Financial Markets Review

June 10, 2016

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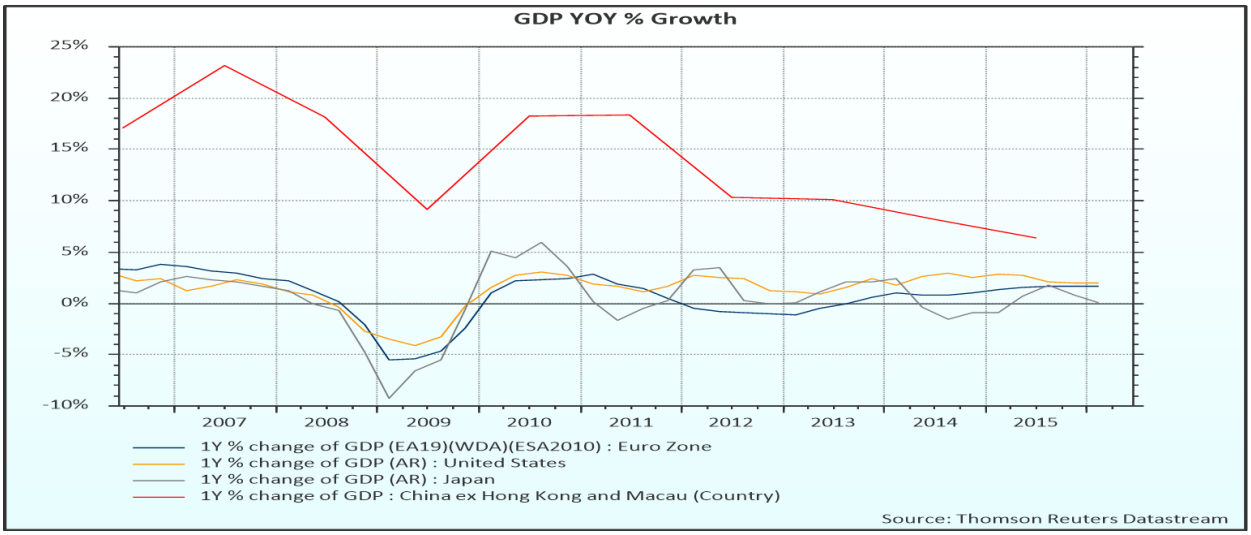
Objective

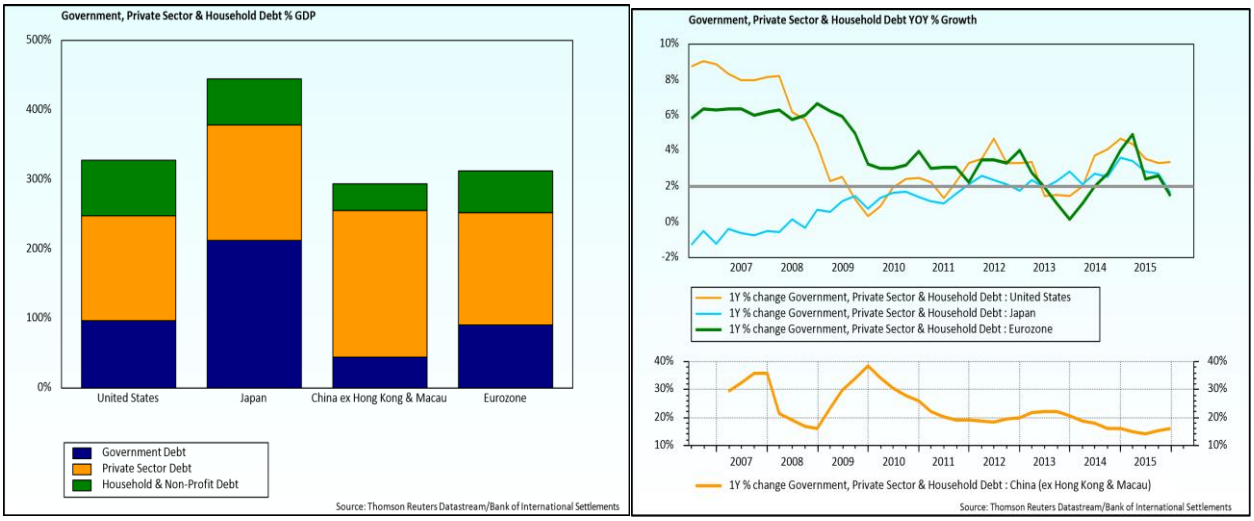
The objective of this review is to provide an overview of global economic variables, corporate fundamentals, interest rates and central bank policy. This information can then be applied towards asset allocation decisions and the identification of further areas of research.

Macro-Economic

Global GDP growth has been too slow following the financial crisis of 2008, prompting major international institutions such as the BIS, IMF and the OECD to become increasingly vocal in their suggestions that governments should take proactive action in terms of fiscal policy to aid their economies. The main reason behind their pleas is that, notwithstanding the unprecedented stimulus provided by monetary policy, economic growth is still low, thereby leading to high Debt/GDP ratios. In light of increasingly deflationary pressures, debts will become unsustainable. The chart hereunder outlines how growth rates in the United States, Europe and Japan have been slowing and/or range bound, whilst China's growth rate is decreasing. Therefore, it is important to assess why growth rates have been persistently low over the last few years.



Debt to GDP



A significant contributor to the low GDP growth rates are high levels of Debt/GDP ratios. In the expansionary economic phase leading up to the crisis of 2008, deficits failed to be reduced, leaving governments with limited ability to apply fiscal policy initiatives to counteract the deleveraging and contractionary effects of the recession. Although significant resources were allocated to the banking sector, little was done in addressing the contraction in other sectors of the economy.

A salient point from the data is that although debt is growing between 2% to 3% a year, this is not being translated in higher growth rates. The focus should not be solely on the quantity of debt but also on the qualitative nature of the debt. The debt issued is not producing a return that is commensurate with the repayment of interest and capital, since a large proportion is being deployed towards entitlement programs that add little value to the economy, programs that are increasingly difficult to reverse due to political ramifications.

A good example of this are the troubled European economies commonly known as the PIIGS (Portugal, Ireland, Italy, Greece and Spain). All countries forming part of the Eurozone have to abide by the rules outlined in the Maastricht Treaty, with the two main pillars of the treaty being Debt/GDP ratios of 60% and budget deficits that do not exceed 3% of GDP. The treaty was the bedrock for the creation of the Euro and laid out these rules to promote price stability in the region by discouraging participating countries from pursuing inflationary policies and currency devaluations, a requirement strongly adhered to by Germany following the Weimar Republic hyperinflation episode between June 1921 and January 1924.

Following the introduction of the Euro, these countries (PIIGS) found their cost of borrowing decrease considerable due to a substantial reduction in foreign exchange risks. Although countries meet the criteria established by the treaty, these targets were on numerous occasions meet by the privatization of public corporations which left a windfall in government coffers, but also created a short fall in government revenues through the loss of dividends. Instead of taking advantage of the lower borrowing cost to implementing structural reforms, countries such as Spain, Portugal, Italy and Greece enacted unsustainable entitlement programs. When the recession hit, these countries were found unprepared due to the un-competitiveness of their industry, rigidity of labor laws and liabilities that could not be paid. The common currency (Euro), up to this point a blessing, immediately became a headache because these countries could not use their preferred tool, currency devaluation to work themselves out of the recession. Unable to use currency devaluations, all economic adjustments had to be made through spending cuts to avoid a default, leading to even weaker economic growth.

These challenges resulted in negative to low growth all across the Eurozone, not only due to lack of confidence but also because a lot of legislative effort and energy was devoted in devising bailout packages. The structure of the European Union, with a central planner, a common central bank, but with no common capital market leads to rigidity in dealing with these situations, especially in the context of the Maastricht Treaty. The enactment of a common policy to deal with all these different economic structures, cultures and values amplify economic challenges leading to political gridlock, unrest and in a number of cases the emergence of far right wing politics. In addition, the inability of countries in the Eurozone to complete a proper debt restructuring and/or the ability to get proper debt relief had a material impact on economies leading to no improvements in Debt/GDP ratios albeit with some improvement in budget deficits due to cost cutting.

It is evident that the relative outperformance of the United States economy versus the European economy comes down to the increased flexibility in labor markets, deep capital markets and a more harmonized economy. However, it should be noted that both Europe and the United States are in need of deep structural reforms in the form of higher research and development, infrastructural spending and worker training that could boast growth through productivity and therefore lower the debt burden.

The expansion of fiscal policy which is being advocated by major international organizations should carry the primary objective of structural reforms in Europe and secondly target initiatives that can support economic growth in the long run.

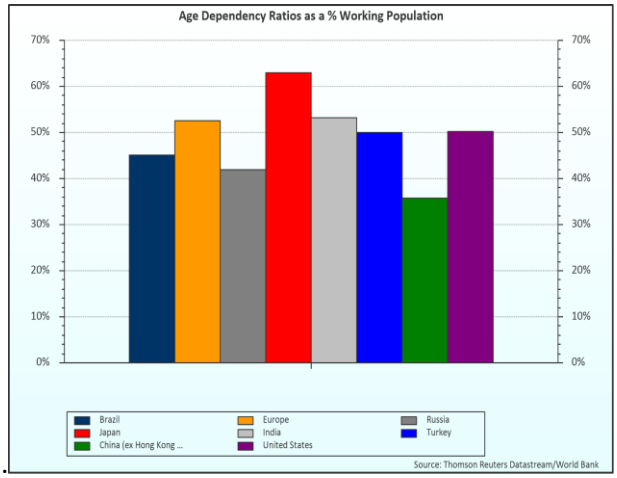
The limitations imposed on the economy by unproductive debt also manifest themselves through interest payments representing a bigger share of GDP. In an economy with a debt to GDP ratio of 200% and an interest rate of 2%, 4% of GDP will be absorbed by interest payments. A situation represented by Japan.

