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CEO Corner

A sharp reversal of expectations

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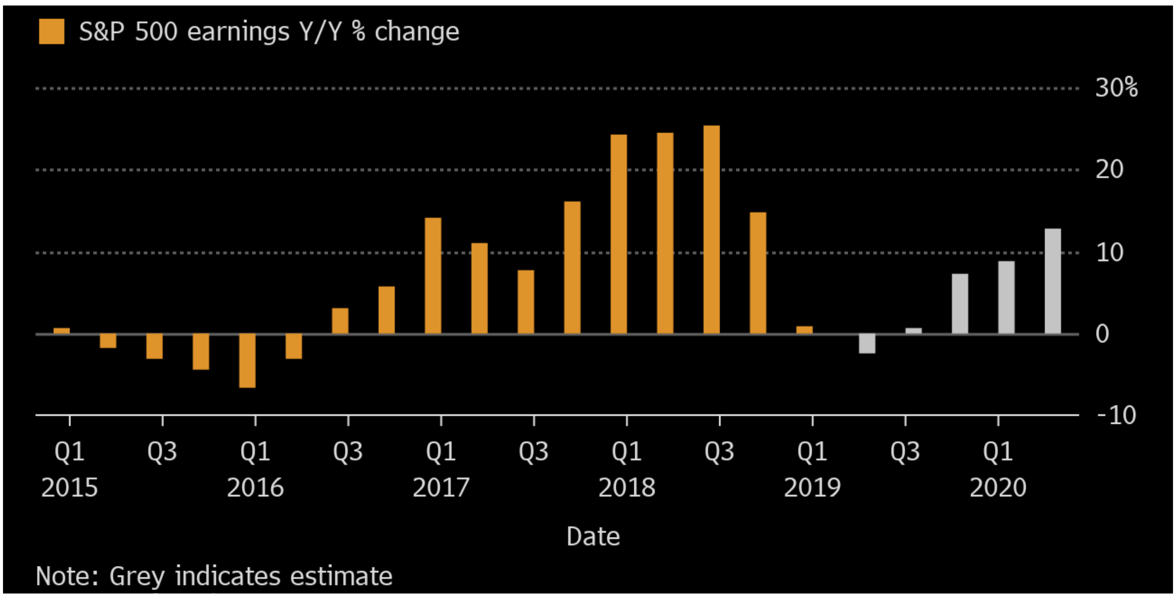
In our April 2019 edition of the BFI Insights, we warned investors to be more careful with equity markets, but we still presented a compelling case on why they should hold on to their equity market investments. Despite a more challenging market environment in Q2/2019, we have not changed our opinion, but we do expect a more difficult terrain ahead for global stock markets for the remainder of the year. In this edition of our InSights, we are going to look at the different central banks around the world and the policy approaches they are likely to adopt in the coming months. While the overall more expansionary trend speaks for continued asset price inflation, we are almost certain that the political risks globally will create more volatility going forward. Once again, we would like to stress the importance of active management in this environment. This simply means that active downside protection and hedging should be an integral part of every investment portfolio. This will, of course, have some costs, but on the other hand, carefully managing the downside and avoiding large corrections is usually one of the most important drivers of outperformance in the long run.

In our latest quarterly Horizon investment strategy meeting, we had an intense discussion about the outlook for equity markets. With global growth expected to slow down further and earnings revisions that have been downgraded significantly in recent months, the overall outlook does not look too optimistic in our view. However, falling earnings and slowing growth do not automatically translate into lower stock markets. It is interesting to see that the sharp downward revision of 2019 earnings has not hurt the market at all, although this might still be the case, especially in the later part of 2019 and in 2020 should earnings not start to rebound. Nevertheless, in the short run, falling earnings do not need to cause falling equity prices.

Earnings growth only expected to rebound in 2020



Source: Bloomberg

This is especially true now that we are witnessing a sharp reversal of central bank policies. Only a few months ago, expectations pointed to higher rates and central banks were expected to try to normalize their policies. Our readers will remember that we have always had our doubts that this would happen so quickly. Now, only a few months later, we find ourselves in a completely different scenario, with the Federal Reserve already discussing the timing of a rate cut and the European Central bank moving in the same direction. Clearly, central banks are concerned about a further slowdown and the ongoing trade tensions, mainly between the U.S. and China, but also between the U.S. and Europe.

