DECALIA

INVESTMENT INSIGHTS

MONTHLY ISSUE #22

November 1st, 2016

FADING SUPERPOWERS

Editorial View

Fading superpowers: Monetary policy is dying, long live fiscal policy!

- Our "Fed is dead" claim from a year ago now applies to all central banks
- Negative rates have pushed long yields to zero and limit central banks' actions
- Active fiscal policies are expected in 2017 but will not boost growth soon

A year ago, we boldly announced "The Fed is Dead!" Indeed, we believed that the American central bank had lost its market leadership and economic impact. Now, far from reversing this claim, we extend it to other major central banks.

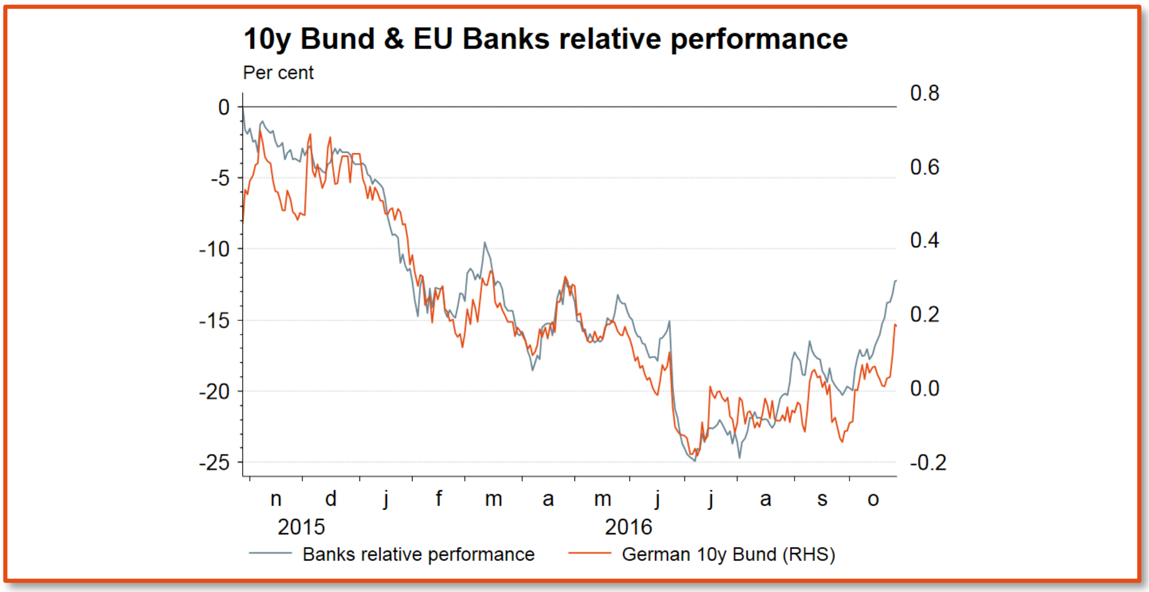
i) Lost market leadership. Most recent declarations by the FED, BOJ and ECB explicitly refer to data dependency, i.e. the usual activity and inflation figures, but also include references to political events (Brexit) as well as financial market data. Major central banks have therefore increasingly adopted a short-term approach sensitive to market fluctuations. This was not the case a decade or two ago, when monetary authorities were "ahead of the curve". In other words, Central bankers are increasingly looking for market confirmation before acting.

ii) **Lost economic impact.** Several academic papers presented at the Central Bankers Symposium in Jackson Hole demonstrated that the economic impact of monetary tools (interest rates and asset purchases) is falling. The obvious signs are short interest rates close to zero and, in the area of asset purchases, the accumulation of excess reserves by commercial banks.

In the vanguard of the global monetary experiment, Japan provides a hint of what lies ahead. A few weeks ago, the BOJ announced no further monetary expansion but rather an explicit targeting of the 10-year JGB bond yield: in other words, a de facto full monetization of Japanese debt if and when the government decides to launch an aggressive fiscal policy. Monetary measures are thus being replaced by fiscal ones. This fact is slowly sinking in: investors are now convinced that monetary policies have reached their natural limits and therefore expect very little from central banks. That is why bond yields reversed their downward trend from late June.

In the US, and especially in the Eurozone, the main focus will be on fiscal spending and how much it could lift growth after years of restrictive fiscal policies. Keynesians will applaud, while monetarists may fear inflation spillover. We remain unmoved. Structural growth potential will remain unaffected by any fiscal stimulus, and the savings glut driven by an aging population will not disappear. Despite cyclical reversals, we believe government bond yields are set to stay low for long.

