WORLDWIDE
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The End Of 35 Years Of Secular Disinflation?

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2016 proved a difficult year for our global products. The reversion in interest rates had a massive impact on factor and sector performance globally. Value outperformed growth as a more benign reflationary – if not outright inflationary– environment was priced in. The big question as we enter 2017 is whether the rise in interest rates is cyclical or secular. While the potential change in political philosophy post Brexit and the Trump victory has massive implications, we do not see the Trump election as a factor that will generate genuine reflation of the economy in the short term. Domestically oriented companies in the US will see positive effects from less regulation and lower taxes, but the business cycle is mature and corporate debt has risen relative to assets and equity to now exceed the last peak seen at the height of the 2000 TMT bubble. Our focus is on GARP stock – growth stocks trading at reasonable prices, and value creators, companies that mid to long term generate significant free cash flows to their shareholders. This has always been our focus, whether through periods of recovery or downturn, and it has generally served us well.

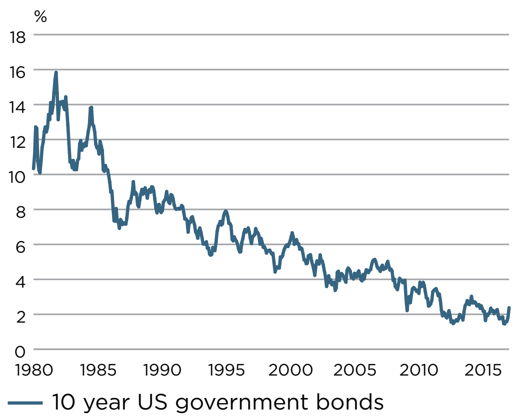
In the following you can read about our views in relation to our global portfolios after 35 years of falling interest rates;

Is the era of falling bond yields over?

The most important economic trend of the past 35 years have been the continuous global fall in interest rates. Most, if not all, investors active in markets today have only experienced falling interest rates in their careers and many have been calling for the end to falling interest rates only to be proven wrong. When this trend eventually does come to an end, the economic outlook and financial market trends will change radically.

Figure 1

Falling interest rates



Source: Bloomberg

We believe that, fundamentally, both technology and demographic trends are deflationary by nature and therefore supportive of low interest rates. However, these are not the only factors with the potential to affect the pricing regime and, by extension, the interest rate environment. The political system we operate under is perhaps equally as powerful, and for the past 35 years we have lived in a world where, until very recently, trade has expanded, economic integration has moved forward and former totalitarian regimes have given in to market-driven capitalist systems. All of this has been disinflationary and therefore conducive to lower interest rates.

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Brexit and the election of Donald Trump as US president can be seen as the final verification that the trend towards ever-growing internationalisation and integration of the global economy is reversing, which at the same time signals the beginning of the end of extreme monetary policy and contrarily a newfound belief in nationalism and fiscal policies as the solution to weak growth in the aftermath of the Great Financial Crisis.

Is a Trump presidency a catalyst for change?

It is much too early to speculate how this will play out, and still too risky to wage one-sided bets on who will be winners in this new political game. A case in point is how defence manufacturers first outperformed strongly in the aftermath of the Trump victory, only to see their share prices plummet due to a Trump tweet about "out of control expenses" in the industry. However, a few outcomes seem likely; less regulation of the financial industry (benefiting our US financial stocks Citi Bank, Wells Fargo and First Republic), changes to ACA ('ObamaCare') and significant tax reform, since there are so obvious benefits from a simplification and reduction of corporate tax levels as well as repatriation of offshore corporate funds. Should the proposed corporate tax cuts materialise, it would on average increase EPS for US companies by 12 pct. Our investment CVS Health is as the number one payer of corporate taxes in the US (1 pct. of total), likely the most positively affected company amongst all US taxpayers. CVS generates 99 pct. of sales in the US and currently pays a tax rate of 39 pct. A 20 percentage point reduction of the tax rate would increase its FY2017 EPS by 33 pct., reduce P/E to just over 10x and boost the FY2017 free cash flow by 30 pct. to a free cash flow yield of 9.4 pct. We like CVS as it is today, but we like it even more with the prospects of a Trump tax reform.