The fast reaction from central banks has certainly helped equity markets hold up fairly well during Q2 and this will certainly also be a major support for Q3 and Q4. We also expect that it will take a long time for central banks to turn hawkish again. This assessment is based on the fact that most major central banks have clearly signaled that they would tolerate longer periods of higher growth and inflation before reacting with interest rate hikes. Thus, with ongoing trade conflicts and slowing growth, the chance for an equity market correction in Q3 and Q4 is certainly there, but it might not necessarily materialize, given the decisive support provided by central bankers.

Furthermore, despite the ongoing trade tensions and the concerns over an intensified global slowdown, it is important to remember that global growth is increasingly influenced by new markets. There, we see the exact opposite trend, namely a push for more free trade and fewer barriers. The Trans-Pacific Partnership (TPP) is just one example that highlights the fact that most of the world is still moving towards more free trade and not less. This should also help stabilize global growth, even if the trade conflict between the U.S. and China remains unsolved for the time being.

Given the environment described above, we are of the opinion that investors need to remain invested in equities, but should focus on defensive sectors and also engage in active risk management and downside protection. The sharp reversal of central bank policies is also helping precious metals a lot and as a consequence, gold has been able to break through the important resistance level of USD 1,370. It is currently trading at USD 1,420 and it looks like the previous resistance level is becoming the new support level.

In our view, the current environment should be very positive for precious metals and we therefore see more upside in the months ahead. Silver has been lagging for a long time and the gold/silver ratio is currently around its all-time high. This means that silver is really

Gold surges on expectations of a Fed rate cut

Source: Bloomberg

cheap compared to gold and we think this offers an attractive opportunity to invest in silver as well.

With regard to currencies, we have become more pessimistic on the outlook of the Dollar. With falling yields and a potential slowdown of the U.S. economy, it seems likely that the Dollar has some significant downside risks in the months ahead, the extent of which will mainly depend on the development of the U.S. economy and the steps taken by the Federal Reserve. However, what is clear already, is that the situation has changed considerably from the past year, when the consensus view was that the Fed would continue to hike and the rest of the world would hold back with rate hikes. The interest rate differential and the recently shrinking global Dollar liquidity still remains supportive for the Dollar, but the trend looks less favorable for the greenback in the coming months.

What hasn't changed in recent months is the fact that global investments continue to look much more attractive from a valuation point of view. U.S. markets continue to look expensive and with the recent earnings revisions this might be even more apparent now than a few months ago.

From that perspective, we feel it is a great time to invest internationally and diversify globally. We are happy to help you with that and any questions you might have in this regard. Please do not hesitate to contact us directly at info@bfiwealth.com. We look forward to hearing from you.

Central Banks at a Crossroads

Dirk Steinhoff
Chief Investment Officer

Just six months ago, it looked as if a decade of extremely supportive global monetary policies was coming to end. Investors' and analysts' expectations pointed to higher interest rates and a slow and steady normalization, in order to rein in the unprecedented accommodations that most major central banks used to support the economy after 2008 crisis. However, following a sharp U-turn in the tone of central bankers and a policy shift led by the Federal Reserve, the outlook today has been entirely reversed.

As the global economy is showing signs of strain, geopolitical tensions are on the rise and trade uncertainty drags on, most central banks appear poised to return to or to intensify their easing policies. Meanwhile, the record-breaking bull market in the U.S., as well as European and other major equity markets, pile on the pressure for more monetary accommodations, as they appear increasingly fixated and dependent upon easing expectations, placing a heavy burden on central bankers.

Federal Reserve: a step ahead

In stark contrast to it peers, the Federal Reserve seems to be in a relatively advantageous position at this stage. Unlike the ECB and the BoJ, the Fed did at least try to normalize its policy direction, with its Quantitative Tightening (QT) program and interest rate hikes. Although these efforts were cut short when the central bank announced in February its intentions to halt the rate hikes and to stop shrinking its balance sheet ahead of schedule, its tightening phase did provide some additional leeway and maneuverability for the next economic downturn.

