting as an official goal, followed later by the Fed and other central banks.

2. Quantitative easing (2008-2015)

In the wake of the 2008 financial crisis came deflation, leading central banks to engage in massive asset-buying programmes (quantitative easing, QE), as central banks moved to the twin objectives of sustaining both growth and inflation. Combined with massive fiscal measures and public spending, this new 'style' of policy-making helped the world avoid an economic depression.

3. Attempted normalisation (2016-2018)

In 2015, after six years of economic growth, the Fed engaged in 'normalisation' of its monetary policy, raising rates and announcing plans to reduce the size of its balance sheet. Later, the European Central Bank (ECB) very

cautiously set out on a similar path. After years of slashing policy rates, central banks' objective now was to build up a margin of manoeuvre for the next crisis without undermining a very delicate recovery.

4. Denial (H1 2019)

After a series of quarter-point rate hikes, policy was on 'auto pilot'. After the Fed last raised its policy rate in December 2018 with still more in the works, it indicated that it would pause rate hikes and suspend its balance-sheet unwinding only six weeks later. In a nutshell, a global economic slowdown, spurred by trade tensions, led to deteriorating financial conditions that forced the Fed to pause. Other factors, like stubbornly low inflation and inflation expectations, also provided food for thought.

5. Renewed quantitative easing (H2 2019-early 2020s)

This June marked a return to the past as central banks moved to support growth and inflation again. The Fed hinted at near-term rate cuts and Mario Draghi signalled the ECB's unequivocal readiness for further stimulus "in the absence of improvement" in growth and inflation. We now expect the Fed to announce two 25-basis point rate cuts between July and September. We expect the ECB could cut its deposit rate in September and even resume QE before the end of this year.

A new style of monetary policy

However, there is no guarantee that a new dose of QE will prolong the growth cycle and lift inflation. Previous QE programmes had some success because they were accompanied by ambitious fiscal and budgetary

measures, taken under the threat of deflation. However, central banks have singularly failed to lift inflation back towards their 2% target, and growth since 2009 has been below that of previous expansionary cycles. There is also the question of accumulated debt. Theoretically, this could keep growing, but constraints will be increasingly felt. According to the Bank for International Settlements, nonfinancial corporate debt in the US had risen to over 72% of GDP in Q4 2018. Gross federal debt in the US rose to 105% of GDP in 2017 from 82% in 2009.

Home-grown dynamics alone will not be enough to prolong the expansionary phase of the business cycle, already the longest ever in the US. This is not only because of businesses' and governments' limited capacity to absorb yet more debt, but also because real rates close to or below zero and slowing growth stymie central banks' ability to ensure extra liquidity feeds directly into the economy (the problem is especially acute in Europe and Japan).

Under these circumstances, we believe that central banks could throw in the towel as growth continues to fade and the limits of further QE become more evident in the absence of strong budgetary and fiscal stimulus. If nothing else, it is hard to see how negative bond yields, in part the result of QE, can be sustained in the long term. The time is therefore ripe to look at setting new central bank goals to contend with the complexity and interconnectedness of today. We believe the debate over goals will lead to the emergence of a new style of monetary policy early in the next decade.

Rising inequalities and job insecurity, mass migration and severe environmental challenges—all factors in the surge in populism—are threatening political stability. Since political instability spills into economic and financial instability, might resolving these issues not become one of the central banks' prime goals? One might therefore imagine a new phase of monetary policy that sees central banks broaden their narrow focus on inflation and growth to include tackling inequalities, for example.

Improved coordination of monetary and fiscal policies will be needed in this exercise. The growing ineffectiveness of older kinds of monetary policy, including QE, combined with public budget plans hamstrung by high indebtedness, could force the political and monetary authorities to find common ground. One might therefore see central banks cooperate more closely with government authorities (but without losing their independence) to combine budgetary and fiscal measures with monetary policy to help create and not just distribute purchasing power. This could involve employing new tools—anything from flexible inflation targeting, to nominal GDP growth targeting to asset-price targeting. Central banks might even explore the option of helicopter money—in other words, distributing money directly to all citizens (and not just banks) to stimulate the economy. The upsurge of interest in modern monetary theory (MMT) points in this direction. Thus, monetary policy could become a part of the solution to inequalities, with the marriage of spending, tax and monetary measures contributing to a new economic policy 'style'.