While Trump and his policies are now widely compared to those of President Reagan in the eighties, the macro-economic starting points are vastly different. Reagan cut marginal taxes from a top rate of 70 pct. to 28 pct. and while he tripled the national debt, debt to GDP only rose from 26 pct. to 41 pct. Trump is starting his term with a public debt to GDP ratio of 105 pct. And while Reagan aggressively hiked military expenditures in a final count down with the 'Evil Empire', he was fundamentally small state and market oriented, while his most important economic advisor, Federal Reserve governor Paul Volker, pursued a tough monetary policy agenda in order to kill inflation in the aftermath of the stagflationary 1970s.

> **The question remains, however, is this a cyclical swing within a falling trend since 1981, or are we in a new paradigm with interest rates climbing higher in the years ahead?**

Today, on the other hand, populists do not strangle labour recoveries with tight money. Populism is hostile to free trade that displaces domestic labour solely in pursuit of lower prices and higher profits (both Trump as well as the new conservative leadership in the UK and most far-from-centre parties in Europe qualify for this tag), and it does not seek to import labour competition or security threats via open borders (giving rise to fundamental questions about some of the founding principles of the EU). The question remains, however, is this a cyclical swing within a falling trend since 1981, or are we in a new paradigm with interest rates climbing higher in the years ahead? We are more inclined to view recent movements in capital markets as a movement back from extreme overbought positions. However, the pendulum is still moving and will likely continue its rising trend until dollar strength, higher interest rates and rising wages reveal their dampening effects on the US economy some time during 2017.

We do not see the Trump election in itself as a factor that will generate genuine reflation in the short term, but domestic companies will see positive effects from less regulation and lower taxes, and from this perspective our US stocks are well-positioned, being to a large extent domestically oriented.

How mature is the business cycle?

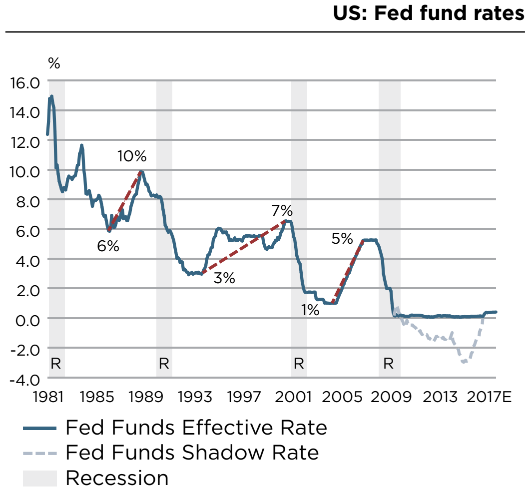
A major difference between the period 2016-2017 and previous periods of rising interest rates is that the United States is already at full employment and growth acceleration will therefore either result in a short spur of the economy overheating or productivity growth accelerating (OECD expects full capacity utilisation in the US by end 2017). The situation in Europe is ambiguous; on the one hand, there is plenty of slack in the economy and a cyclical upturn is noticeable, and giving reason for optimism. On the other hand, however, political uncertainty in terms of both the eventual effects of Brexit and the upcoming elections across the continent will most likely keep corporate investment and thus productivity at low levels for the foreseeable future.

> **Our base case for 2017 is that growth will not improve strongly as interest rates rise, since both the interest rate tightening cycle and the growth cycle are mature.**

In December 2015, the Federal Reserve formally raised interest rates for the first time after seven years of economic growth. However, the so-called shadow federal funds rate, which shows what the Fed funds rate would have looked like if investors had not had recourse to cash, rose about 300 basis points from the middle of 2014 through the end of last year as the central bank tapered, then ended its asset purchase program and prepared the way for its single rate hike in December 2015. Our base case for 2017 is that growth will not improve strongly as interest rates rise, since both the interest rate tightening cycle and the growth cycle are mature.