Of course, interest rates in the U.S. are still very low by historical standards. However, there is still room for cuts. Furthermore, as dark clouds gather over the global economy and as monetary policy is becoming increasingly politicized in the country, the return to zero, or even the idea of negative interest rates, is no longer inconceivable. Statements by President Trump, who has been fiercely advocating for a decisive return to an accommodative monetary approach, have also increased the pressure on the central bank.

The Federal Reserve is now widely expected to implement its first interest rate cut in almost a decade in July, while subsequent cuts are also seen as very likely. In fact, given the distinctly dovish tone that the central bank has adopted in the last few months, it might not even take a recession or a severe correction to trigger further cuts. Following its policy U-turn earlier this year, most reports out of the Fed seem to be geared towards protecting the historic bull market. As Fed chief Jerome Powell recently put it, "it's very important this expansion continue as long as possible", as he strongly hinted at the upcoming rate cut. St. Louis Federal Reserve President James Bullard described a quarter-point rate cut as a wise "insurance" move against slower growth.

It can also be argued that zero interest rates could soon become necessary for the U.S. government too, that already faces a formidable challenge in managing its own finances, a problem which is only going to get worse. The latest projections by the Congressional Budget Office (CBO) show that steadily rising deficits are in the cards for the next 30 years. Federal government borrowing, now around 4.2% of GDP, is expected to more than double by 2049. Interest payments, now at an average of 2.4%, will rise to 4.2% in 30 years, according to the CBO's conservative forecasts.

This daunting debt problem that the U.S. is facing is to some extent reminiscent of Japan's situation. Also over-indebted for years, the country's extremely low interest rates have played a key role in keeping the economy afloat, as well as in propping up the government's perceived ability to repay its debts, warding off investor panic. Of course, there are many essential differences between the two cases, however, keeping interest rates lower and for longer appears to be an obvious solution to the U.S.' debt burden and much more politically tenable than tax hikes or massive federal spending cuts.

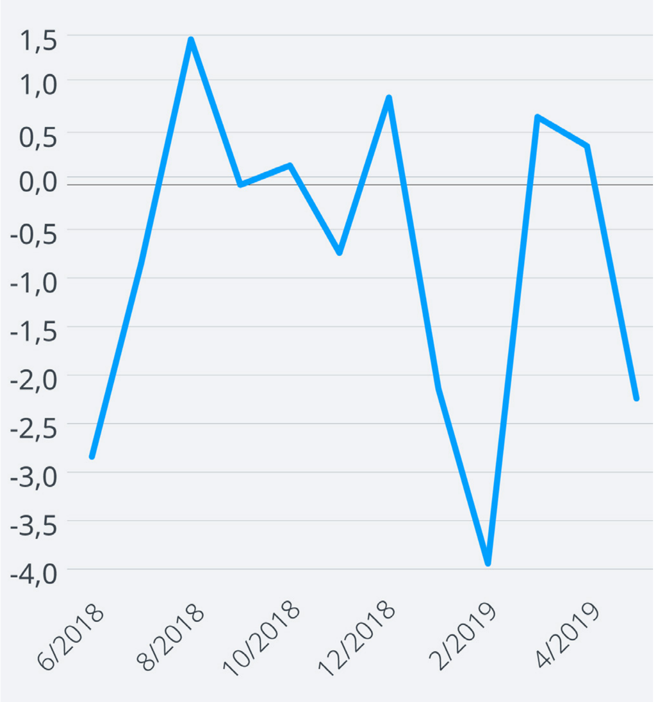
The ECB's depleted arsenal

Compared to the Federal Reserve, the European Central Bank has a very limited range of tools at its disposal to combat an upcoming economic downturn. Having already adopted unprecedented measures after the last recession and having failed to normalize its policies ever since, the central bank is today in a trap of its own making. It has been more than five years since the institution of its negative interest rates policy, which was supposed to be a "temporary" and extreme countermeasure to help keep the Eurozone economy standing. And yet, interest rates are now expected to be pushed even deeper into negative territory, to -0.5%, most likely in September.

