The new economic order

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Over the last few months, some investors seem to have finally accepted the idea of a US-driven macro world similar to that of the second part of the 90s. Markets have partly repriced such an environment as illustrated by the recent strength in the US dollar against emerging currencies. Although positioning on FX is now a bit better aligned with the macro regime, on many other asset classes such repricing is either incomplete or simply missing. Indeed, there is still a lot of resistance to the idea of a new economic order "a la 90s". **If the US supremacy has imposed itself as a fact since February of this year, scepticism is still prevailing as expectations are now turning to the prospect of the next US recession. This is another similarity with the 90s.**

From 1995 to 1998, expectations of an exhausted US business cycle have been persistently and prematurely surfacing before capitulating in the 1999-2000, at the very end of the New Economy. The same arguments were used to fear an eventual recession: a long time since the last recession, and a flat curve. What also proved to be underestimated at the time was the strength in private sector balance sheets, after years of containment following the Savings & Loans balance sheet's recession. Recessions are not due on a calendar basis. They are due as a by-product of former excesses in investment and private sector balance sheets. These two are missing in the US today, as they were missing in the middle of the 90s. **Still, the predictive power of the shape of the US yield curve has kept its magic like an ancestral belief that does not want to die.**

This is all the more surprising that the economics of the yield curve is pretty well understood. The curve is steep whenever the Central Bank is actively maintaining a loose monetary policy. It eventually normalises to a moderate steady-state slope whenever monetary policy turns back to neutral. This is broadly what has happened from 1992 to 1995 and from 2013 to now. The 30-5 year Treasury yield spread reached the current 27bp in early 1995, but the recession did materialise only six years later, in 2001. The 30-5 spread over the five years period (1995-2000) preceding the recession was on average at 40 bp, the best guess of what equilibrium might be. Indeed from an economic point of view, over this period, the yield curve was on a kind of steady-state whereby monetary policy remained rather neutral, growth was driven by private agents doing their thing without much support/distortion from public authorities. In that perspective, there is thus not much to worry about regarding the current flatness of the yield curve. **On the contrary, it most probably indicates that the US economy has just entered an era of self-sustained, somehow above trend growth driven by private investment and consumption.**

Steady growth and inflation in the US would support a full repricing of the new economic order "a la 90s" whereby the US economy leads the G3 business cycle - while being still far away from its end- the EMU is following suit with a lag, and the rest-of-the world is structurally handicapped by excessive private leverage. Although positioning is now long USD and short US Treasuries, holding on to these strategies should be rewarding on a trend basis. What would require a hefty repricing at this stage is the economic trajectory of the EMU. This is where one can find excessive risk premia that offer abnormal potential returns. **A simple way to characterise this set of opportunities is to consider that the EMU lies where the US was two to three years ago.** Whatever one should have done with hindsight on US assets three years ago, should be considered doing on EMU assets today: long stocks, long banks, flatter yield curve, and long high yielders (Italy).

Being long EMU assets is not a brand new theme though. From 2017 to January 2018, investors were consensually invested on the idea that strong EMU growth would deliver some kind of catch-up towards the US. Although the ECB indeed decided in 2017 to move away from QE as the US did in 2013, the catching up process did not have much leg beyond a repricing of the QE premium on the euro. Contrary to expectations, the US economy kept on surprising to the upside while EMU eventually had a weak patch. Both dynamic moved some investors away from the belief in a synchronised global business cycle. The very recent turnaround in the surprise index for the euro area could locally revive such expectation, although it has now become clear to many that the Fed will continue to hike, supporting the USD and continuing to put pressure on the external financing of emerging countries. **So the rebound in EMU economic activity should rather help build steadier expectations that the euro area is indeed following the US with a lag, as it did in the late 90s.**

Beyond the economic soft patch of late, the anti-establishment coalition in Italy has generated another blow to foreign investors that were still long EMU assets. This was the volatility shock too far. Capitulation followed with outflows driven by short-term risk management as well as longer-term despair towards EMU assets. **Although this does not bode well for an imminent strategic reallocation from deep pocket foreign investors into EMU assets, it constitutes a perfect base for a sustained and powerful rally in these very assets.** Indeed, attractive valuations are now aligned with a widespread underweight/short position across most type of investors. Scepticism is extreme and willingness to participate is close to nil. Besides, who cares that the Italian anti-establishment collation has turned into an establishment government in just a matter of a few weeks, embracing the constitutional request of an eventual balanced budget and accepting all the international commitments of the country. Who cares that the EMU business cycle is still immature, that pent-up demand is large, private leverage is low, and public deficits have converged below the 3% threshold? Who cares that the valuation of EMU equities is cheap, dividend yields are high, and banks' NPLs are low or on a clear downward trend?

In this context, EMU assets are expected to climb the "wall of worries" that has been raised in front of them, slowly but surely at first. Future economic and political news have plenty of room to feed such positive dynamic. Proper participation might not come initially, but it is not really needed to see the extreme risk premium beginning to ebb down in EMU equities. If confirmed, the new economic order "a la 90s" would eventually support a reluctant participation that is so characteristic of bull markets. Finally, the late 90s offers a further clue on what to expect at this later stage of EMU equities catching-up with the US: astronomical returns over a rather short period of time. In this case, the wisdom would be to buy early rather than late.

Edited by H2O AM in London on July 22, 2018

Additional notes