NEWSLETTER

Peter Seilern-Aspang & Raphael Pitoun

THE MOST IMPORTANT YEAR

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Most forecasts for the year ahead are not taken seriously, perhaps with good reason; the track record of such forecasts and their predictive power are indeed historically poor. This year's crop appears no different. Invariably, there is the temptation for market participants to talk their own book to attract publicity suited to their own trading interests and styles of investing. Predicting stock market indices, for instance, is at best guesswork given the dependence on dozens of known unknowns and unknown unknowns. Perhaps a more modest but realistic ambition is to try and ask the right questions. In our view, most issues in the capital markets are predicated on answering one key question: is the secular bull bond market, started thirty-five years ago, coming to an end?

If bond yields do finally start to rise then there is a good chance of answering the many other related issues debated by experts on the economy and the capital markets. The question regarding the secular decline of advanced economies will be looked at as an anomaly rather than the new normal. Growth factors, such as innovation and supportive fiscal government policies, would have won the battle to offset the near-certain negative impact of demographics. Also, rising yields would be reflective of improved price expectations, hence solving Yellen's so-called "mystery" of low inflation.

From that perspective, we cannot emphasise enough how 2018 will be pivotal. Why so? Because all the ingredients of a sustained expansion, a recovery in inflation and the subsequent increase in the long-term bond yields are there. At the end of 2017 we were witnessing an economic recovery that was broad-based and relatively strong. Japan had started to show some encouraging green shoots; Europe had entered a potentially long upcycle following the sluggishness of the economy since the Lehman crisis; and, finally, the US had experienced its third quarter of two point five per cent GDP growth, or better. On top of that, the budgets of many developed economies are destined to stop contracting and even expand, for example in the US following the adoption of the "Tax Cuts and Jobs Act". Many European countries, notably in the South, will continue to taper their austerity policies. Even France has been starting to implement some serious and long-overdue reforms.

Budgetary expansion measures will pick up while monetary policies will remain generous – a perfect combination. In contrast to much of common thinking, however, despite the planned end of asset purchases at the Federal Reserve and the recent rate hikes, the worldwide mint will likely remain very much in place and, in total, the combined balance sheets of the three largest Central Banks will continue to expand in 2018. This is underpinned by new or coming appointments showing little philosophical change at both the Federal Reserve and the Bank of Japan, as well as the recent indications given by the European Central Bank. This backdrop does not seem to question the overall trajectory of monetary policies: data dependency and attention to market participants' anticipations appear to remain key factors for those at the helm.

But what if the economy does not really expand and if inflation rates remain depressed? What would happen if the US ten-year bond yield remains in its current range? Then, 2018, despite being a textbook positive environment for both Wall Street and Main Street, would be the year of final capitulation on inflation. Both levers, monetary and budgetary, would have touched their limits without having been able to relaunch inflation. Market participants would durably write off high and sustainable growth prospects for the world economy. The tenants of secular stagnation, that we translate into what we coined two years ago *The Big Long,* would win a decisive battle against the techno-optimists.

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Last month, we talked about the tax plan and how we consider it a beautiful Christmas gift to investors. Despite the public relations efforts of many US companies, it is confirmed that the main beneficiary will not be the real economy. Since then, three other less mentioned phenomena linked to the tax reform attracted our attention. First, some industries will use the proceeds to reinvest in prices and capacities. For example, many products and services in the banking sector are priced according to the cost of capital which is itself dependent on the prevailing tax rate. Jamie Dimon, the CEO of JP Morgan, confirmed that earlier this month and consumers and corporates can expect a solid competition for loans in the future. A second example is airlines, where the unexpected tax benefits will be used to increase capacities in an industry where pricing power is historically fragile. Third, merger and acquisitions announcements have started to increase, as a confirmation that the tax plan will mostly end up in the pocket of shareholders (if not those from your own company, it will be of others). All in all, overcapacities, price war and rationalisation are not inflationary but deflationary. For lack of space, we mention the other long term side effect of tax reform. The new investment incentives are directly beneficial to automation and robots and the investment opportunity increases in the current context of a tight labor market.

If we are allowed one prediction, from the perspective of investing in only the highest quality-growth companies, our conviction is that inflation is and will remain absent except in some distinct pockets of the economy. The factors at work - demographics, technology disruptions and the extinction of the middleman - are just too strong. But this would not be necessarily bad for investors. Profit increases combined with a reasonable economic background as well as low interest rates would continue to be a favourable cocktail. Bank stocks would become, once again, a mirage for investors while companies with pricing power, healthy balance sheets and previously proven growth records would continue to be the fortress and fortune builder for the astute investor. 2018 would seemingly have marked the death of inflation.

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