While the ECB argues that their approach prevented deflation and supported growth, its policies have also been responsible for keeping "zombie" companies afloat, incentivizing an unsustainable spike in corporate debt and asset prices, punishing savers, and hurting the banking sector. Now, as the Eurozone slows down, the fear is that negative interest rates will become a permanent fixture in the ECB's policy playbook. As Mario Draghi is set to leave office in October as the only ECB president never to have raised interest rates, this scenario is further supported by the appointment of Christine Lagarde as his successor. The ex-chief of the IMF is a strong advocate of negative interest rates, which she views as "good for the global economy", and is thus not expected to change the dovish course set by her predecessor.

As an ING analysis highlighted, the outlook for the ECB is no longer about "what negative surprise is needed for the ECB to cut rates", but rather "what positive surprise could actually prevent the ECB from cutting rates". At this point, a positive surprise seems unlikely.

Month-on-month change in German factory orders, from June 2018 to May 2019

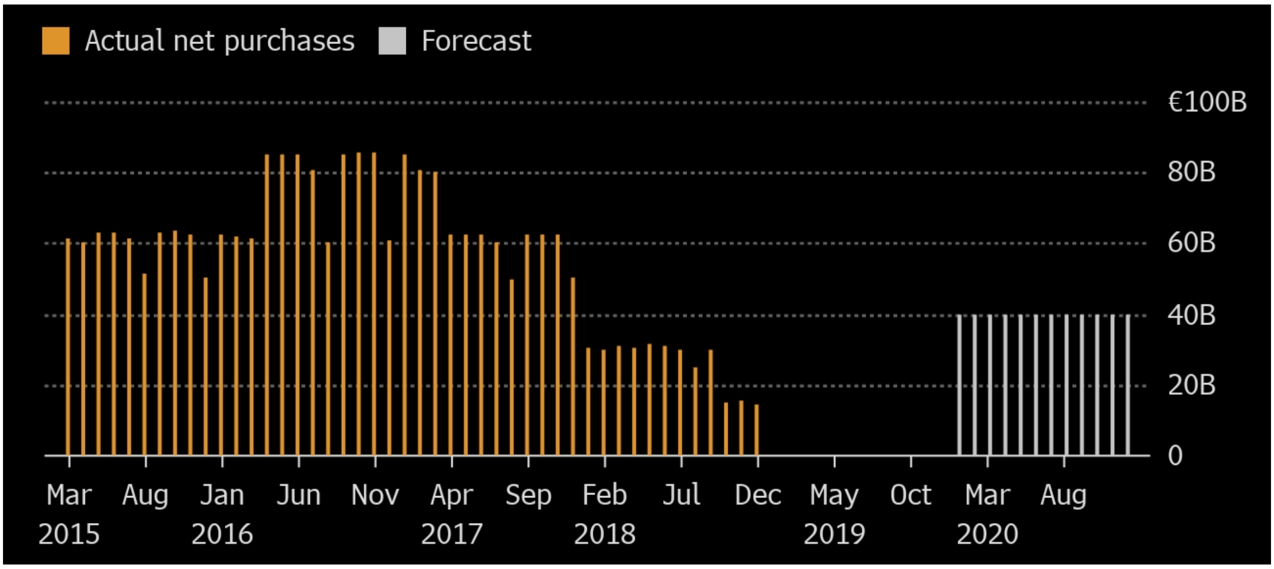


Source: Federal Statistical Office of Germany, DW

Despite years of record low interest rates and the ECB's swollen balance sheet, the outlook for growth was lowered and the Eurozone has stagnated. Many of the key economic indicators are flashing warning signs, while inflation is still stuck at 1.2%, far from the 2% target set by the central bank. The risk of a disorderly Brexit persists, recent German data have shown sustained weakness in the Eurozone's economic powerhouse, while in July, the OECD's chief economist, Laurence Boone, warned of an upcoming economic shock that could hit by the end of the summer.

Given this worrisome outlook, a return to Quantitative Easing (QE) also appears increasingly likely. Although the asset purchasing program was halted last December, Mario Draghi has already opened the door to its possible resumption, promising further stimulus in a distinctly dovish speech in June. The potential revival of QE is anticipated to come after September's expected interest rate cut, as it seen as a more effective measure, arguably to be deployed in the event of a more severe slowdown.

