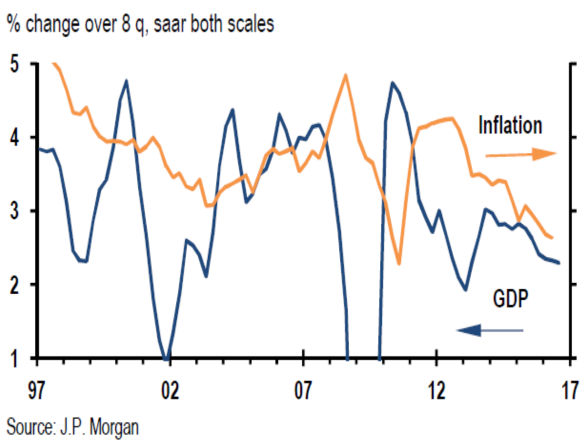
COVENANT CAPITAL

The Month Ahead Aug 2016: Me Before You

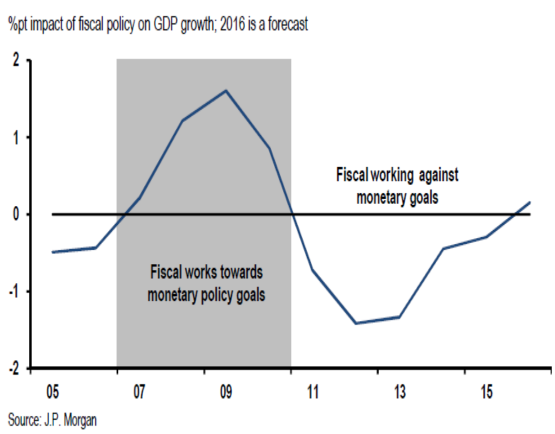
In recent months, the clarion call to increase fiscal policy before more monetary accommodation can be deployed has been sounded by several institutions including the G7 and even the ever-miser IMF. This call for greater synchronicity between fiscal and monetary actions is largely in response to persistent sub-par growth and declining inflation expectations witnessed over the last four years for the global economy. Looming doubts of the efficacy and the limits of central bankers' further monetary largess conflate the concern. Global real GDP has only grown 2.6% pa from 2013-2016; a good 1% point below its full potential and below the previous 2 global expansions. Global headline inflation remains below central bankers target as well with global headline CPI inflation averaging 1.7% since 2013; the lowest recorded during an expansion in the past half-century.

Immediately post the global financial crisis in 2008, many economies utilised a combination of super easy monetary policy and expansionary fiscal policy to stimulate growth allowing the global economy to grow by 5.4% 2010, 4.2% in 2011, 3.5% in 2011. However, since the implosion of the Greek economy in 2011 which subsequently posed an existential risk to the whole of Europe, a new accord of fiscal austerity took place throughout Europe. Furthermore, the global economy never reached its full potential as an ill-conceived hike in consumption tax in Japan, followed by China's economic restructuring and the ensuing impact of a calamitous decline of commodities prices created significant headwinds for growth.

Disappointing growth and inflation



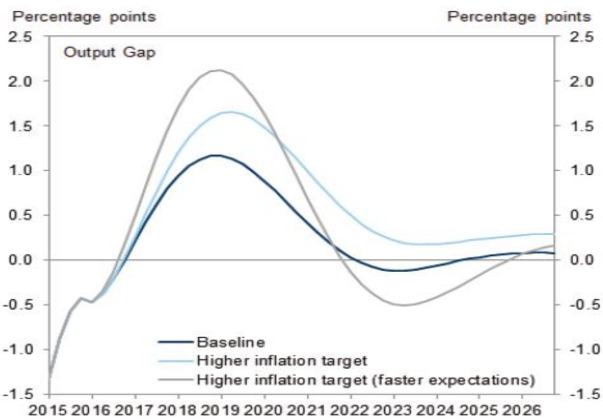
Fiscal tightening have hampered monetary loosening



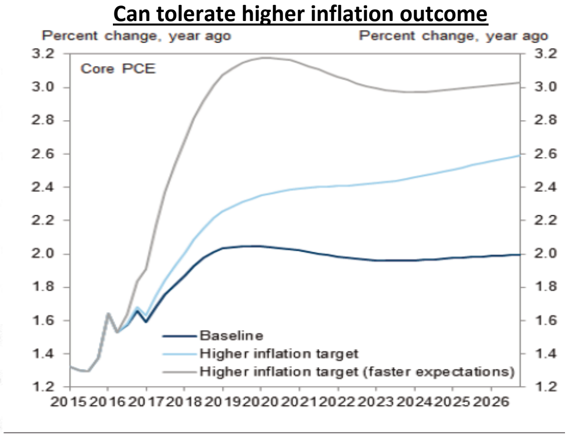
Market participants renewed sense of urgency of what else can be done should the economy slip into recession is accentuated as the litany of countries pursing negative interest-rate increase by the quarter (7 and counting) while close to 50% of global government bonds now yield zero or negative returns. There are several options that are being studied by various central bankers with their governments and they include both conventional, hybrid and outright controversial ideas. The conventional approach maintains the status quo with central banker's independence respected but with moral suasion from the central banks directed towards their respective government to deploy fiscal impulses. The hybrid approach is what economist would term economic thresholds dependent policy. This include expanding its original mandate of stable inflation and full employment to specific economic goals such as nominal GDP or higher inflation targets. The last and most controversial involves the central bank comingling monetary and fiscal policies with the central banks financing fiscal plans through an increase in money supply that doesn't pay interest on excess reserves. The last specific is important as it does not increase future tax burdens, induce crowding out effects hence Ricardian Equivalence is avoided. Helicopter money is considered a form of this type of coordination whereby monetary authorities abandon the inflation objective and alter the path of interest rate policy to fund fiscal objectives. This approach is labelled controversial because central banker loses its independence and could in future be raided by existing government to pursue their political agenda beyond economic considerations.