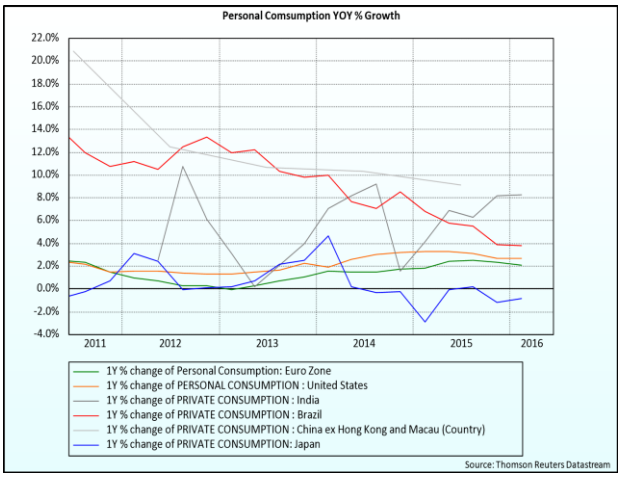
Productivity

Since economic growth is a function of increases in productivity and workforce population, it is helpful to look at measures of productivity to assess the prevailing trends. The chart above shows that year on year growth in productivity has been declining, concurrent with a decline in private sector investment. Investment is a critical driver of productivity, due to better education of the workforce, advances in technology and increased efficiency of resources. Demographics also provide valuable insight, although they are long term structural forces that are more difficult to influence.

The 1990's and early 2000's have been characterized by sizeable marginal gains in technological advances, leading to equally sizeable investments initiated by the private sector to maintain competitiveness. This led to increases in productivity ranging between 2%-4% on a year on year basis thereby supporting economic growth. The last two decades were characterized by the rise of globalization and the emergence of emerging markets such as China, India and Brazil together with a host of other emerging economies in Asia and Latin America. Although this development supported global aggregate demand, it also led to increases in global capacity and over investment, especially in emerging markets. This overcapacity coupled with low consumption growth (*chart below*) and increased regulation, is unlikely to be supportive of near term investment from the private sector, until capacity is absorbed or retired and/or consumption resumes a healthy growth clip.

This void has to be filled and government initiatives should be initiated to propel productivity. History teaches us that public sector investments such as the interstate highway project and the space program all contributed to advances in various sectors of the economy, directly or indirectly.



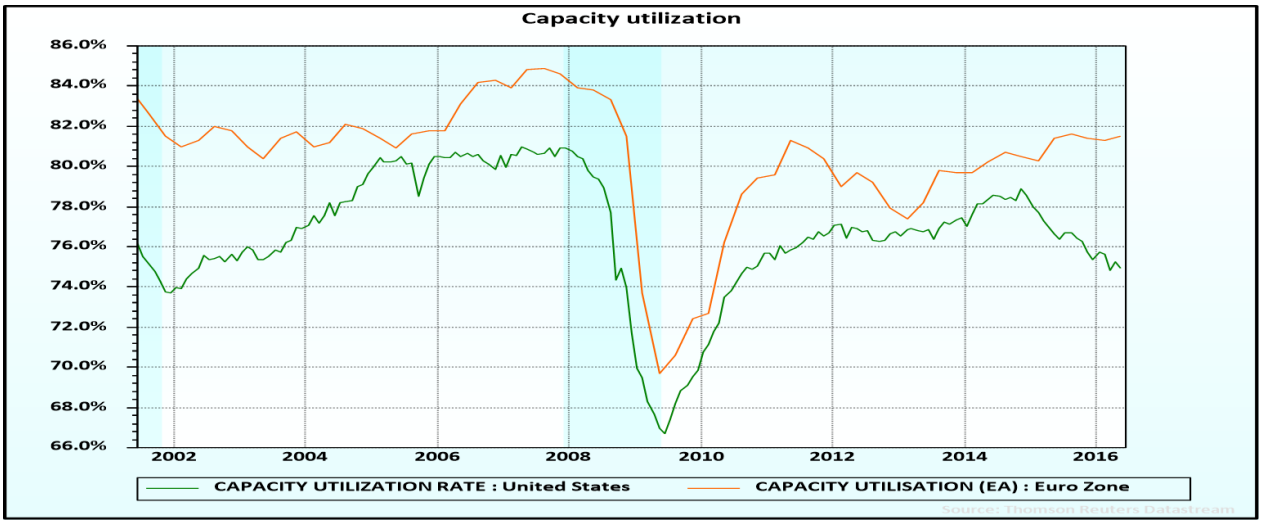


A look at demographic profiles reveals that age dependency ratios are in long term uptrend, most notably in the developed world, leading to a shrinking labor force and a reduction in potential output.

Inflation

The policy response to the Great Recession of 2008 was a reduction in interest rates and the expansion of central bank balance sheets through the implementation of quantitative easing programs. One of the major concerns of these injections of liquidity, was that this would lead to higher inflation. Higher liquidity leading to higher inflation is based on the economic principle that all else being equal, a higher quantity of money supply chasing the same amount of goods and services should lead to higher prices and therefore inflation. So, why has inflation not materialized? The reason is deleveraging. The leveraging of central bank balance sheets was meet with a corresponding deleveraging of household and corporate balance sheets, leading to no pressure on inflation and inflation expectations.

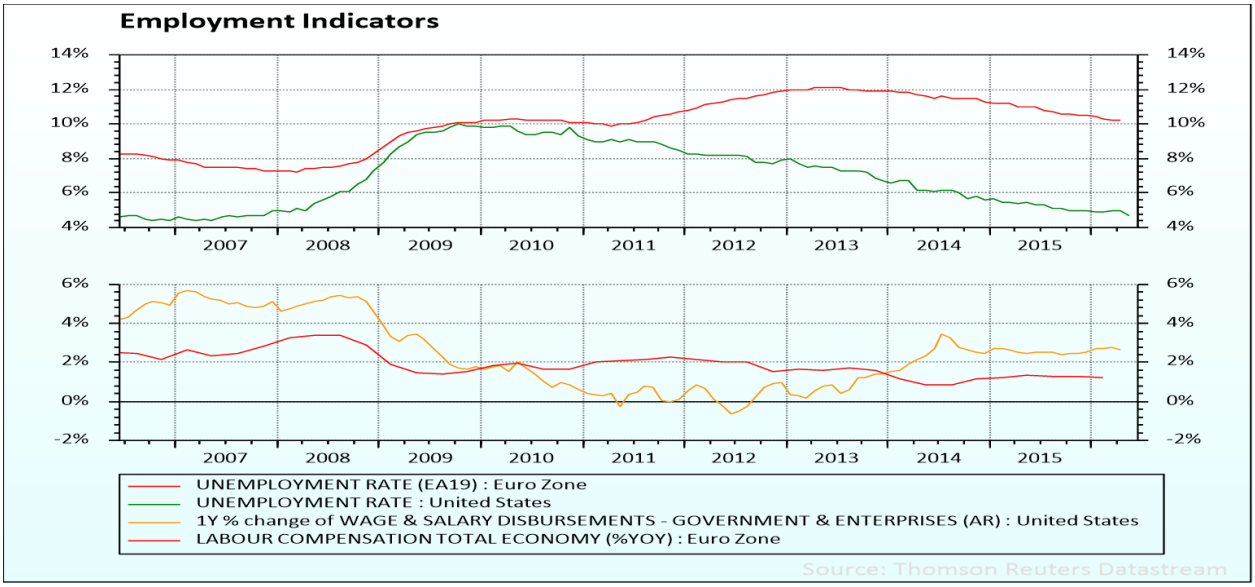
In the years leading to the financial crisis, emerging markets, most notably China had their GDP Growth propelled by an unprecedented investment boom. This contributed to a lot of excess capacity. Other emerging markets such as Brazil also took advantage of their strong currency and borrowed USD dollars that have been funneled into capacity expansion.



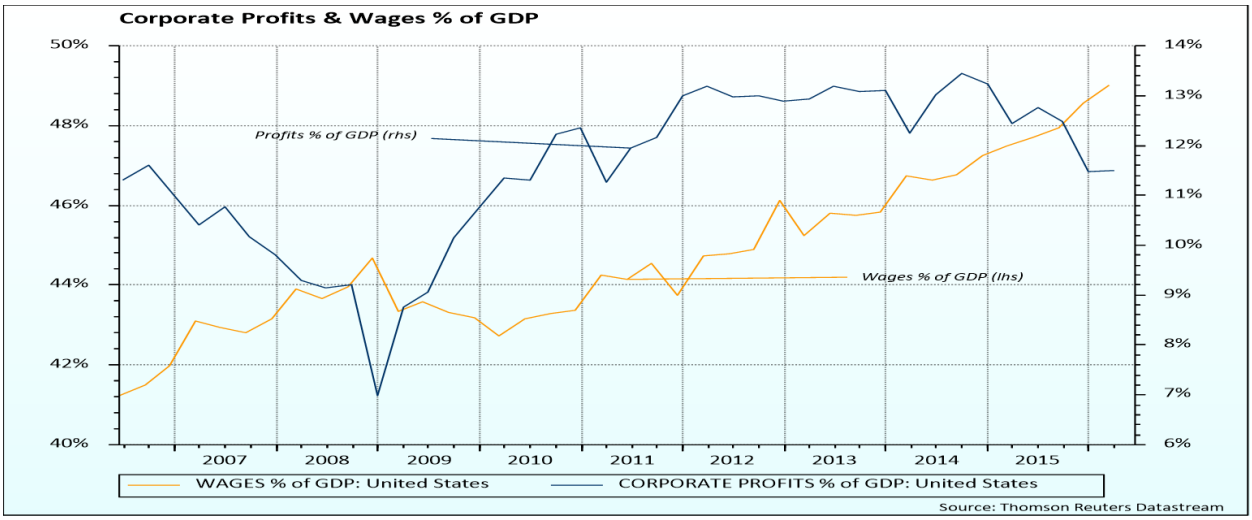
Nonetheless, over the last few years, capacity utilization has been trending higher in Europe and the United States. The divergence between the European measure of capacity utilization and the United States since 2015 can be attributed to the contraction in the oil and gas industry in the United States which coincided with the drop in the price of oil and capacity coming offline. The following table shows the increase in the job growth and subsequent decline that was experienced during the last decade in the oil & gas energy sector.