Most economists expect QE to be revived in January



Source: Bloomberg

However, the ECB is constrained in its ability to provide additional accommodations through QE, as it is already very close to its self-imposed limits on sovereign debt purchases. This ceiling, designed to stop the ECB from becoming a dominant creditor of Eurozone governments, currently prevents the purchase of more than 33% of any individual country's sovereign bonds. Having almost reached this limit already for some countries, such as Germany and the Netherlands, there is little to no headroom to expand the government bond purchases. Of course, this problem could be solved if the central bank were to revisit its own rules, a possibility which Mr. Draghi already acknowledged, as he hinted in June that this threshold could be lifted if the circumstances demanded it.

Nevertheless, at this stage, corporate bonds seem more likely to be the prime beneficiary of a QE relaunch. In fact, in anticipation of this scenario, following the recent dovish statements by Mr. Draghi, bond investors pushed the corporate debt market to record highs.

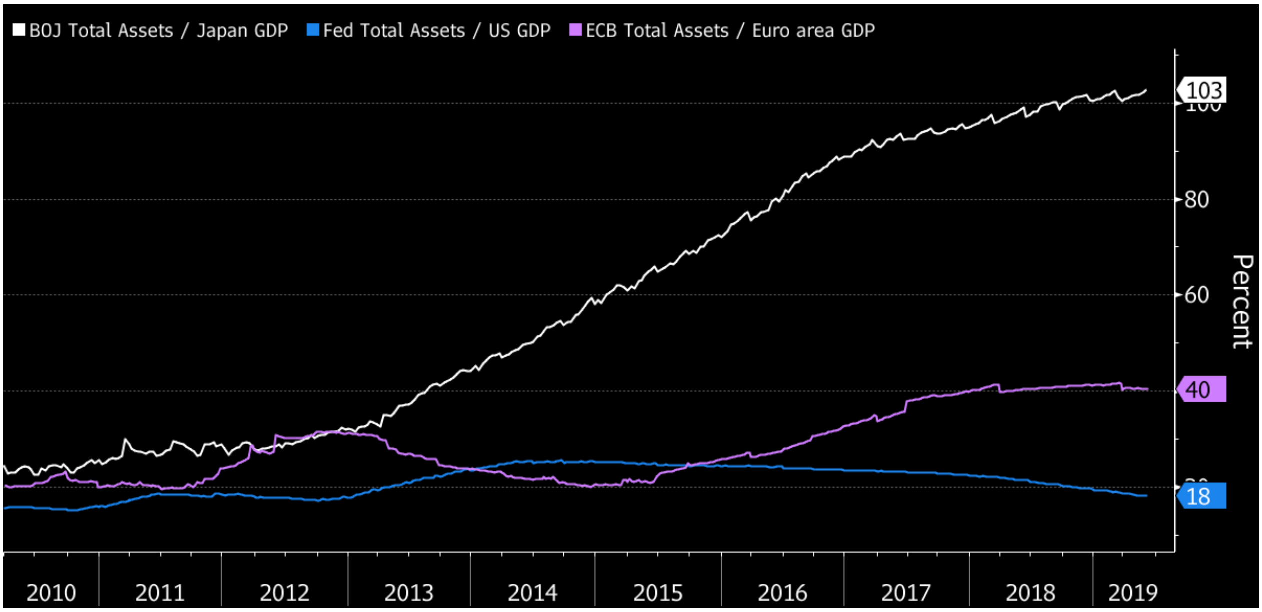
BoJ, a central banking trailblazer

Japan is the most indebted country in the world in debt-to-GDP terms, which stood at over 250% in 2018 and averaged at 137.4% from 1980 until 2017. The country has also been dealing with long bouts of low inflation, weak growth, inflated asset prices and, of course, huge debt servicing costs. In many ways, the Bank of Japan can be seen as a pioneer in the central banking arena. The BoJ has been experimenting with unconventional and often aggressive policies for over 25 years, with mixed and often underwhelming or even adverse results. It introduced a zero-interest rate policy already back in 1999, at the beginning of the so-called "Lost decade" that followed the asset bubble collapse, while it was the first to use quantitative easing policies in 2001.

