Monthly Commentary

For wholesale investors only

The *IMF* clocked in with its *World Economic Outlook* update and, as now seems routine, set about reducing the bulk of its growth forecasts issued just four months ago. World output for 2019 was downgraded to 3.3% from 3.5%, the Advanced economies from 2.0% to 1.8% and Emerging Market and Developing economies from 4.5% to 4.4%. World trade volume growth which was projected at 4.0% received a substantial downgrade to 3.4%.

The *IMF* commented: "The global growth forecast reflects a combination of waning cyclical forces and a return to tepid potential growth in advanced economies; a precarious recovery in emerging market and developing economies, driven to a great extent by economies currently experiencing severe macroeconomic distress; and complex factors that shape the prospects for potential growth in both groups… the possibility of further downside revisions is high, and the balance of risks remains skewed to the downside." We have heard that language before.

Amid all this *IMF* caution the US economy blasted through with an *annualised* real GDP growth rate of 3.2% in the March quarter. This is the advance estimate which will be followed by at least two revisions (the next on 30 May). The average revision between the advance and second estimate is 0.5% and advance to the third estimate is 0.6% (without regard to sign), so history suggests that not too much reliance should be placed on this initial guesstimate. If we comb through the detail of the release by the *Bureau of Economic Analysis (BEA)* it is apparent that net exports provided an unusually large contribution (imports fell resulting in net exports contributing 32% of the percentage increase in GDP). Another unusually large contribution came from private inventory build (20% of the total change in GDP) whilst government expenditure contributed 13%. We will see what the next release brings.

Whole-economy corporate profits for the first quarter will not be reported by the *BEA* prior to 30 May so the latest available US profits data is through the 4th quarter of 2018. It discloses that pre-tax corporate profits rose by 7.8% in 2018 (3.1% in 2017). Profit margins remained close to an all-time high whilst the share of labour remained close to its all-time low. *After-tax* profits rose by 16.2% in 2018, much higher than the pre-tax increase, reflecting the Trump-sponsored corporate tax cuts.

Once again, the devil is in the detail. Much of the corporate economy in the US struggled in 2018 – recording lower profits. Down were manufacturing, wholesale trade, retail trade and transportation and warehousing. On the other hand, incoming profits from offshore businesses made a substantial contribution (net of payments to the rest of the world).

Over the long-haul profits rise at much the same rate as GDP as it is nonsensical to assume that profits will forever be grabbing a steadily growing or steadily falling share of GDP. If we pick our way through some of the ancient *BEA* releases we find that since 1950 nominal corporate profits and nominal GDP have both grown at an almost identical compound annualised rate: 6.5% for profits and 6.4% for GDP. The slightly higher rate for profits reflects its currently higher-than-normal share of GDP. Profits have of course been far more volatile than GDP. For example, between the end of 2006 and the end of 2008 pre-tax corporate profits fell by 37% whereas nominal GDP actually *rose* by 3.7%. Profits then quickly moved ahead and caught up with the GDP growth rate.

The US share market, in particular, is in an effervescent mood. We have little doubt that growth expectations for the economy and corporate profits have attained levels that simply cannot be achieved over the long-term. As we have remarked many times in the past it is inevitable that the US and rest of the advanced world will experience lower GDP growth in the future than in the past 60-70 years – thanks largely to demographic factors.

It is also worth reflecting on the extraordinary level of share buybacks in the US in recent times – shrinking outstanding issuance, increasing earnings per share and increasing corporate debt (to a record level relative to GDP). According to *S&P Dow Jones Indices* S&P500 buybacks totalled $806.4 billion in **2018**, up 55.3% year-over-year, and up 36.9% from the **2007** record of $589.1 billion. By **2009** buybacks had collapsed to just $137.6 billion. If stock markets are truly prescient buybacks should have been almost non-existent in **2007** but racing ahead in **2009**. We guess that answers that question.

Sticking with economics for the moment we note the latest hot topic is Modern Monetary Theory, or MMT. Our view is that one of the "M"s should stand for madness. The theory runs that if you have control of your own money supply deficits don't matter as you can always print as much money as you need. Japan is often held up as one of the poster-boys for this theory as it runs never-ending budget deficits and by the end of 2018 had expanded general government gross debt to 237% of GDP (source: *IMF*). It may not have escaped your notice however that despite all the deficits and prolific central bank buying of government bonds and listed equities (through Exchange Traded Funds) Japan doesn't qualify as a poster-boy for economic growth and an improvement in real living standards. An entire generation of savers has been disenfranchised through negligible interest rates whilst those that are in employment (a shrinking number) have not had an increase in real wages in many years.