Oil & Gas Energy Sector - All Employees (000's)											
Year	FEB	FEB	FEB	FEB	FEB	FEB	FEB	FEB	FEB	FEB	FEB
Month	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
No of Employees	130.00	141.70	155.00	164.40	156.40	164.20	182.60	194.90	195.50	197.20	179.70
% YOY Growth	5.61%	9.00%	9.39%	6.06%	-4.87%	4.99%	11.21%	6.74%	0.31%	0.87%	-8.87%
											Source: BLS Data Series

Assuming that the recent rebound in commodity prices is sustainable and job growth is resumed in the energy sector, both the US and European economies will be approaching the upper bound of capacity utilization. In order for inflationary pressures to emerge from full utilization rates, employment and wages play an influential role.



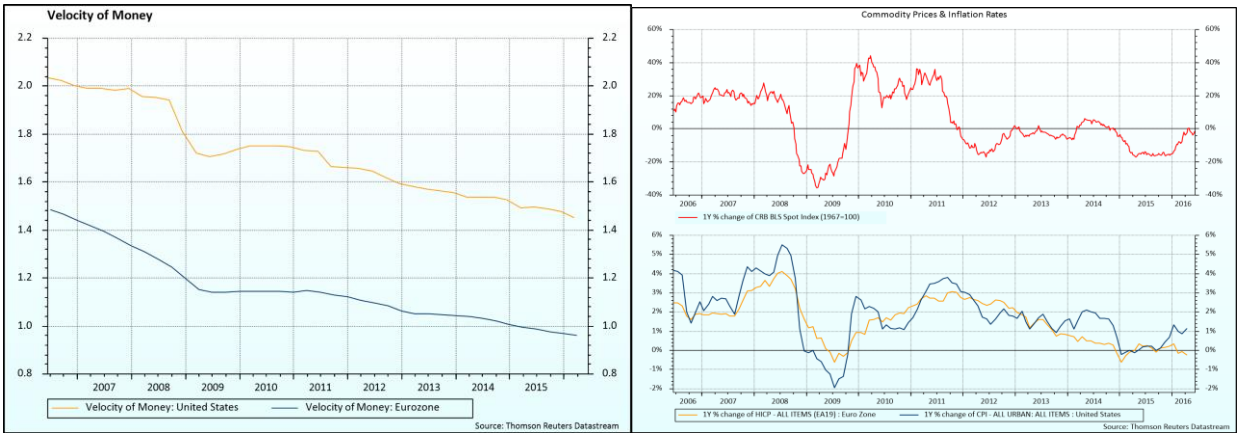
The chart above shows the marked difference in the labor markets of both countries. The US economy has almost reach the point of full employment, whereas Europe still has ample room to reach full employment at approximately 7%. In addition, labor cost are increasing at a higher rate (+2%) in the US compared with Europe (+1.3%), thereby indicating that any wage cost inflation has a higher likelihood of materializing in the United States than in Europe.



In the US economy, high capacity utilization, low unemployment rate and wage cost pressures could portend to inflationary pressures, however, inflation will materialize if corporations are able to pass these higher operating cost via price increases of their products and services. In other words, can corporations maintain their profit margins? Judging from the above chart outlining corporate profit and wages as a percentage of GDP, corporations are absorbing the costs via margin compression. It should also be noted

that companies have varying degrees of control in the transmission of higher cost into higher prices. Companies focused on the production and sale of commodities have their selling prices determined by international markets, companies involved in old economy products are experiencing margin compression due to increased competition from emerging markets leaving them with few options but to merge to find additional sources of efficiency, while other specialized sectors such as engineering and services tend to enjoy more pricing power.

An other element of inflationary pressures is the velocity of money. This economic indicator shows how much one unit of currency changes hands in the economy, a measure of the multiplier effect. A similar interpretation is how much a unit increase in money supply generates in GDP. The chart outlines that a US $1 increase in monetary supply produces $1.35 in GDP, in Europe the ratio shows that a €1 increase in money supply corresponds to a €0.95 increase in GDP. This indicator shows that deflationary forces are still present in both the European and US economies. Inflation is unlikely to take hold without increases in this indicator, therefore, it should be monitored carefully bacause subtle changes can have material impacts on inflation readings and consequnetly real rates.



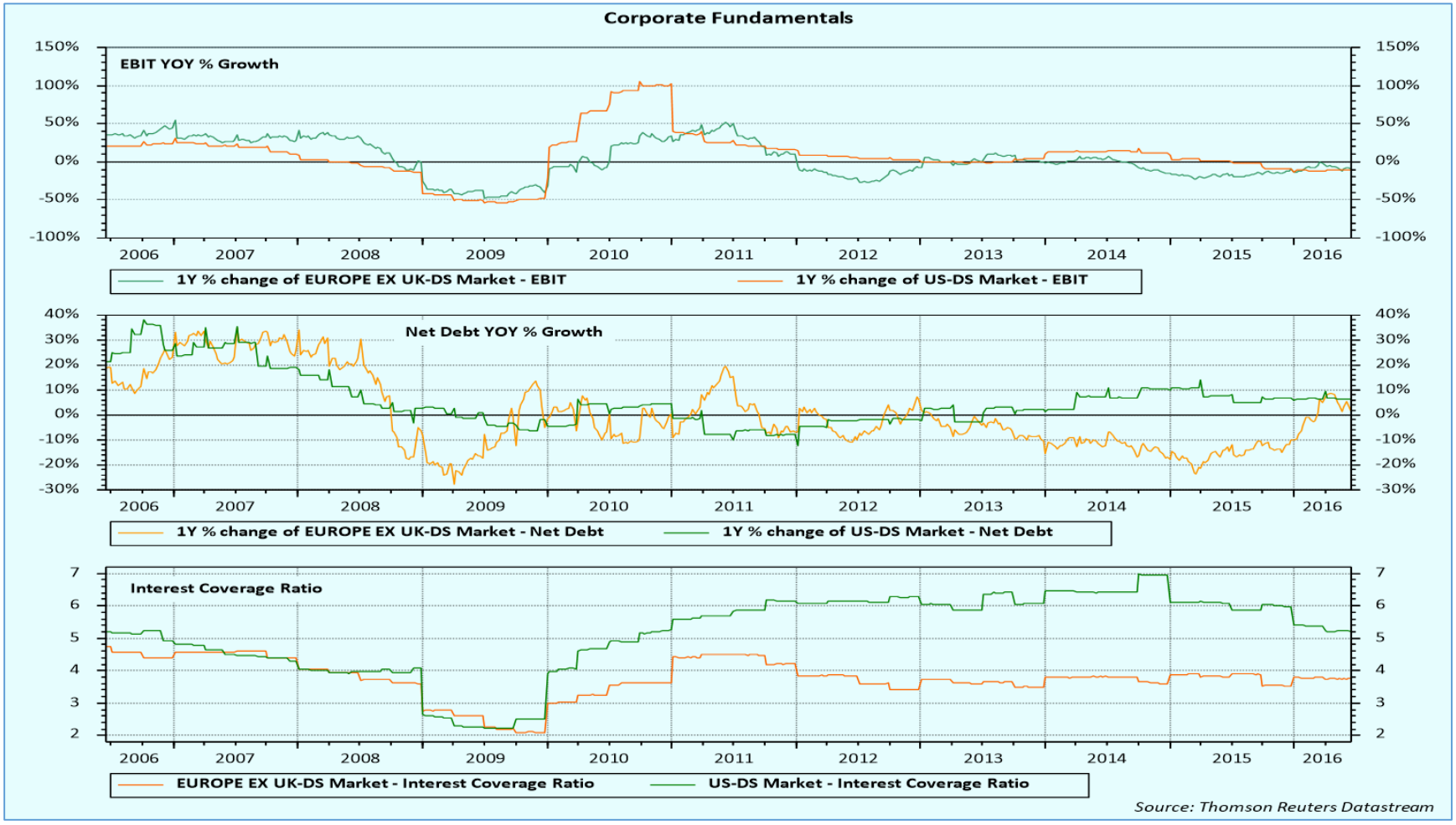
Commodities are another source of inflation. The chart above shows the relationship between the CRB index and the rate of inflation in the United States and Europe. The rate of change in the price of commodities has been in a downtrend since 2011. As mentioned in the previous sections of this report, this could be attributed to the expansion of capacity in emerging markets. A case in point is the increase in steel production in China and the advent of shale oil in the US resulting in excess supplies in both markets without any corresponding increases in aggregate demand. The price declines in 2014, 2015 and the subsequent rally in 2016 should be carefully evaluated. The introduction of steel production on the upcoming G20 agenda and recent data by the EIA outlining an improvement in the demand/supply

imbalances indicate a bottoming process. Therefore, although deflationary pressures from commodities are waning, inflationary pressures are also unlikely in the next few years due to the low level of growth.