As can be seen from the chart in the following collumn, the US has historically entered a recession on average one year after a 400 bp move in Fed funds rate. If we are to believe that the trend for the shadow federal funds rate is as reliable an indicator as nominal rate changes have been historically we only need another 50 bp hike before we reach critical levels, if history is any guide to the future. To contrast this view ISI's Ed Hyman – the top rated US economist we have followed for the past two decades – believes that after a very deep recession, we've had an unusually slow recovery, which means the business cycle has not matured as much as it normally would, and that judging by most of the indicators ISI follows, the next recession is years off, say four years. But to quote another legend: "None of the US expansions of the past 40 years died in bed of old age," MIT economics professor Rudiger Dornbusch famously observed in 1997. "Every one was murdered by the Federal Reserve."

Figure 2



Source: Stifel, Macrobond

Therefore, we monitor the US yield curve closely. The yield curve inverts prior to recessions by roughly 12 to 24 months; it is regarded as the best recession signal and will react if the FED raises interest rates by too much.

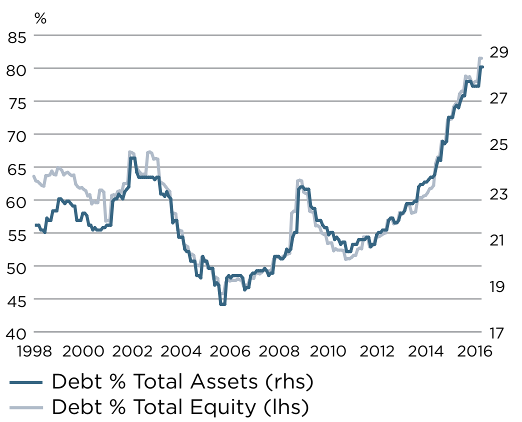
How much further can interest rates rise before it becomes a negative?

There seems to be consensus that rising bond yields will not become a headwind for equities or the economy until 10-year US yields rise to 3.0-3.5 pct. The problem with this is, as Ray Dalio of Bridgewater Associates, the world's largest hedge fund, has formulated: "... it would only take a 100 basis point rise in Treasury bond yields to trigger the worst price decline in bonds since 1981. And since those interest rates are embedded in the pricing of all investment assets, that would send them all much lower." We have reached that 100 basis point increase for 10-year US Treasuries; yields bottomed out at 1.35 pct. in June 2016 and are now at 2.5 pct., so bond investors will have very large unrealised losses – in fact larger than the losses of 1994, losses that among other events led to the default of Orange County, a default that might seem small today but at the time was a major event.

The interest rate differential between the US and the rest of the world is widening. Combined with corporate profit repatriation from abroad, this means higher dollar funding costs for the rest of the world. This is a problem for emerging market countries and corporates with significant USD debt and also leads to a perceived weakening of the CNY, the Chinese currency. Any threat of major emerging market stress or a CNY devaluation is negative for global growth and is a cause of deflation, not inflation. Currently, this is not a market focus, but we question how much more the USD can strengthen before the stress in emerging markets begins to affect reflation in the US?

Figure 3

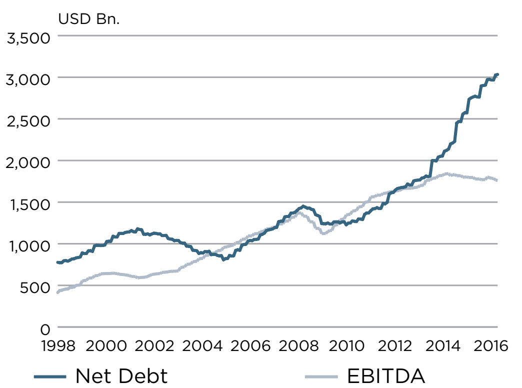
US: Company leverage I



Source: Factset, Societe Generale

Figure 4

US: Company leverage II



Source: Factset, Societe Generale

Companies are highly exposed to rising interest rates

While it is probably too early to worry about the effect of rising interest rates on public finances, that is not the case when it comes to the US corporate sector. Falling interest rates have so far overshadowed the leverage that has taken place as the debt is easily serviceable at today's current low interest rates. However, corporate debt has rocketed relative to assets and equity to now exceed the last peak seen at the height of the 2000 TMT bubble (Figure 3). Perhaps because of the extremely low funding costs, interest coverage has (except for the largest (tech) companies) increased to levels last seen at the depths of the last recession.

