Letter n°1

Global economic outlook: strong pep pills, disappointing growth, resilient markets.

Germs coming from Asia are an old story. While the impact from SRAS was minimal, European collective memory still recalls the Black Plague, brought around 1350 from China and Mongolia to Europe through Genova outposts on the Black Sea and maritime traffic. It devastated what is today France and Italy, causing over 30 million deaths i.e. between one third and one half of the population of the area. Nothing of the kind today, unless the C-virus spreads to Africa, South Africa, Egypt, Algeria are the most exposed to Chinese trade and they are preparing for it.
We leave aside questions on viral dissemination prospects to focus on the current state of world economy. Everybody is aware of weak production figures and disruptions in production chains, but we see no recession signals in major economic blocks, and we expect increased deficit spending, central bank vigilance and weak material prices to mitigate risks for the next few months. We remain positive on equity markets for this period.
The 2.9% growth rate for world GDP in 2019 – before any impact from the C-virus - is the lowest since 2009 and somewhat lower than the average of previous decades. Should we worry? Pessimists point to weak economic growth, despite massive monetary and budget stimulation in the last few years. Optimists look at the outstanding length of the current economic cycle, at ten-year age a record since the second world war, they see no recession signals this year and they expect a global economic recovery.

Economic trends

Pessimists refer to the 6% annualized decline in the 4th quarter GDP for Japan, and expect the same in 1st Q2020, plus a 0.5% to 1.5% GDP decline in 2020 for Singapore, 0% for Germany, and a slowdown to 5% for China. Optimists note that global industrial production stabilized in January – with US IP growth positive since September - and that advanced indicators are now positive for most developed countries. They argue that the Fed and ECB policy reversals to expansion are only now starting to yield results. Also, the GDP decline in Japan has one-off causes: the VAT rate rose from 8% to 10% in October, and this quarter will suffer from weaker tourism and much reduced trade with China, Japan's first trading partner.

Liquidity trends

Pessimists complain that persistent money creation since 2009 – around USD 15'000 billions – has inflated asset prices out of proportion, squeezing young people out of real estate markets, destroying the life insurance industry, compromising long-term health of pension funds and bond portfolios, and biasing risk valuation.
They further note that the marginal impulse of liquidity expansion on the economy has been progressively weaker, and that currency debasement has induced negative retroactions on economic growth: as per weaker GDP growth in 2016 for the UK together with the weaker GBP after the Brexit vote, or weaker growth in 2013 for Japan after the Shinzo Abe yen devaluation, or weaker growth for the UE after the Euro decline engineered by Mr Draghi in 2014. In each case, the negative impact of rising import prices on purchasing power finally overtook the incremental profits from rising exports. Two sources of worries for when the global economic cycle will turn over.
Optimists reply that Greek 10-year sovereign debt now yield 0.9%, half the rate for Italy or the US despite a public debt ratio of 1.8 x GDP. Liquidity creation has not induced much growth, but has providentially alleviated debt service and substituted Japanese-style stagnation to economic depression and social upheaval as in the 1930's.

Financial and budget trends

A more immediate worry is surging African debt. Despite up to 100% public debt ratios in Angola, in Ghana and in Gabon, recent issues were oversubscribed. Many investors are foolishly looking for higher yield at any future cost. Optimists align with **Olivier Blanchard** and look at public infrastructure investments as a vector of external savings for business, translating into productivity gains in these countries.

Pessimists point to very indebted countries: Japan, Greece, Italy, which not surprisingly registered the weakest growth in the last ten years. This reminds us of **Carmen Reinhart's** work which identified a risk for growth through low productivity for countries burdened with public debt ratios above 90% of GDP. Correlation or causation? Many governments find it easier to kick the can down the road and to ignore that risk. Japan just launched a $ 120 billion budget stimulus plan. China is increasing by $ 170 billion its 7-day interbank market facility, after disclosing a $ 45 billion relief plan for business and lowering by 10 bp the repo rate. The US have no qualms with a budget deficit close to 5% of GDP, a record figure for the peak of economic cycle. Boris Johnson increases the minimum salary by 5%, plans for massive investments in rail infrastructure and calls for another £ 34 billion spending on NHS. More deficit spending is the rule for France, Spain, Italy, as it is each year at budget planning time.

Corporate margins and long duration assets

Pessimists frown at toppish operating margins and fear that low unemployment ratios across developed countries will soon lead to higher wages. Optimists aware of **Thomas Philippon's** analyses of US economic structures are confident that many large companies can pass through costs and maintain margins, at the expense of consumers but beneficial to themselves.

As for equity markets, optimists have many arguments: share buybacks reached $ 770 billion in 2019 after $ 805 billion in 2018, dividends rose to $ 1430 billion (500B. for the US), a lower number of IPOs (190 for the US compared to nearly 500 in 1999), the diminishing number of quoted companies (-50% in 10 years for the US, -20% for Europe), the rise in dollar liquidity, a scarcity in alternative investments, all are bullish factors compounding the recent positive US earnings trend.

Long-term sovereign bonds are enjoying a reprieve which will last as long as the C-virus is seen as able to disrupt travel, transportation, tourism and production. They should be avoided and investors looking for yield should favour dividends and high yield bonds in undervalued sectors.

Conclusion

For those who believe, as we do, that the C-virus problem will not morph into a black swan and stop in its tracks the ongoing global recovery, we advise to buy oil and copper plays, along with transportation and cyclical equities. Long term sovereign bonds should be avoided. We see clearer opportunities in Korea or Thailand than in China because of disruption in production chains, and high corporate debt ratios at 1.5 x GDP. Bankruptcy risk is currently high for many companies, and several banks are already loaded with NPLs. For pessimists we advise cautiousness in view of high equity and bond valuations, and overweighting USD and CHF currency plays.

Bruno Desgardins

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Bruno Desgardins
Directeur de la Gestion