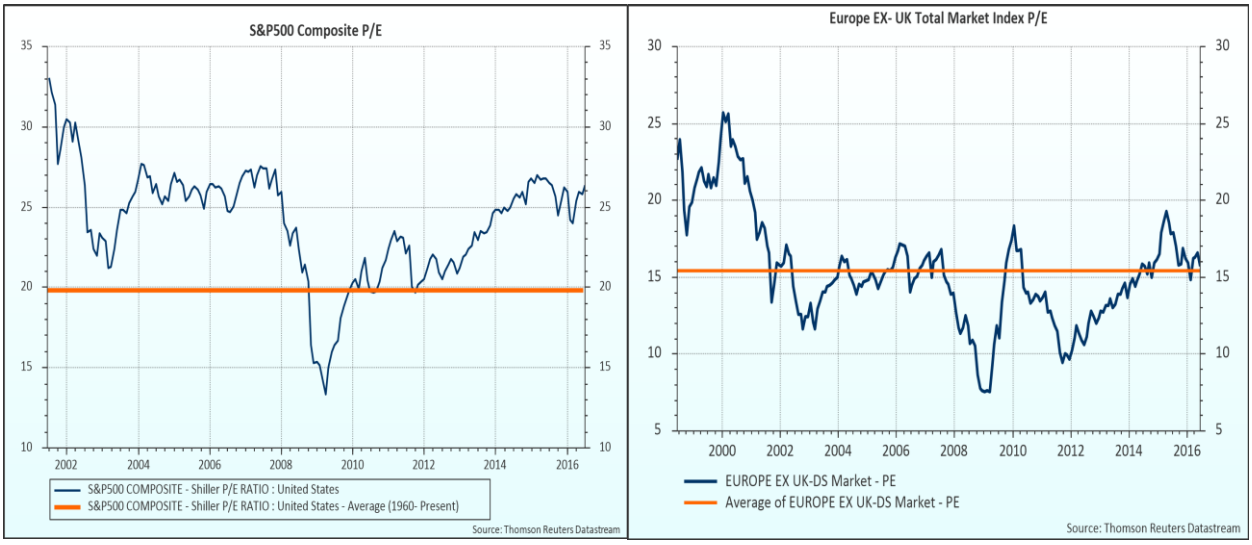
Corporate Fundamentals

In the preceding sections we focused on the macro-economic environment. At this point, emphasis should be placed on corporate fundamentals to determine whether the data is supportive of additional strength in financial markets and whether financial instruments have drifted from their true economic values.

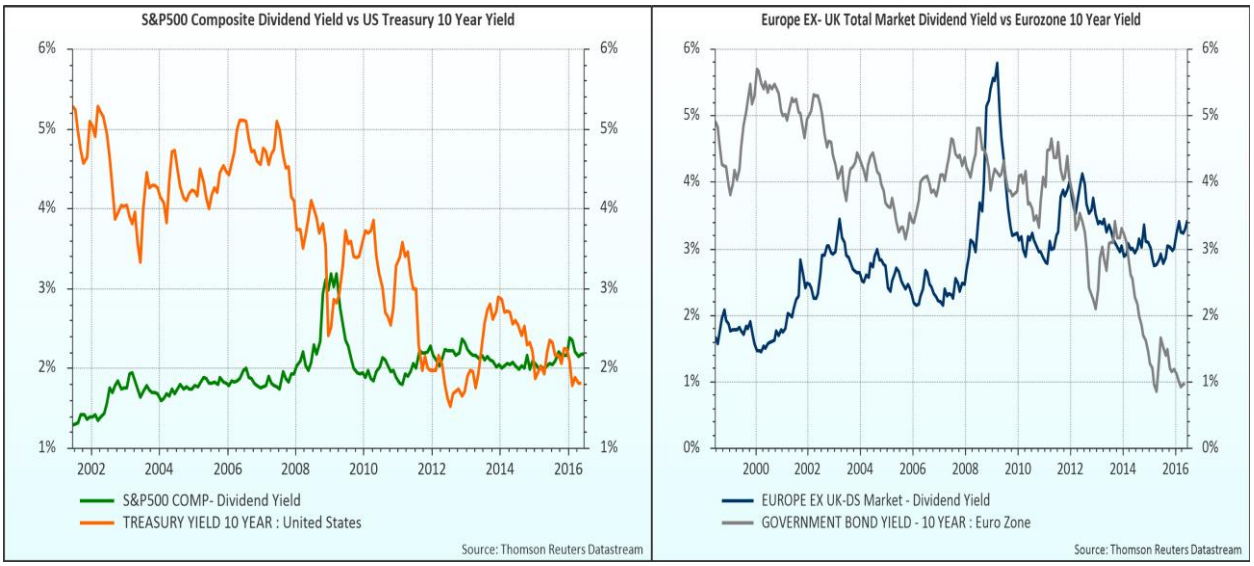
The chart below outlines year on year percentage changes in operating earnings (EBIT-Earnings before Interest & Taxation) and net debt, together with the interest coverage ratio for the United States and Europe (excl. United Kingdom) total market indices. These indices have a larger constituent base and should provide a more accurate representation of the total economy. The data shows that EBIT growth has been declining significantly in the US with the annual growth rate now negative. In Europe, the growth rate has been in negative since early 2014, but has since been recovering with declining negative growth rates. Coincident with this development, US companies have been increasing their net debt at a clip of 8%-10% since 2010 with no corresponding increase in earnings growth, whilst in Europe net debt growth has been negative since 2012 but as with earnings, the negative growth rates are getting smaller. This failure of earnings growth to keep pace with net debt growth also explains the decline in the interest coverage ratio in the US. However, these interest coverage ratios are in the context of historically low interest rates. In addition, the data also suggest that US corporates have used this increase in debt to finance dividends and buybacks. The current pace of dividends and buybacks are simply unsustainable without an improvement in earnings growth.


Corporate Fundamentals
EBIT YOY % Growth
150%
100%
50%
0%
-50%
-100%
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
1Y % change of EUROPE EX UK-DS Market - EBIT
1Y % change of US-DS Market - EBIT
Net Debt YOY % Growth
40%
30%
20%
10%
0%
-10%
-20%
-30%
1Y % change of EUROPE EX UK-DS Market - Net Debt
1Y % change of US-DS Market - Net Debt
Interest Coverage Ratio
7
6
5
4
3
2
EUROPE EX UK-DS Market - Interest Coverage Ratio
US-DS Market - Interest Coverage Ratio
Source: Thomson Reuters Datastream

Declining earnings and increases in net debt, support the fact that recent market returns have been driven by multiple expansion. One of the most popular measures of equity valuation is the P/E ratio. The chart hereunder depicts this measure of valuation for S&P500 composite and the European Total Market Index (excl.UK). The Shiller P/E ratio which provides a more accurate measure by normalizing earnings for inflation is being used for the S&P500. The main inference from the chart is that based on this valuation measure, both the US and European markets are overvalued compared to their long term averages, but the extent of overvaluation is more pronounced in the case of the S&P500. Based on these long term averages and assuming a revision to the mean, it could be implied that a fair value for the S&P500 would be approximately 1600, whilst in Europe, mean reversion would imply a level of 1788, an overvaluation of approximately 23% and 9% respectively.



An often cited measure to support the current high level of P/E ratios compared with their historical averages, is the dividend yield. The underlying chart compares the index dividend yield to the corresponding 10 year yield.



Although the spread between dividend yields and government bonds is positive, justifying the valuation of equities based on this measure has two major flaws, namely risk and duration. Apart from the fact that government bonds in these countries carry much lower risk due to lower volatility, a US Treasury with a maturity of 10 years has a modified duration of 8.86 while the S&P500 has a duration of 45 based on the price/dividend ratio. A similar computation for the European markets would yield a modified duration of 9.25 for the government bond and a duration of 31 for the index. Duration has important implications for investors since portfolios should be constructed to reflect the expectation of investors' spending habits. Age dependency data (discussed above) would suggest that investors should seek to shorter the duration from their portfolios by reducing their allocation to equities.

The premise that both equity and corporate bonds are a claim on the future cash flows of an entity, a way to look at market valaution is by calculating the intrinsic value of the market based on the expectation of future cash flows through dividends and buybacks.. This can be computed by a variation of the dividend discount model. The calculation hereunder shows an example of this approach to detemine the intrinsic value for the S&P500.

The assumptions applied: (i) Growth Rate in earnings is based on Reuters forward earnings estimates; (ii) Risk free rate = US Treasury 10 year yield; (iii) Equity Risk Premium = historical average returns of equities over treasuries; (iv) Historical average distribution of dividends and buybacks as a percentage of normalized earnings.