Chart of the Month



Global Strategy

ECONOMICS & ASSET ALLOCATION

Waiting for Hillary...

- Global activity seems to be accelerating, but US leadership is at risk
- Short-term indicators are sending confusing signals on US cycle position
- Inflation building up in US labor markets, confirming likelihood of FED tightening

In an almost complete reversal of previous 12-month trends, Government bond yields have suffered a steady decline for the past three months, while cyclical assets and sectors entered recovery. This about-face cannot be attributed solely to the widely touted Fed tightening scheduled for December. No, the more likely cause is that little thing known as a US presidential election! Indeed, Trump's chances of winning have fallen since the Brexit, leading markets to re-price assets to "business as usual" levels. Though the odds now largely favor Clinton, in a sign of how nervous investors have become, the recent announcement of another FBI inquiry has shaken the consensus view and caused another U-turn in markets.
Fortunately, news on the global economic front is more reassuring. Manufacturing went through a soft spot earlier this year, but recently released preliminary results of surveys in Emerging regions, in Japan, the US and the Eurozone indicate continued improvement in October and suggest that global industrial production will maintain its progression until the end of the year. It is worth noting that the UK economy did not collapse, as many pundits feared.

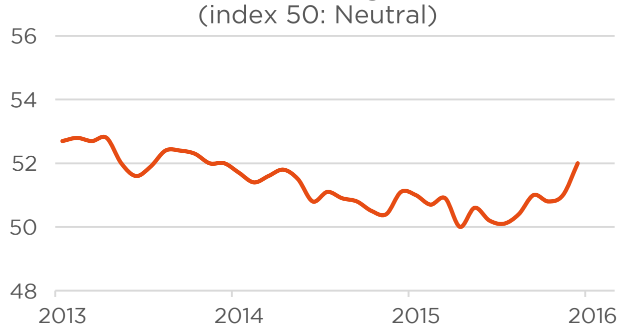
On the monetary front, visibility has increased, with the Federal Reserve signaling the likelihood of a rate hike in December. The ECB, meanwhile, is expected to keep its purchasing program in place until March 2017. As a result, the USD resumed its appreciation in October, only to be halted by last-minute political uncertainties.

On the corporate front, signs are encouraging for both equities and credit.

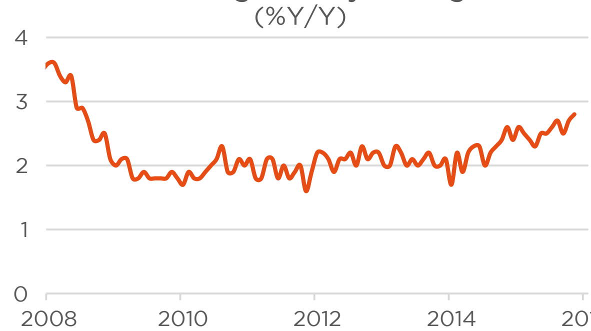
- Q3 earnings season is tracking ahead of expectations: 68% of US firms beat analysts' forecasts so far, with Financials making a strong showing.
- In the global speculative-grade universe, defaults now number 140, already higher that the year-end total for 2015 (113). Given that 55% of these defaults occurred in the energy sector, higher oil prices should now help improve the picture.

In short, overall macro and micro fundamentals are supportive of "reflation trades". However, the possibility that upcoming political events (including the Italian referendum) could lead to extreme outcomes keep us cautious about risky assets. Consequently, we leave our portfolio allocation close to neutral with a more "barbell-shaped" positioning in order to profit from a potential relief rally following the US elections (i.e. a combination of two extremes: safe or short-term and risky or long-term, weighted to replicate a neutral position in terms of risk or time horizon). More specifically, our core positions remain focused on quality assets, combined with satellite bets on US financials and high-yield bonds. Moreover, we remain underweight gold and government bond duration in the wake of the Fed tightening. Overall, we keep an opportunistic and flexible approach, seeking profits from exaggerated corrections and/or better visibility from the FED.