A radical departure in monetary policy would initially cause widespread uncertainty in markets. Currencies could depreciate, increasing the attractiveness of physical gold and real assets. A long time could pass before central banks regained their credibility among investors, meaning an increase in equity volatility. Overall, markets would have to change the way they look at central banks—no longer seeing them simply as operating the levers of interest rates, but

as instigators of social and economic change.

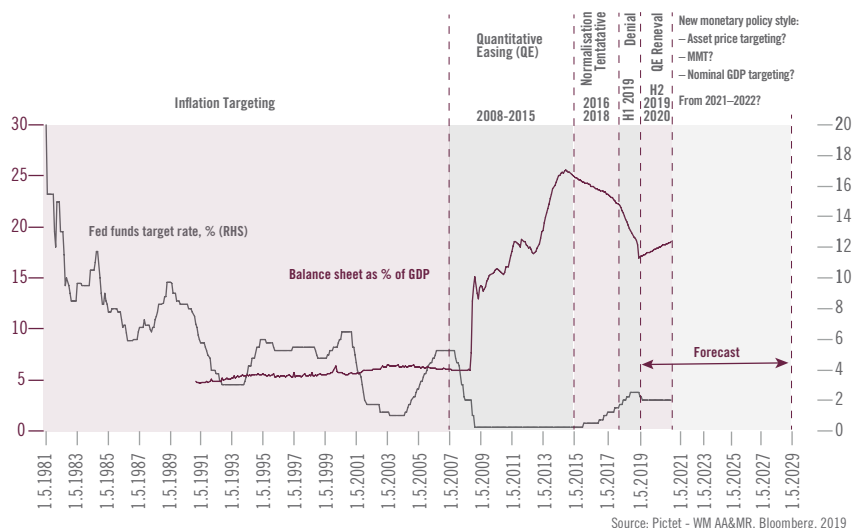
Giving a new sense of purpose to central banks would also require a level of policy cooperation and synchronisation that we have mostly only seen in times of crisis. But such cooperation could help dampen initial market volatility.

How successful central banks were in their new mission could determine how far they maintain their independence under their own terms. Finding a way to work with politicians, who have to face an increasingly volatile electorate might be a sensible path forward. The appointment of Christine Lagarde, formerly France's finance minister, is an interesting move in this respect. Otherwise, there is a risk that central banks become 'politicised': the blatant pressure the Trump administration has put on the Fed and its attempts to appoint cronies to the Fed board could be the shape of things to come.

Deep-seated issues concerning the ends and the means of monetary policy remain unresolved. Central bank mandates will need to be rewritten. Courage will be needed if we are to avoid the excesses of the past and the economic and financial crises that follow in their wake. But central banks need to show they can engage with the issues of today if they are to head off the economic and financial crises of tomorrow. The need to reinvent their mission and set new goals is becoming more imperative. ■

“Giving a new sense of purpose to central banks would also require a level of policy cooperation and synchronisation that we have mostly only seen in times of crisis.”

TOWARDS A NEW MONETARY POLICY STYLE (REGIME)





MARIE-LAURE SCHAUFELBERGER
Investment Stewardship
Pictet Group

The Sustainable Development Goals: a blueprint for a better future

In September 2015, 193 UN member countries came together to commit to 17 Sustainable Development Goals (SDGs) to be achieved by 2030. With a mere 11 years on the clock remaining, channelling investment towards these challenges will be key to achieving this ambitious vision.

“... commitment from the private sector is essential to achieving these goals, and many investors are already allocating accordingly, having recognised the financial opportunity presented.”

The UN Conference on Trade and Development estimates that achieving the SDGs by 2030 will require USD 3.9 trillion to be invested in developing countries each year. Today, the investment gap is significant, with USD 2.5 trillion per year still needed beyond spending committed by governments. This means commitment from the private sector is essential to achieving these goals, and many investors are already allocating accordingly, having recognised the financial opportunity presented.

Each of the SDGs offers a range of investment potential, as illustrated by a sample selection below.

SDG 6 – Clean water and sanitation Opportunity: water infrastructure, treatment and management

Investments are needed along the entire water value chain, in developed and emerging markets alike. Global water infrastructure projects alone are expected to see annual growth of 5%-8%.¹ Examples of areas where investors could play a role include exploration, desalination and wastewater treatment plants.