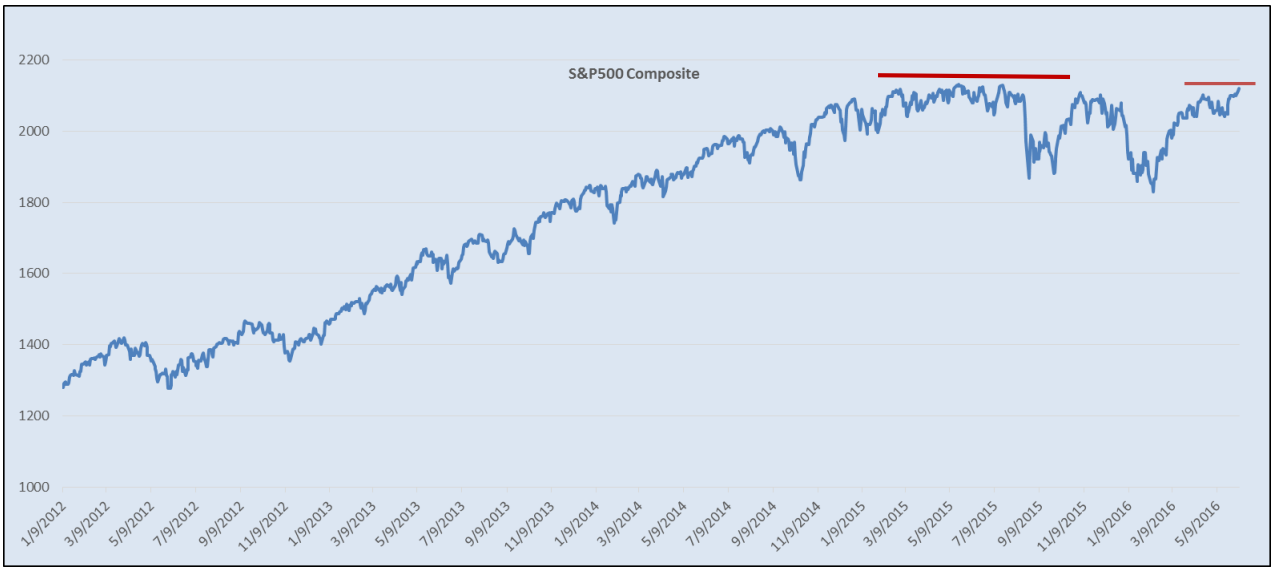
Intrinsic Value Estimate Based On Historical Equity Risk Premium							
Index: S&P500	**Input**						
Index Level	**2096**						
Assumed Growth Rate in Earnings	**4.21%**						
Long term Risk Free Rate (10 year Government Bond Yield)	**1.60%**						
Historical Equity Risk Premium (Average)	**4.54%**						
Long Term Growth Rate = Long term Risk Free Rate)	**1.60%**						
Payout as a % of Normailzed Earnings	**69.50%**						
Intrinsic Value Calculation	***Last 12 months***	**1**	**2**	**3**	**4**	**5**	***Terminal Year***
	2015	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Expected Earnings	$ 117.46	$ 122.41	$ 127.57	$ 132.95	$ 138.55	$ 144.39	$ 146.99
Expected cash payout (dividends + buybacks) as % of Normalized earnings	69.50%	69.50%	69.50%	69.50%	69.50%	69.50%	69.50%
Shareholder Cash Returns (Dividends & Buybacks)	$ 81.63	$ 85.08	$ 88.66	$ 92.40	$ 96.29	$ 100.35	$ 102.16
Expected Terminal Value =						$ 2,248.59	
Present Value =		$ 80.15	$ 78.70	$ 77.27	$ 75.86	$ 1,769.32	
Intrinsic Value of Index =		**2081.30**					
Intrinsic Trailing PE =		17.72					
Intrinsic CAPE (based on inflation-adjusted ten year average earnings) =		22.78					
Implied Risk Premium in Index	***Last 12 months***	**1**	**2**	**3**	**4**	**5**	***Terminal Year***
	2015	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Implied Risk Premium	***4.37%***						
Expected Earnings	$ 117.46	$ 122.41	$ 127.57	$ 132.95	$ 138.55	$ 144.39	$ 146.99
Expected cash payout (dividends + buybacks) as % of Normalized earnings	69.50%	69.50%	69.50%	69.50%	69.50%	69.50%	69.50%
Shareholder Cash Returns (Dividends & Buybacks)	$ 81.63	$ 85.08	$ 88.66	$ 92.40	$ 96.29	$ 100.35	$ 102.16
Expected Terminal Value =						$ 2,248.59	
Present Value =		$ 80.28	$ 78.95	$ 77.64	$ 76.35	$ 1,782.78	
Intrinsic Value of Index =	**2096.00**						

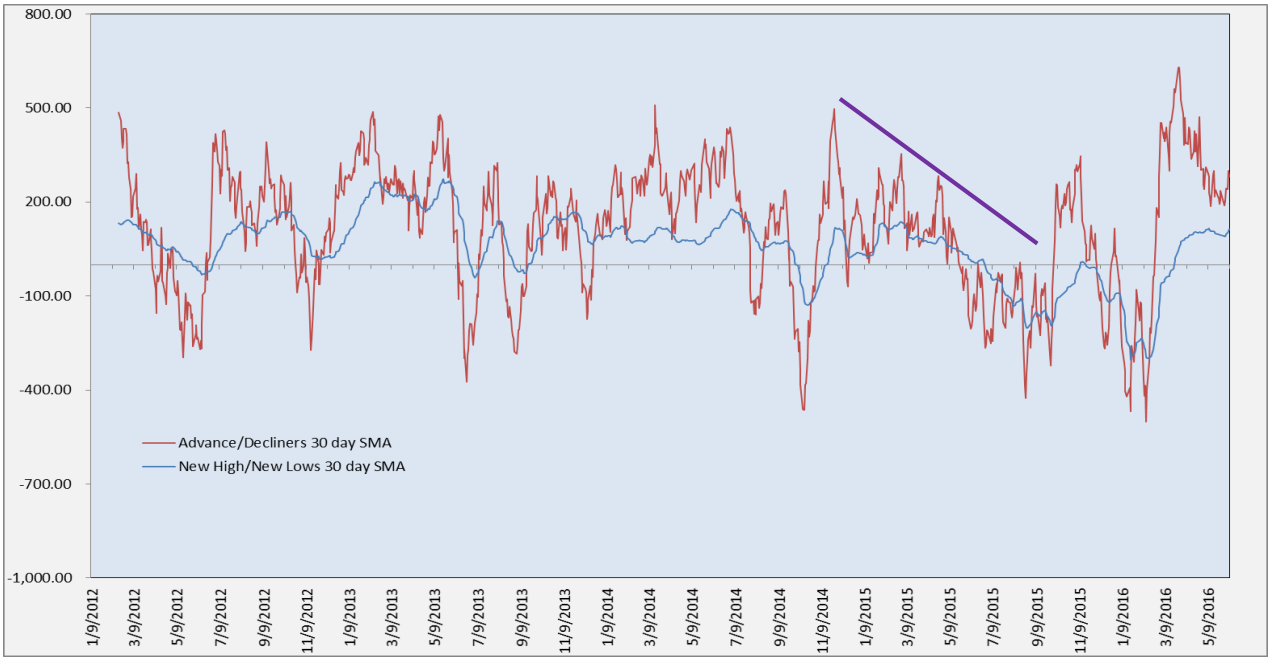
Although the assumptions used in this model might appear conservative, this is justified considering the economic backdrop. This model also allows interest rates to play a significant role in the determination of intrinsic value since the discount rate is a function of the risk premium and the risk free rate. The current level of the S&P500 carries an implied return from equities of 4.37% + 1.6% = 5.97% based on these assumptions. It could therefore be argued that the future performance of the index will depend on consistent improvement in earnings, lower interest rates to maintain the equity risk premium at current levels and/or a compression in the equity risk premium below its long term average, consequently leaving little room for error. In addition, investment grade corporate bonds carry the following yields; AAA – 2.11%, A – 3.54%, BBB – 4.38%. Relative to the index, these yields are very competitive and carry less volatility.

The above illustrates that the equity market is overvalued on valuation measures, fairly valued on the basis of equity risk premiums, but offers little margin of safety should corporations fail to meet expectations.

So, what allows indices to stay over or under valued for extended periods of time? The answer might lie in behavioral factors such as investors' propensity to take risk. The market is the best framework for price discovery, consequently, it represents the collective psychology of all market participants.

An insight into the propensity of investors to accept risk, is through the evaluation of market internals. Although there is array of iterations and can be applied to any index, here the focus will be on two measures, namely, Advancers to Decliners and New High/News Lows. The results are smoothed by the application of the 10 day and 30day moving averages.