Because interest rates are close to zero in much of the world the "experts" believe that monetary policy has run its course and fiscal policy is the only lever that governments have left at their disposal. Our view is that they should focus on why the world is in this predicament and not on the latest radical panacea. Is not the "predicament" something to do with too much debt?

Looking through the latest *IMF* forecasts it is clear that the US is already close to testing the MMT theory. It is expected to run budget deficits averaging 4.2% of GDP over the next six years whilst general government debt to GDP is forecast to reach 110% of GDP by 2024. Unlike Japan around 30% of US government debt is held by non-residents (mainly China and Japan) so that any loss of confidence in the US dollar because of escalating debts could have nasty consequences. In the case of Japan around 10% of the debt is held by non-residents.

Another fascinating calculation by the *IMF* is that between 2015-2050 the *net present value* of anticipated US healthcare spending changes amounts to a staggering 122% of GDP. They will have to run the printing presses flat out to pay for that. Data for other major countries: Canada: 46.8%; France: 30.6%; Germany: 47.8%; Italy: 40.8%; Japan: 72.0%; UK: 65.0%; Australia: 59.6%.

In Spain a rambunctious general election campaign appears to have handed controversial Socialist leader and current Prime minister, Pedro Sanchez, a surprise victory - provided he can cut deals with several smaller parties. The Prime Minister's party won 29% of the vote following a voter turn-out of around 75%. Somewhat controversially a new far-right party, *Vox*, won around 10% of the vote which will see it enter parliament for the first time. The formerly dominant conservative *Popular Party* lost around half its seats.

The splintering of the traditional political establishment is happening throughout Europe. Spain has also been dealing with the Catalan separatist movement which has proved divisive. Mr Sanchez has taken a leaf out of the MMT gospel by promising to substantially ramp government spending (and upset many other eurozone leaders). The only problem is that Spain has no control over its currency. This could prove interesting.

In Beijing China's President Xi Jinping has announced a planned expansion of its Belt and Road Initiative (BRI) to embrace broader economic and social co-operation between signatory countries. To quote the President: "We need to promote a global partnership for connectivity…we will transcend geographical distance and embark on a path of win-win co-operation…we want to sow the seeds of co-operation, harvest the fruits of development, bring greater happiness to our people and make our world a better place for all."

The BRI was initially conceived as a series of widespread infrastructure projects (roads, ports etc.) but it seems that China's ambitions now extend further. Around 120 countries have already signed various agreements as part of the project. The stated goals are lofty and idealistic, but some have questioned China's motives. The tentacles of the communist superpower already spread far and wide and the expanded BRI will ensure further influence and spread. Legitimate questions are also being asked about cost and return. We don't know the answers, but we understand the reservations that have been expressed.

Looking elsewhere we note that Brexit has once again been postponed. Any further comment will induce boredom.

Share markets extended their bull run in April providing excellent returns in the year-to-date. In local currencies and utilising MSCI price indices the month's stars were: Sweden (+7.4%); Austria (+ 6.7%); Germany (+6.7%); Singapore (+6.5%) and Ireland (+6.1%). It is interesting that out of these top five only the Swedish market is

higher than 12 months ago. Performance in other selected markets in April: France (+4.4%); USA (+3.9%); Spain (+3.6%); Canada (+3.5%); Switzerland (+3.0%); Australia (+2.1%) and Japan (+2.0%).

Yields at the benchmark 10-year maturity in government bond markets nudged marginally up in the US, UK, Germany, Australia, Canada and Japan – although the Japanese yield remained below zero. The inverted yield curve in the US (difference between the 10-year bond yield and 3-month treasuries) which grabbed attention during March returned to a tiny positive of approximately 0.08% at the end of April. In other words, the yield curve remains very flat.

Bond yields virtually everywhere are absurdly low. Even Germany, the largest and most solvent country in the eurozone bloc, has a 10-year bond yield of precisely zero. What does that tell the world about growth prospects? The latest OECD productivity calculations (GDP per hour worked) indicate that Germany managed an average productivity growth rate of only 0.7% over the last five years. The eurozone in aggregate achieved a rate of only 0.6%.

It is clear that the financial environment experienced since the end of the global financial crisis has been little short of crazy. We doubt that it is about to change.

Pyrford International
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