Recent research piece from FED Governor, John Williams of San Francisco, seems to presage the possibility of the hybrid combination. In the paper, he has urged central bankers to rethink the standard framework of targeting stable inflation and full employment in light of the probability the world is set for a lower equilibrium rate in face of lower future growth environment. He specifically mentions threshold dependent policy may include targeting a higher level of inflation and towards GDP targeting. The latter is a tectonic shift for someone who is considered a hawk. Do bear in mind, the FED current mandate is stable inflation and full employment. The purview of GDP outcome targeting is never its responsibility. That is confined to the whims and fancies of the ruling party via fiscal impulses and animal spirits of consumers and corporates. According to GS, should FED adopts a higher inflation mandate, the outcome would be positive as the market is aligned to think asset can be utilized more while the subsequent increase in higher core PCE read is acceptable.

Asset can be utilized higher



Can tolerate higher inflation outcome



Source: Goldman Sachs Global Investment Research

The timing of such discussions cannot be more urgent. For 2016, we have fiscal thrusts aiding an already tepid growth by 10bps with positive accretion arising in US, Europe, Japan and EM Asia. However, if current policy stance is not altered, come 2017, fiscal thrusts experienced in 2016 will become drags subtracting 10bps from growth with only Japan as the major economic bloc stimulating further, China subtracting while Europe and US are unchanged. To borrow the term made famous by celebrity ex-couple, Chris Martin and Gwyneth Paltrow, this conscious decoupling between fiscal and monetary policy will continue to adversely affect growth.

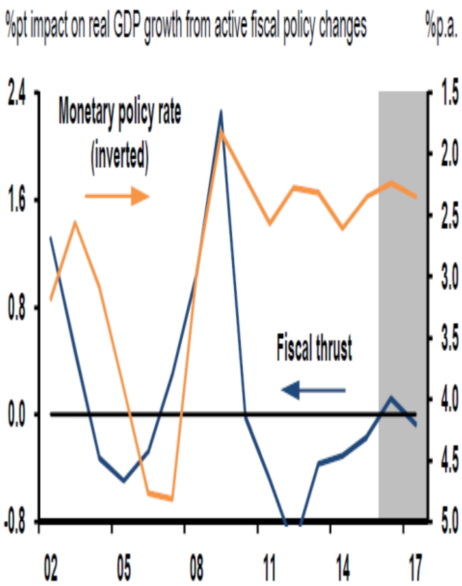
Fiscal thrust becomes a drag again 2017

%-pt impact on real GDP growth

	2013	2014	2015	2016	2017
Global	-0.4	-0.3	-0.2	0.1	-0.1
Developed	-1.2	-0.4	-0.2	0.2	0.1
US	-2.2	-0.5	-0.4	0.3	0.0
Euro area	-1.1	-0.4	0.0	0.1	0.0
Japan	0.6	-0.9	-0.4	0.1	0.6
UK	-1.0	0.4	-0.5	-0.5	-0.1
Other	0.3	-0.1	0.3	0.4	-0.2
Emerging	1.1	-0.1	0.0	0.0	-0.3
EM Asia	1.6	-0.3	-0.1	0.3	-0.2
China	2.4	-0.5	-0.4	0.4	-0.1
India	-0.3	0.5	0.1	0.2	-0.6
Korea	0.4	-0.1	0.9	0.2	-0.4
Other	0.1	0.1	0.4	0.1	-0.1
Latam	0.4	0.7	0.2	-0.5	-0.6
Brazil	0.4	0.9	0.1	-0.4	-0.5
Mexico	-0.3	0.5	0.0	-0.5	-0.8
Other	1.1	0.6	0.4	-0.7	-0.7
EMEA EM	0.3	-0.7	-0.1	-0.3	-0.4
Russia	1.3	-0.9	0.1	-1.0	-1.0
Turkey	-0.7	-1.3	-0.3	0.3	-0.2
South Africa	0.0	-0.2	-0.2	-0.4	-0.4
CEE	-0.6	-0.2	-0.2	0.6	0.6