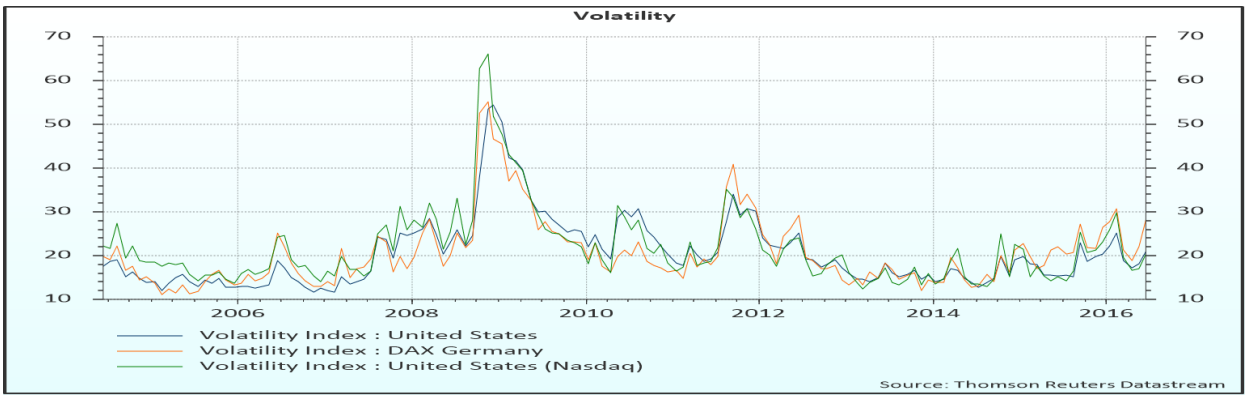




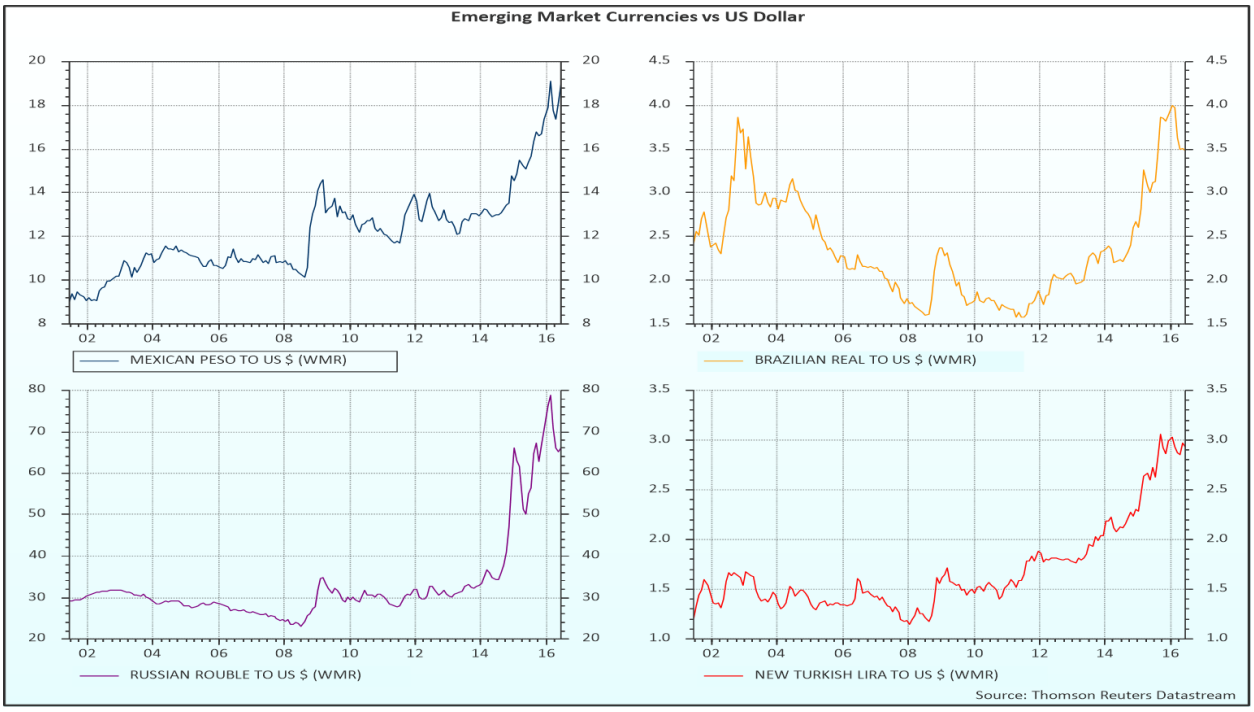
Although these indicators in the short run are suited to determine if the market is overbought or oversold, thereby aiding in the allocation of capital of active portfolios, in the medium to longer term the usefulness of these indicators emerges by the divergences that are created between the underlying index and the indicator. These divergences can therefore differentiate between periods of consolidation and distribution, providing an insight into the qualitative nature of an ensuing market advance or decline. In addition, these measures of market internals carry additional weight when fundamental measures that have significant correlation to prospective future returns such as P/E ratios, market capitalization to GDP, and corporate profits to GDP indicate substantial over valuation. These are the conditions that we currently observe in the market.

Market participants can be split in two distinct groups; (i) a group that follows a value approach and (ii) a group that invests on momentum relying heavily on technical analysis. Historical data supports the argument that sustainable market rallies are usually associated with positive fundamentals and improving market internals since both groups are marginal buyers of stocks, pushing equities higher. When fundamentals change, the value group becomes increasingly nervous holding stocks, therefore becoming net sellers leaving the momentum group to carry prices higher. The further prices are pushed away from fundamentals, the more significance technical analysis gains and the larger corrections in prices have to be in order to entice value buyers back into the market.

Volatility can also provide clues as to the risk appetite of investors. Market trends that are accompanied by stable and/or declining volatility are favorable. Inversely, market trends accompanied by rising volatility tend to signal unstable trends and a greater potential for a reversal. The chart hereunder, shows that market gyrations have been accompanied by higher readings from late 2014 to the latest market bottom in February 2016. Nonetheless, volatility readings remain well anchored, indicating market expectations that sources of risk such as China (credit bubble), Europe (deflation) and emerging markets will be contained through the confidence and faith in central banks.



FX rates of emerging countries against the USD can also gauge risk appetite in financial markets. Investment flows into emerging currencies indicate investors' confidence in the global economy and lead to increased confidence in the establishment of carry trades. Emerging currencies have weaken considerably in the last few years, but are witnessing improvement in the last few months coincident with the improvement in commodity prices. Although the fall in commodity prices is beneficial to consumer economies by improving the purchasing power of these nations, the counter effect is less aggregate demand from producing nations. Since emerging markets share of global GDP is increasing, an improvement in FX rates is a welcome development, since it conveys a lower probability of systemic risks lower volatility and a possible improvement in aggregate demand.

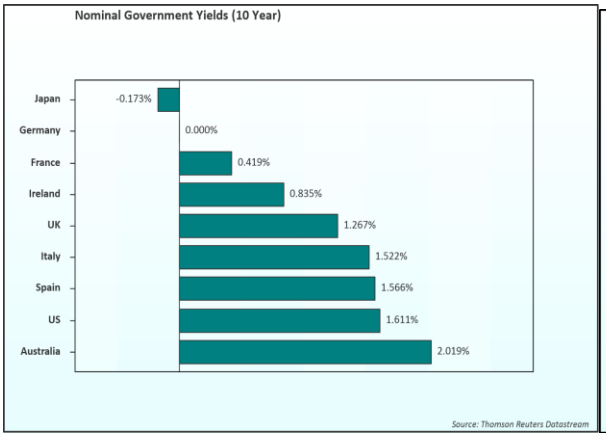


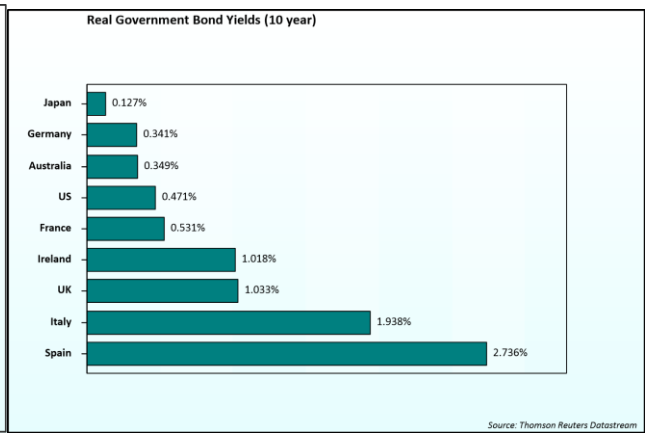
The most important influential driver of financial markets is the availability of credit and the flow of credit in the economy as can be attested by the experience of 2008. Consequently, in the following section, focus will be on interest rates and corporate spreads.

Interest Rates, Credit Spreads and Fixed Income

Interest rates have been turning increasingly negative, especially during the last two years with the monetary programs of the European Central Bank and the Bank of Japan. In fact, the amount of debt that is trading with a negative yield is approximately US$ 10 trillion, meaning that investors are confident in their ability to never consolidate a loss at maturity.

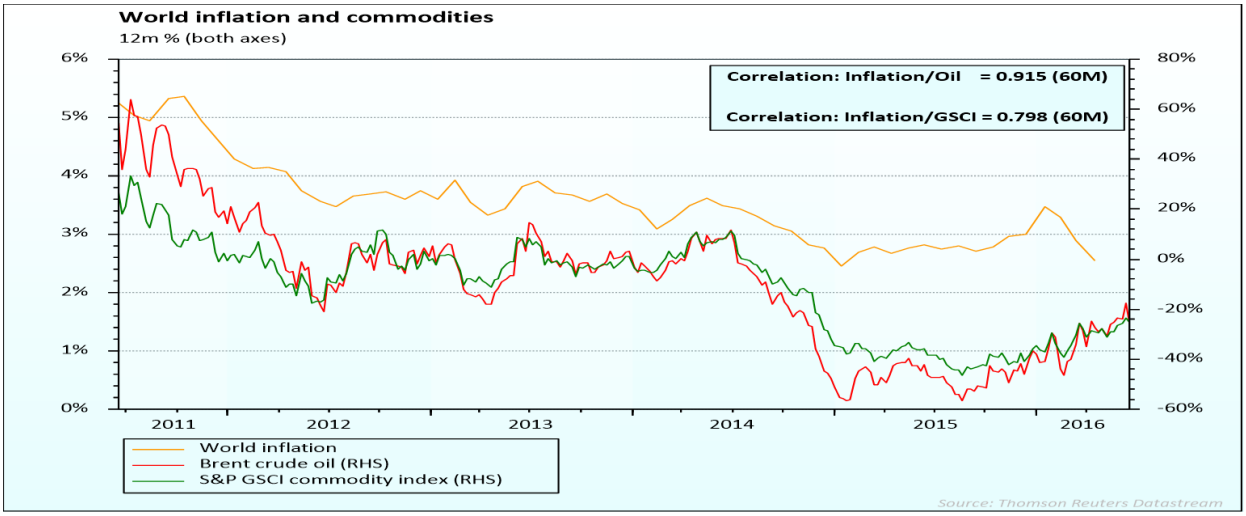
It is interesting to note that in the 1980's bonds which carried yields of 15% were often referred to as "*certificates of confiscation"* due to high inflation expectations. Forty years later and investors are buying bonds with negative yields, with the presumed expectation that interest rates will continue to be driven into negative territory by deflationary factors. A graphical representation of nominal and real yields is presented hereunder.





The last four decades in fixed income markets have delivered positive consistent returns to investors in sovereign paper with low volatility, but risk management would dictate a careful consideration in extrapolating these past returns into the future. The factors driving real positive yields are the negative inflation readings, especially in Europe and Japan. Europe is embroiled in a deflationary environment due to high unemployment, high debt to GDP ratios, and a currency that in some countries is not reflective of economic fundamentals. However, one of the most important contributors to deflation has been the price of commodities, especially oil. It should be noted that on a currency adjusted basis, the deflationary effects of oil prices in Europe is lower due to the recent weakness of the Euro.