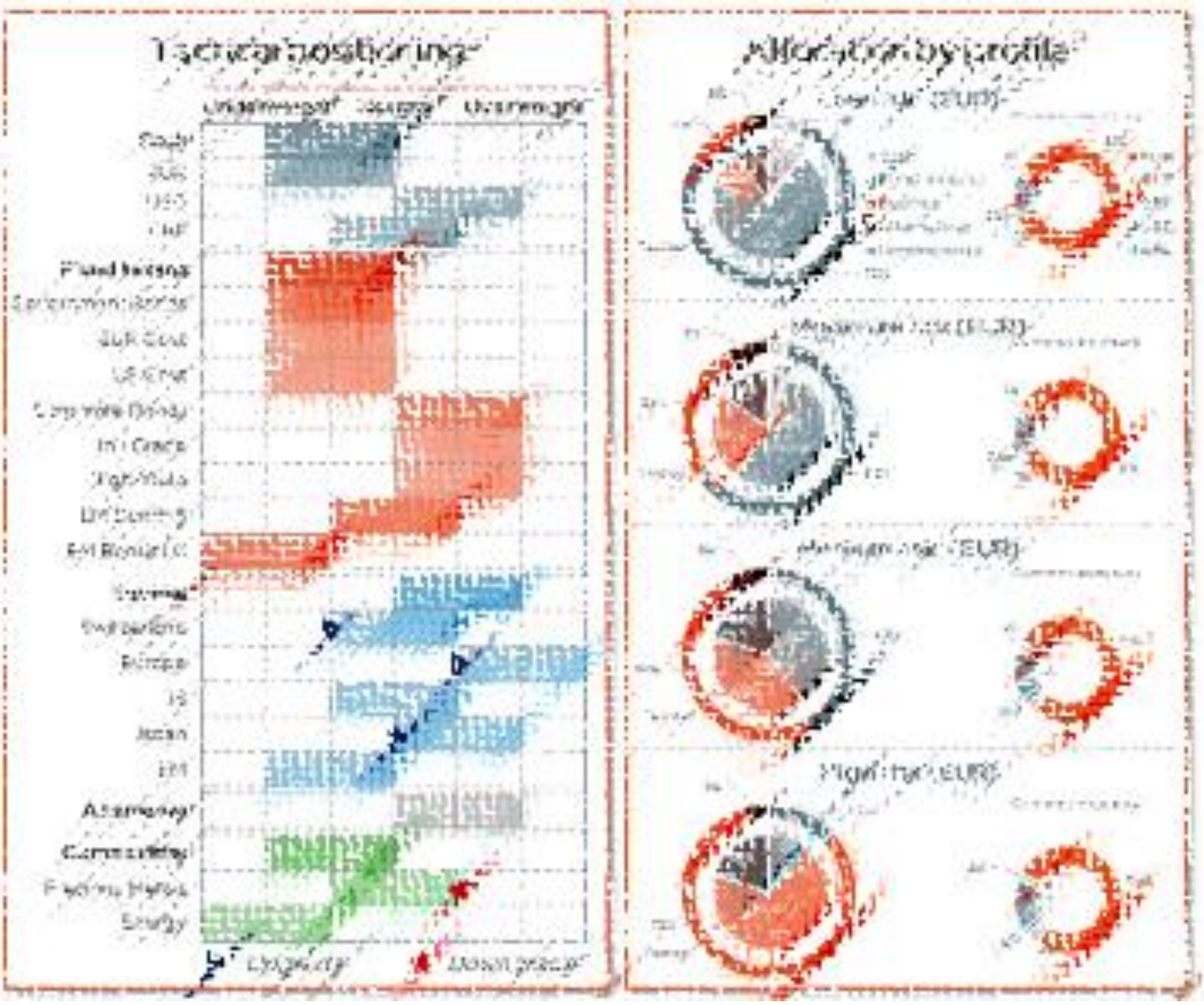
Global manufacturing confidence
(index 50: Neutral)



US Average weekly earnings
(%Y/Y)



Asset Allocation



- Neutral stance with cautious bias ahead of key events later this year
- Downgraded EU government bonds, still favoring US Treasuries
- Adopted a more “barbell-shaped” equity exposure

Contacts

DECALIA Asset Management SA

31, rue du Rhône
Case postale 3182
CH – 1204 Genève

Tél. +41 22 989 89 89
Fax +41 22 310 44 27
info@decaliagroup.com

External sources include: Cartoon by Bloomberg's Steve Epting, Thomson Reuters Datastream, Decalia, Iowa Electronic Markets, Bloomberg, Federal Reserve of Saint-Louis, JP Morgan..

Finished drafting on November 1st 2016