In more recent years, the central bank pushed short-term interest rates into negative territory, at -0.1%, in 2016, but it also went a step further and tried to fix long-term interest rates near zero. Nevertheless, the inflation target of 2% still remains elusive. In fact, despite many years of heavily accommodative polices, Japan's core inflation hit a two-year low in mid-July, sparking calls for further stimulus.

Furthermore, the BoJ is currently in its tenth year of domestic stock buying through exchange-traded funds (ETFs) and according to Nikkei, it was ranked as a top-ten shareholder in 40% of all listed companies in 2018. The central bank also owns close to half of all outstanding Japanese government bonds, while last year it became the first among G7 nations

The BoJ has by far outspent its peers



Source: Bloomberg

to own assets collectively worth more than the country's entire economy. Quite predictably, the unusually aggressive approach of the BoJ has raised concerns over market distortions and artificially inflated valuations, which have all been dismissed by its governor, Haruhiko Kuroda.

As for future expectations, a recent Reuters poll of economists showed that three quarters of those asked expect that the BoJ's next step will be to expand stimulus, with two thirds of them anticipating the move within the year. This would add to the already massive stimulus that began with the launch of "Abenomics", a bold economic policy mix introduced by PM Shinzo Abe in 2013, which has heavily contributed to Japan's public debt.

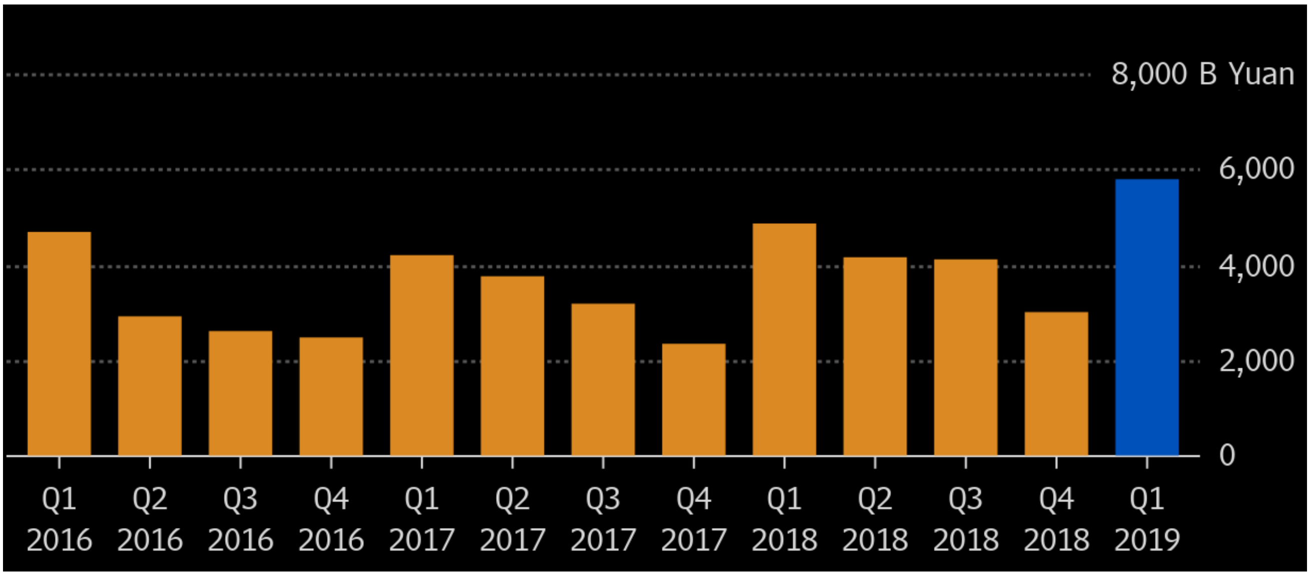
Despite the mixed results that the country has seen from the various monetary experiments initiated by its central bank, its western peers appear to be increasingly interested in the Japanese approach, especially in the BoJ's "yield curve control" initiative. According to Reuters reports, "the BoJ has been receiving queries from several central banks, including the Fed, on how the unconventional program works".