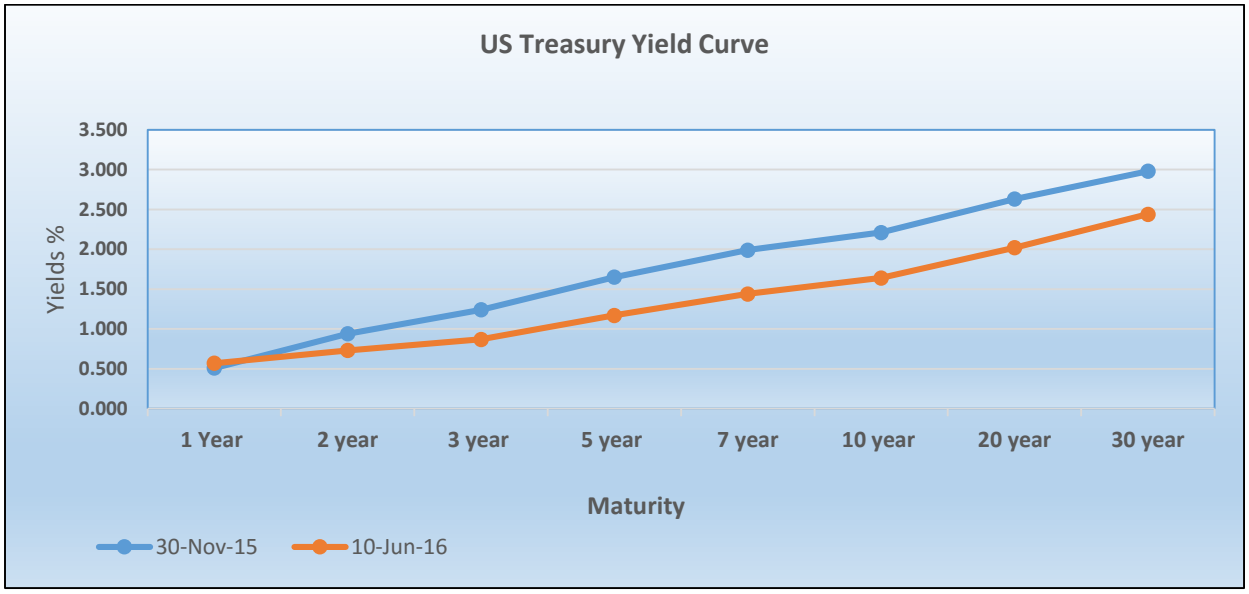
The following chart shows the price performance of oil, commodities and world inflation rate.



Although the correlation of commodity prices to inflation is relatively weak over ten years of data, the correlation is strong based on the last 5 years of data. The prevalent notion in the market is that commodity prices are highly influenced by China. While this may be true, prices might have already fallen to the extent that are reflective of lower demand from China. An example is the prices of oil which after a substantial decline is showing signs of stabilization due to supply/demand imbalances being corrected. The latest data from the US Energy Information Administration (EIA) confirms that imbalances are being corrected. Placing continuous reliance on the falling commodity prices to drive negative inflation rates and pushing real yields upwards might not be a justification for buying bonds, since it looks increasingly unlikely for continuous deflationary forces to emerge from the commodity complex.

Low and negative nominal yields are also the result of central bank intervention in the bond market. Quantitative easing programs have caused a higher demand for sovereign credit. In Europe, monetary programs by the ECB, could not be implemented without causing major price distortions, due to the fragmentation of the market and the available supply of bonds. This is one of the reasons why the ECB have recently included corporate bonds as eligible assets for QE programs, with many expecting the same result. Large institutional holders are reluctant to sell their holdings to the ECB due to lack of investment alternatives, but most importantly, they are unwilling to abandon the income stream from their bond portfolios knowing full well that bond prices and therefore capital gains are going to be underpinned by central bank demand.

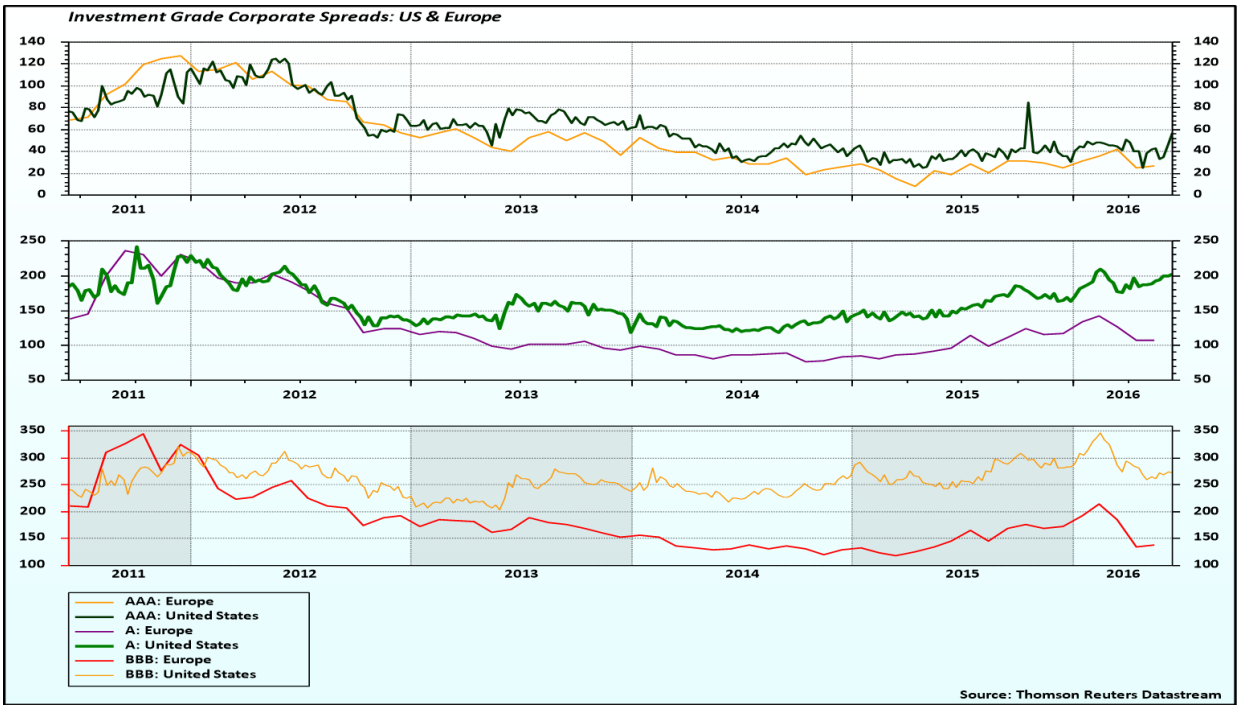
In this scenario, demand overwhelms supply with governments unable to expand their issuance due to already high debt levels and in the case of Europe, the limitations imposed by the Maastricht treaty. In the US, the Federal Reserve is on a divergent path to Europe and Japan with accommodative as opposed to expansionary policy. The Federal Reserve raised interest rates at their December 2015 in an attempt to normalize policy, however the consequence is a flatter yield curve. A flatter yield curve is often attributed to low growth expectations but in this instance it could also be due to capital flows into treasuries. This increased demand is underpinned by expectations of a higher US dollar due to interest rate differentials, and lower volatility due to the inherent safety of US treasuries. Consequently, for international private and institutional investors, the US offers positive yields with the expectation of currency appreciation against their base currency providing downside protection should interest rates rise. The changes in the yield curve before the rate rise and the time of writing are represented in the following chart and table.



US Treasury Yields %								
Date	1 Year	2 year	3 year	5 year	7 year	10 year	20 year	30 year
30-Nov-15	0.510	0.940	1.240	1.650	1.990	2.210	2.630	2.980
10-Jun-16	0.570	0.730	0.870	1.170	1.440	1.640	2.020	2.440
% Chg	***12%***	***-22%***	***-30%***	***-29%***	***-28%***	***-26%***	***-23%***	***-18%***

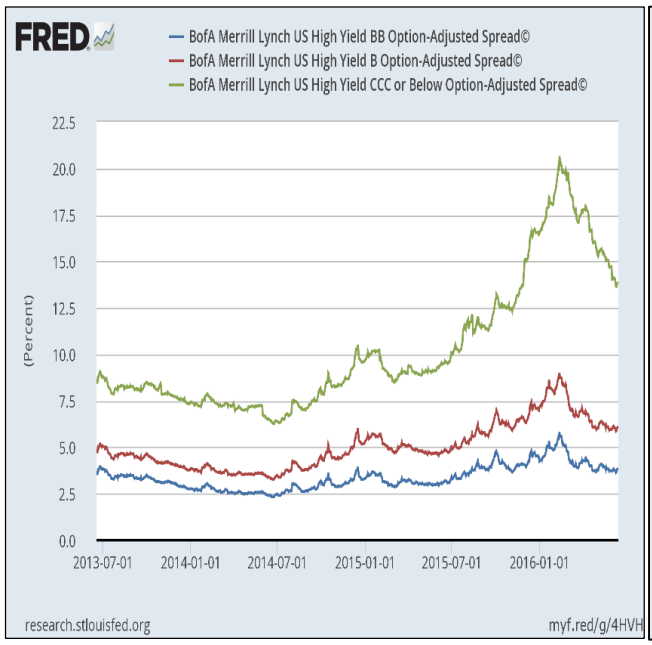
In this context, the Federal Reserve might be inclined to normalize policy by not reinvesting the maturing assets on its balance sheets and/or go a step further by putting some of its assets for sale on the market, thereby allowing the increased demand for US treasuries to be absorbed by the increased supply delivered by the Fed. However, the central bank might be reluctant to take this step due to the repercussions that it could have on financial assets and the US dollar.

Further to the above it would be useful to investigate whether these low rates are being reflected into higher risk bonds such as Investment Grade and Non- Investment Grade Bonds.