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So, as interest rates rise, funding costs will increase for the corporate sector at a time when leverage is historically high. Obviously, it would have a big impact on earnings should interest rates spike.

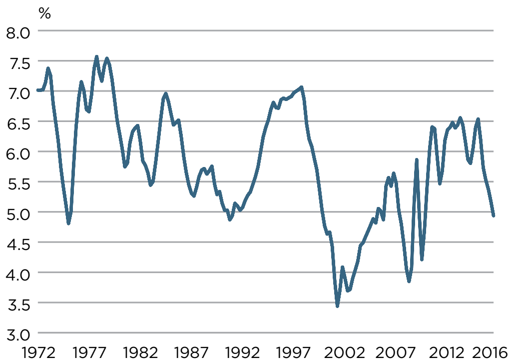
Has US corporate profitability peaked?

While recognizing some near-term positives for earnings in the US (less regulation and tax reform), we are seeing headwinds develop. Labour continues to gain pricing power, which – while good for the 99 pct. - is bad for profit margins. This is probably one of the things we can be certain of; that "the pendulum has started to swing back, to the advantage of labour – simply due to populist pressure as reflected in recent elections in the US, UK and Italy". Furthermore, a quarter of the US margin improvement since 2012 had come from lower rates and a third of EPS growth from buybacks: the former is now a headwind, the latter a reduced tailwind. Besides accelerated corporate tax reform, only higher top-line growth will be able to counter these headwinds. Is that likely?

It is being argued that the US growth outlook has improved, in part because of the stimulative promise of a Donald Trump presidency. But this is a hope for the future that may or may not materialise before the next recession sets in. The facts on the ground today for US corporates in aggregate are: 1) ROIC is falling as are corporate earnings as a percentage of GDP (Figure 5 and 6), 2) even if the incoming president can fulfil his promises to fix the economy it will be a long time before his program can deliver, and 3) in anticipation of stimulus, the US dollar is appreciating to ever more uncompetitive levels while interest rates are also rising together with wages.

Figure 5

US: Return on invested capital

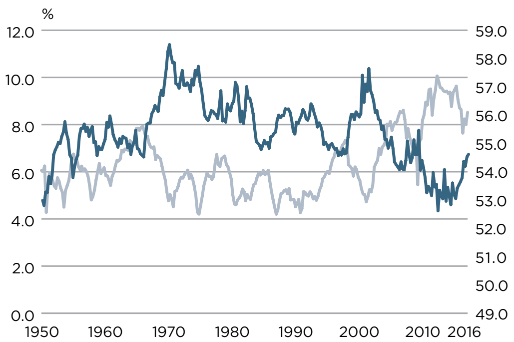


Real return on Invested Capital for non-financial corporations

Source: Gavekal, Macrobond

Figure 6

US: Corporate profits



Employee compensation as % of GDP (rhs)
US Corporate Profits as % of GDP

Source: Macrobond

In such an environment, prudent corporate executives will wait for real policy changes and/or for interest rates and the US dollar to settle before they commit to major capital expenditure. Therefore, it can be expected that the economic environment will be characterised by continuous accommodative monetary policies in an effort to prevent excessive interest rate volatility, while labour markets are being allowed to run a bit 'hotter' than they used to be. The new reality will be 'protective', hence the term 'Protectionist'. We do not see this as a reason to become more optimistic on aggregate growth, and specifically there are many reasons to believe corporate earnings growth will see headwinds over the next few years. While regulatory pressures and taxes will eventually fall, the reality today is that wages and financing costs are going up.

A difficult environment for Growth investors

Arguing that the market is wrong can be a lesson in futility. However, for the moment the market believes recent events at the political level are reflationary – contrarily to our thinking. To a large extent being large cap growth investors at C WorldWide Asset Management, we have felt the pain of rising interest rates, and the equities we hold are typically relatively long-term duration and therefore interest rate sensitive.