China: leaning on fiscal stimulus

Since July 2017, the People's Bank of China (PBoC) has had the largest financial asset holdings of any central bank in the world, with close to $3.7 trillion in foreign exchange reserves. Its monetary policy approach in recent years has often been described as "prudent", while the central bank works with a wider variety of tools than the Federal Reserve and other major central banks, such as the reserve-requirement ratios for commercial banks, which it has already reduced six times since early 2018, to provide cheap liquidity.

Over the past few months, the bank has been facing some fresh challenges, as key economic indicators have shown signs of weakness, while the impact of the trade war with the U.S. has also been widely felt, especially harming exports and employment figures. China's economic growth, which stood at 6.6% in 2018, is expected to slow to 6.2% in 2019, its weakest pace in almost 30 years, while it is projected to slow even more in 2020, to 6.0%, according to the OECD. Nevertheless, in the event of a severe economic downturn, PBoC officials maintain

Chinese banks advanced record loans in Q1 2019, supported by relaxed lending standards



Source: Bloomberg

that the bank has adequate tools at its disposal to support the economy and as its governor, Yi Gang, recently put it, there's "tremendous" room to adjust monetary policy.

However, fiscal measures also play a very important role in China, especially during economic downturns. For example, in 2008-2009, the Chinese government announced a US$586 billion stimulus plan in response to the crisis that had a double-edged impact. On the one hand, it had a stabilizing effect on global markets and officials at the World Bank and the IMF praised the initiative. The plan's critics, on the other hand, blamed it for a massive surge in Chinese debt. Also, the fact that most of the funds were funneled through state-run companies exacerbated one the most pressing problems that the country still faces today: the support of unproductive and inefficient state-controlled companies over their private sector equivalents.

While debt remains a major concern for the Chinese economy, this year Beijing has stepped up fiscal stimulus again in response to weaker domestic demand and the trade war pressure. A recent report by the OECD warned that the considerable spending increase can "lead to a further build-up of imbalances and capital misallocation", while S&P Global Ratings estimates showed that local governments have already accumulated hidden debt that could amount to 40 trillion yuan. Policymakers have also pushed lenders to support the private sector with looser lending standards, adding to the fears of spiraling bad loans.

Nevertheless, investors and analysts expect the Chinese government to deploy even more stimulus measures going forward, mainly targeting infrastructure and household domestic consumption.

Implications for investors

As the outlook of the global economy darkens and as geopolitical risks intensify, central banks are being called upon once again to play a supportive and stabilizing role and stave off recession concerns. However, at this point, they appear to be much more limited in their ability to effectively play that part compared to the previous decade.

Not only do they have fewer tools at their disposal, but also the existing ones appear to provide weaker results. Furthermore, the prolonged use of the measures deployed after the 2008 crisis has also had unintended consequences and inflicted considerable collateral damage. Long periods of negative and ultra-low interest rates have encouraged the accumulation of bad debt, protected unproductive "zombie" companies and hurt the banking sector, as well as individual savers. Also, according to Barclays data, $12.5 trillion of investment-grade corporate and government bonds have negative yields, mostly in Europe and Japan, while according to Bank of America, 2% of European high-yield, or "junk", bonds are now also offering negative yields.

From a political point of view, the pressure for further monetary and fiscal accommodations appears to be mounting as well, especially in the U.S. where the 2020 election is already on the horizon. Support for radical ideas, such as Modern Monetary Theory (MMT), is also on the rise, promoting money-printing and deficit spending as economically viable and sustainable policy approaches.

Overall, interest rates are expected to remain at very low levels, while fiscal measures are likely to play an important role as well in most major economies. A decisive return to easing policies is very likely, as debt levels are too high, equity markets have grown too dependent on monetary policy support and the strain from a global economic slowdown continues to intensify.

The long-term outcome of these policies is unclear and likely entails significant risks, however, in the short- and mid-term they could continue to support the global economy and prevent a major correction in equity markets. Nevertheless, we do expect higher volatility going forward. As long as interest rates remain low, the real estate market could also continue to provide interesting investment opportunities, bonds will likely remain unattractive, while precious metals could benefit both from the upcoming interest rate cuts and from the expected uptick in market turbulence going forward.

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