The above chart provides some interesting insights. Corporate bond issuance has been running at a stable pace after a slow start to the year due to the market correction, however, it seems that European Credit spreads are more sensitive to the decline in sovereign yields than their US counterparts. The market correction between last December and February pushed up credit spreads across all ratings to multiyear highs, but the subsequent retreat has been far more pronounce across European credit. This divergence could be explained by the difference in the relative central bank policies and by the announcement of the ECB announcing the eligibility of corporate bonds for quantitative easing. Nonetheless, corporate spreads continue to point to a healthy market with corporates on both side of the Atlantic having no obstacles to fulfil financing needs. The data also illustrates the relative attractiveness of US corporates in terms of yields.

As expected, spreads increased measurably in the sub investment grade arena during the latest market correction. Although spreads tightened markedly, mostly aided by the recovery in commodities and oil prices, spreads are nowhere near their lows of 2013 in the case of the US and 2014 in the case of Europe. The data indicates a tightening of financial conditions in this space.



In consideration of the above information, financial conditions are benign in sovereign and investment grade corporate fixed income markets with a tightening bias in sub-investment grade markets. Nonetheless, the low nominal yields present challenges in terms of duration, credit risks considering the deterioration in corporate fundamentals and also liquidity risk associated with the thinning of market markers across major investment banks bond desks. The successful navigation in bond markets will largely depend on a comprehensive understanding of central bank policies, economic and corporate fundamentals and an understanding of investor psychology.

Central banks

This review would not be complete without an assessment of Central bank policy. Although one can debate endlessly about the ramifications of central bank policies, especially QE and negative interest rates, it is important not to lose sight of the primary objective of Central Banks, which is to aid their

respective economies by promoting price stability (inflation at 2%) and in the case of the Federal Reserve also full employment.

In the period prior to the financial crisis, central banks were relatively successful in fulfilling their mandate by adjusting interest rates. The exception is the Bank of Japan which has been battling deflation since the early 90's. In this last cycle, the reduction of interest rates was not enough to restart the economy, therefore it was necessary to implement quantitative easing via the expansion of central bank balance sheets. These policy responses were deployed due to the large buildup of debt in the economy which instigated a deleveraging cycle accompanied by falling asset prices.

Central banks have one common mantra, inflation can be addressed more effectively than deflation. Since deflation is associated with falling prices and asset values, the hardships on the economy are significant, lowering the propensity of buyers to borrow, stress existing debt obligations and lead to lower economic growth. With Debt/GDP ratios at their current levels, central banks have no option but to support asset prices.

The reserve currency status of the US dollar allows the US Federal Reserve to exert the most influence on financial markets. Whilst the European Central Bank, Bank of Japan, Bank of China and to a lesser extent the Bank of England are still pursuing expansionary monetary policy, the Federal Reserve started to communicate in the October 2014 that it is slightly reversing its policy from expansionary to accommodative. The Federal Reserve achieved this by stopping its QE program but with no contraction in its balance sheet since maturing assets are still being reinvested. In December 2015, the Federal Reserve officially announced an increase in its Federal Funds rate by 25 basis points. Markets reacted negatively to this announcement with a concurrent expansion in credit spreads. This reaction allowed market participants to assess the impact of Federal Reserve policies on global financial assets, notwithstanding the fact that all other major central banks are still pursuing expansionary policies.

As alluded, these reactions to Federal Reserve policy changes are due to the influence of the US dollar. Since the Federal Reserve is on a divergent course to other central banks, the interest rate differential between the USD and other currencies causes an upward pressure in the USD against all major currencies. Given that a lot of debt is denominated in USD, especially in emerging markets, an increase in the US dollar absorbs resources from these economies since the debt servicing and repayment obligations cost more in local currency terms. A stronger dollar also presents challenges to China. The Chinese yuan peg to US dollar implies that China has a stronger currency relative to the rest of the world (especially other Asian economies), making Chinese exports more expensive. Although China is transitioning from an export

led to a consumer led economy, the export sector is still very important. A stronger yuan puts additional pressure on exporters, exposing the fragility of its credit markets and therefore put pressure on global financial markets.

The market correction following the rate hike by the Federal Reserve has been reversed after a massive credit expansion in China and soothing communication from the Federal Reserve as to the course of further rate hikes. Institutions such as the International Monetary Fund were openly critical of any suggestion of interest rate hikes because these institutions are aware that the global economy can be derailed easily from its fragile growth path. They also understand that Emerging markets and China should be supported since they are the drivers of aggregate demand.

The Federal Reserve is actively being featured as the steward of global financial conditions. This added responsibility imposes on the bank a dual role, that of fulfilling its mandate on the domestic economy and also the role of measuring the repercussions of its policy on the global economy, a role not without its conflicts. This would suggest that the Fed will trend lightly in financial markets, due to the contractionary secondary effects of its actions, namely a lower wealth effect because of lower asset prices, lower exports due to stronger dollar and tighter financial conditions abroad.

Considering all of the above, and the experience of the Bank of Japan with the deflationary effects of an asset and credit bust, the most logical conclusion is that major central banks will lean to tolerate higher inflation for much longer than in previous cycles. This could be achieved by allowing nominal rates to stay low and negative real yields to take hold until inflation expectations are well anchored.

Acknowledging that central banks are assuming a more influential role in the management of the economy, what are the limitations of monetary policy in addressing the current economic difficulties?

Amongst the negative implications of an expansionary policy, is the fact that central banks become active participants in financial markets, leading to rising asset values which are not representative of their true economic values. In addition, monetary policy aids the economy through increases in the wealth effect, however, this could lead to increased inequality, in turn causing political repercussions. Since a large majority of the population does not hold financial assets, they derive no benefit from this policy whilst savers are penalized through lower interest rates.

The limitations of central bank policies without structural reform can be gleamed from the Bank of Japan's fight against deflation following the real estate bubble of 1989. The Bank of Japan is an excellent example of the limitations of Quantitative Easing because the BOJ is far ahead than any other central bank in its

iteration of QE. Just to put some context, the BOJ is now the biggest holder of Japanese stocks through its QE programs without any permanent reversal of deflation. In fact, following the last two meetings, the value of the Japanese Yen strengthened thereby reducing any stimulatory effects on the economy. This puzzling outcome could be attributed to a reversal of short positions on the Yen, a reversal of the carry trade, and an indication that the market was pricing in even bigger interventions.

The success of monetary policy is also dependent on the compliance of financial markets, through the direction of interest rates and to a lesser extent the currency value. The risk of running an inflation policy with negative real yields is that bonds prices and therefore interest rates become unhinged and start pricing independently of policy. Although this possibility is remote, it is nonetheless a risk that should be monitored.

This arguments brings us to the new form of monetary policy that is increasingly being discussed in financial markets, 'Helicopter Money'. Although one can have reservations on such an initiative, it should be noted that this is a form of fiscal policy. Details are scant about how such a program would be implemented, however, the general idea is for central banks to finance government spending in the form of infrastructure projects, research and development programs and training programs to increase the productivity of the economy and the development of new products and services. Another form would be an outright distribution on funds. The difficulties underlying this type of intervention emanate from the fact that there are no legal frameworks in place to allow the direct financing of governments by central banks. This could also be interpreted by investors as an attempt to monetize debt. It should be noted that numerous examples exist over the past century when governments have used expansionary fiscal policies to spur economic growth. In and of itself, this is not a novelty, the novelty is the way these projects are financed. The advantage of this policy is that it represents a direct stimulus throughout the whole economy with all classes of society participating and not only owners of financial instruments, thereby avoiding the inequality problem inherent in QE. In the mist of persistent deflationary pressure, this policy could be justified.

During the last economic cycle, politicians have relied excessively on central banks to support their respective economies. Although central banks can provide liquidity to the banking system and financial markets they cannot address structural reforms. The easing financial conditions should therefore be used by governments to implement needed reforms to make their economies more competitive and increase productivity.

Investment Implications

- Low global GDP growth and a disenchanted electorate could increasingly lead to external risks such as Brexit, and the emergence of more right wing political parties in Europe. These developments point towards a more isolationist approach to politics. Financial markets could therefore experience higher volatility as a result.

- The continuous questions raised about the European Union could undermine the structure of the European bloc. A disintegration could bode ill for European nations, politically, militarily and economically, and therefore the Union's ability to compete internationally.

- China's management of its economy and the ability of the government to lead a successful transition from an export led to a consumer led economy is crucial for financial markets. A credit burst in China, is a source of systemic risk that should not be underestimated.

- Valuations of equity markets are stretched compared to historical data. Justification of higher equity prices without a corresponding increase in operating profits and earnings is increasingly difficult. A reduction to the allocation of equities and/or the implementation of hedges could be warranted at this stage.

- The performance of bond markets and the emergence of negative yields points to lower economic growth, thereby contrasting sharply with the message delivered by equity markets. Historically bond markets have been far more accurate than equity markets in anticipating lower economic growth and/or recessions.

- The tendency of Central banks to pursue inflationary policies to counteract deflationary pressures, indicates their determination to achieve price stability. Central banks could therefore allow inflation to run higher than their mandate until inflation expectations are well anchored. An allocation to investments that provide a hedge against inflation such as property, precious metals and inflation protected securities should be evaluated.

- In fixed income portfolios with a base currency in Euro, a shift towards US dollar investment seems appropriate, due to relatively higher yields, lower duration and the prospect for the US dollar to strengthen against the Euro. In the event that US interest rates rise, the expectation would be for a higher interest rate differential and therefore a higher US dollar that can provide a hedge against the fall in bond prices.

- Emerging countries forex rate against the US dollar have been showing signs of stabilization, aided by the recovery in commodity prices. A comprehensive review of the economic drivers should be done to determine the risks of further fall outs from economic data. Should the data point to a constructive fundamentals, an allocation to local currency debt through an experience fund manager could provide an investment alternative. Needless to say, such an allocation would be only for clients with a high risk profile.

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