According to Société Générale, the global rally in Value stocks has been the second-most powerful since 1989. A market previously obsessed with secular stagflation and bond proxies has adjusted rapidly to a world of rising bond yields and a potential shift away from monetary policy towards fiscal policy.

> **After the last five months of cyclicals outperforming defensives, the two are now trading at the same P/E multiples.**

As such, after two very strong years, 2016 has clearly been a disappointment. We invest with a three to five year horizon in companies we believe have strong competitive moats and products or services so attractive that they can continually raise their prices. One of the best gauges of strong barriers to entry is the ability to sustain a high return on capital employed through the cycle. Analysts from William Blair have been monitoring how companies in the S&P 500 index with a high return on capital employed vs their weighted average cost of capital have performed. This year companies with a high return on capital employed (and strong barriers to entry) have underperformed companies with a low return on capital employed by a stunning 18 pct.

So, for how long can these headwinds persist? We would like to point out that after the last five months of cyclicals outperforming defensives, the two are now trading at the same P/E multiples This is above their average 10 pct. discount since 1980. Historically during the past 35 years, cyclical rallies have generally ended after reaching between 1.0x and 1.1x those of defensives. Alternatively, one can look at individual stocks; one example being Caterpillar (which we do not hold in our portfolios). One year ago, Caterpillar traded at 16x 2017 earnings. Since then, earnings expectations have fallen by 22 pct. while the stock has risen 46 pct. The P/E has now risen to 29x 2017 earnings. It is impossible to tell when this cyclical rally will peter out, but we believe that for it to continue the onus is now on having to shift to an actual improvement in earnings growth.

Conclusion

According to the National Bureau of Economic Research, there have been 11 business cycles from 1945 to 2009, with the average length of a cycle lasting about 69 months, or just less than six years. The average expansion during the same period has lasted 58.4 months, while the average contraction has lasted only 11.1 months. The current business cycle began in 2009 and has now lasted 93 months or 60 pct. longer than the average. While the age of a business expansion has no validity in estimating when it ends, there is no arguing that the current business cycle is mature. We are now finally seeing labour cost inflation in the US, but that is being offset by Fed rate hikes, rising long-term interest rates and dollar strength, all of which are working against reflation. The Fed is letting labour 'run hot', with a potential bonus of global demand getting stronger in 2017 . Any US fiscal expansion in 2017 would accelerate this process, but it would happen at a time of full capacity utilisation, and therefore causing a risk of the economy overheating and inflation accelerating unless there is a simultaneous acceleration of productivity growth.

A major positive theme for 2017/18 is reductions in US corporate taxation as well as repatriation of offshore earnings back to the US. This will to a certain extent counteract the headwinds corporates are seeing as the highly leveraged ROIC is falling because of rising wages and interest payments. We believe there are limits to how much the longer-term US interest rates can continue to rise before corporate debt becomes an issue. Emerging markets as a group (very simplified) cannot cope with the USD appreciating much further due to very large short USD positions. A strong USD leads to capital outflows – especially from China, and could become a theme for 2017.

Europe is gradually improving, but internal stresses in the Euro area due to an ill-constructed currency and political radicalisation is causing a very murky outlook, and at the end of the day Europe is a cyclical asset that relies on global growth and on the US economy to do well.

Domestic stocks in most regions will probably continue to outperform multinationals. This environment presents a challenge to global trade and capital flows, at least until we have a better view of Donald Trump's intentions in terms of trade agreements and international institutions like the WTO.

Value stocks have outperformed growth stocks significantly over the last year. There might be opportunities in chasing the current rally in value stocks, but we fear it is like 'picking up nickels in front of steamrollers', since it is impossible today to determine how long value stocks will continue to outperform (probably as long at long-term interest rates continue to increase), and when owning value stocks, you do not get the comfort of owning companies that create value over time. Our focus is on GARP stock (growth stocks trading at reasonable prices) and value creators (companies that mid to long term generate significant free cash flows to their shareholders). This has always been our focus, whether through periods of recovery or downturn, and although there have been times when this strategy has been challenged, it has generally served us well.