Note. Fiscal thrust defined as the change in the structural deficit as a % of potential GDP as projected in the April 2016 WEO report. For the major economies, these figures are adjusted judgmentally by J.P. Morgan economists. Source: J.P. Morgan and IMF

Conscious decoupling hurting growth

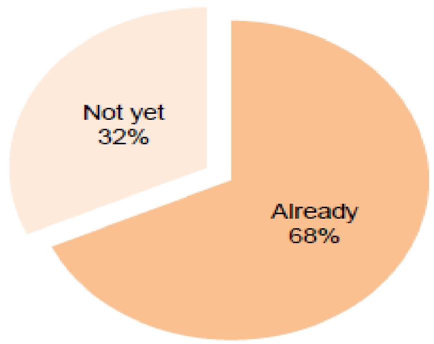


Source: J.P. Morgan, IMF

Another "Me Before You" conundrum that is impacting growth is China's SOE reform plan. While it was launched 2 years ago with much fanfare, the momentum in the past 12 months have stalled. However, recent developments including the permission by the authorities to allow several SOEs to default on their bond obligations seems to point renewed vigour to restructure zombie SOEs. Comments from recent working committee and specific documents issued by the State Council and State-owned Assets Supervision and Administration Commission of the State Council (SASAC) have provided the critical legal and political framework to push through this initiative. We interpret the recent lower than expected monetary and total social funding where a visible decline (yes you read it right; negative year on year comparison) in corporate loans underscore the conviction to stymie liquidity to such SOEs.

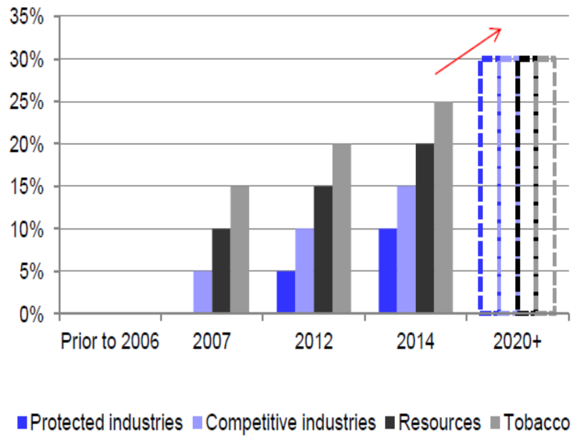
Central SOE reforms will focus on 1) piloting state-owned capital operation and investment company reforms, including the delegation of operating powers, market-oriented recruitment of managers and adjustment of the pay system; and 2) merger and reorganization in the overlapping fields of supply-side reforms such as coal, steel, building materials, nonferrous metals, machinery, construction, shipping and tourism industries. At the local level, the focus is for central government to support local SOEs in provinces where they are less developed, through a combination of merger with central SOEs or local enterprises that are financially stronger and more capable. They are also demanding SOE increase their payout ratios. If implemented, it will bring about long term benefits to the country. But in the short-ran economic momentum will slow down as China undertake these much needed reforms.

CICC-covered SOEs: planning or already conducting SOE reforms?



Source: CICC Research

Government demanding higher dividend payout



Source: Deutsche Bank, Global Times

Asset Allocation Strategy:

The reason in the past 3 months we have written a whole megillah about fiscal policy and greater coordination between fiscal and monetary actions is because should both materialise, our defensively postured portfolio could be adversely affected. If growth concerns abate, the market will be prompted to rotate from income related strategies that features prominently in our current portfolio to growth strategies such overweight equities underweight bonds, buying cyclicals sectors and commodities and further extension of EM currencies strength against the USD. For now, we stick to our current defensive portfolio stance with neutral in equities, overweight in fixed income, dollar long overlay and zero exposures in commodities. We have been raising cash again after redeploying all of our cash post Brexit as we contended the impact of Brexit is largely localised. We are also acutely cognizant that August is the worst monthly performance for all major equities markets in a year. It has been down 13 of the last 25 years, have the worst monthly performance in the year of -1.02% on average and is the month which has four of the top 15 worst months in the past 25 years.

Equities: Reduce to Slight Underweight. We are slightly underweight equities with Asia as our major overweight and US the underweight. We retain a larger portion of our equities exposures via alternatives hedge funds in US and Asia and small cap manager in Japan, Europe and Asia.

Fixed Income: Overweight. Within fixed income assets, our preference is for emerging markets and high yield credits versus government bonds and investment grade. Among the government bonds, we continue to switch from US to UK given BOE renewed QE.

Commodities: Unchanged Neutral on Oil but long Gold looking precarious; time to exit.

FX: Unchanged maintain the view to get back long USD and Short JPY and SGD.

Alternatives Investments: Increasing for non-correlated market returns. We continue to like non-correlated strategies like our quantitative trend follower manager, long/short equities managers in the US and Asia. We have also been very bullish about real estate particularly in Europe and Japan and look to introduce more private equity real estate managers.

Featured Picture/Quote: A real good butterfly

Edward Lim, CFA

Chief Investment Officer