Not often associated with water, technology has a vital role to play in averting a global water crisis. In particular, agriculture, which accounts for 70% of total global water consumption, is an area where water technology improvements can have a huge impact. Closer to home, smart sprinklers can reduce water use in domestic gardens and the global micro-irrigation systems market is expected to

more than triple to USD 14.9 billion by 2025.²

In addition to reducing usage, water recycling is another area where technology can play a central role, with the waste water recycling market growing at 20% per year. Other areas where innovation is key include improving ageing infrastructure – where water leakages result in large scale water loss each year. Smart water meters, for instance, could play a significant role in detecting such leaks early on.

SDG 7 – Affordable and clean energy Opportunity: Energy efficiency opportunities, from tech to transport and logistics

Demand for energy efficiency has driven innovative financial products and a new range of blended solutions. A key example is India. India's Bureau of Energy Efficiency develops policies and initiatives to help reduce the country's energy intensity, including innovative financing of energy-efficiency projects. ICICI, a private domestic Indian bank, was one of several to embrace the programme, introducing a loan scheme to help commercial and industrial companies, small and medium-sized enterprises and public sector organisations to finance energy-efficiency services and purchase equipment and lighting for energy-efficiency projects.³

While coal supplied 80% of India's total power mix in 2016 and 2017, new wind and solar energy is now 20% cheaper than energy generated

by existing coal-fired power plants.⁴ India's wind and solar energy costs have fallen 50% over the past two years, now costing less than the amount required to justify new imported coal or liquefied natural gas capacity.

Meanwhile, according to energy analysts RepuTex, Australia is on track to achieve 50% renewable electricity by 2030 on surging renewable energy, driven by state schemes and rooftop solar installation that is driving wholesale prices down. Indeed, 80% of the global population could be living in regions where alternative energy is as cheap as traditional fossil fuels by 2025, according to Leo Johnson of Sustainable Finance⁵.

SDG 3 – Good health and well-being Opportunity: Healthcare and education providers in emerging markets

Demand for quality healthcare and education is increasing in emerging markets. Several development finance institutions have invested in companies providing education and healthcare in developing countries. These investments are often made via fund-of-funds structures, with funds funnelled to the companies via financial intermediaries, such as local private equity funds, that have built their portfolios around the notions of innovation and quality services that cater to a growing middle class.

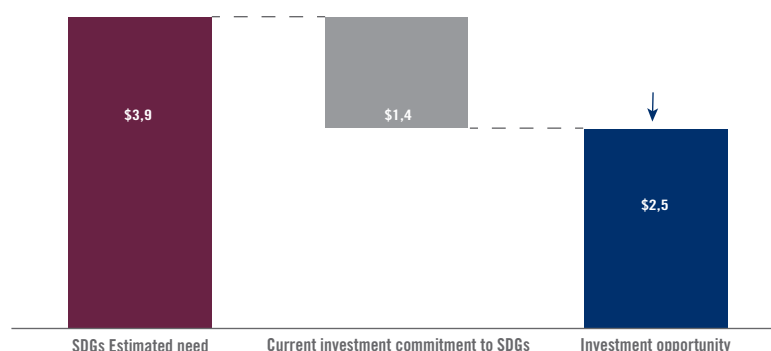
Emerging market policymakers are racing to meet the needs of their ageing populations. China alone is undergoing ambitious healthcare reform programmes and targeting a seven-fold increase in medical spending from 2011 to 2020, an amount McKinsey estimates to reach USD 1 trillion by 2020.⁶

From AI-assisted diagnosis tools to smart transport for faster ambulance journeys, the investment opportunities are as vast as they are awe-inspiring.

The compound financial benefit of investing in the SDG opportunities at a micro level is in a rising tide that lifts all boats (not to mention the personal satisfaction of investing in good causes). McKinsey calculated that US GDP over the past decade could have grown an additional USD 1 trillion if the whole economy had performed at the same level as the companies that prioritised long-term, rather than short-term, value generation, creating more than five million additional jobs at the same time.⁷ ■

¹ Bank of America Merrill Lynch, 2016
² Mega.online, Inkwood Research, 2017
³ The SDG investment case, PRI, PWC
⁴ Forbes, 2018
⁵ Mega.online
⁶ Reuters, UBS, 2017
⁷ McKinsey Global Institute, 2017

THE USD 2.5 TRILLION PER YEAR OPPORTUNITY FOR PRIVATE INVESTORS



Source: UBS White Paper for the World Economic Forum Annual Meeting 2019, January 2019

Content completed on 15 July 2019
Editors: Isidore Ryan and Melanie Larkin
Design: Stéphane Bob, Forth Studio
Printed on FSC-certified paper.

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