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The US recovery will surprise on the upside

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The United States is undeniably the critical market within the global economy. However, many commentators suggest that although its economy is recovering, growth will remain subdued as the country's best days are behind it. Despite this, there are real sign-posts that clearly suggest the US is off its knees, has dusted itself down and is ready to surprise the world on the upside! This thesis has significant implications to the unwinding of Quantitative Easing, investment markets and portfolio construction.

1. THE US RECOVERY WILL SURPRISE ON THE UPSIDE

In general, equity markets were strong in 2013, driven by flows into equity funds on the back of a recovering US economy, a stabilising environment in Europe, positive data out of China and the short-term positive impact of Abenomics in Japan. Since June 2013, however, investors have become increasingly focused on the implications of the US Federal Reserve (the Fed) ending its quantitative easing programme (QE). This has been evident in US 10-year Treasury yields, which rose from 2.2% to 3.0% between 31 May to 31 December 2013 (although they have since fallen to 2.6% at the end of January 2014), and in certain major currency movements. The Australian dollar, Indian rupee and Brazilian real, for instance, depreciated against the US dollar by 6.7%, 8.6%, and 9.4%, respectively, over the same period.

We believe there are three primary drivers of equity prices at a macro level:

- **Economic growth** – As economies grow, so too do the opportunities available for privately-owned businesses to sell their goods and services and earn profits for shareholders. A faster rate of economic growth should, all else being equal, lead to faster growth in profits, dividends and higher returns on investment for the equity market as a whole. Some companies will continue to perform poorly while others will surprise on the upside.
- **Profit share as a percentage of the economy**
  Changes in the distribution of the economic pie will determine whether companies or employees benefit most from economic growth. The greater the share of the pie captured by companies as profits, if sustainable, the higher aggregate equity prices are likely to be. However, corporate profit share is difficult to estimate as many companies earn a material portion of their profits abroad. This is particularly true of US-domiciled companies.
- **Interest rates** – All else being equal, the higher the interest rate on longer=dated government bonds, the higher the discount rate that should be used to discount a

company's future cash flows and, as a result, the lower equity price-earnings (PE) multiples will be in aggregate.

This paper focuses mostly on the first driver of equity prices - economic growth - with some discussion on risks associated with rising interest rates as QE ends.

We now turn to a discussion on prospects for the US economy and why we expect growth to surprise on the upside.

2. THE STRENGTHENING US ECONOMY

2.1 Improvement in the labour market is real

The US labour market is showing real signs of improvement, suggesting that the country is undergoing a modest to accelerating economic recovery. Positive indicators include:

- Non-farm payrolls increased by 173,000 per month, on average, over the four months to 31 December 2013 (which is equivalent to new job creation of 2.1 million per annum). Since the bottom of the recession in December 2009, approximately 6.6 million jobs (net) have been created in the US. The total number of people employed in the US is now only 2 million below the all-time high of around 147 million in November 2007.
- The unemployment rate falling to 6.7% in December 2013, from 7.6% in June. This compares with the peak unemployment rate of 10% in 2009.
- Continuing falls in the total number of unemployed people. At the end of December 2013, there were 10.4 million unemployed people compared to a peak of 15.4 million in October 2009.

Some economists believe that the declining labour-force participation rate indicates that the unemployment situation is far worse than headline figures suggest. While it is true that the participation rate has decreased since 2007 (63.0% versus 66.0%) due in part to the economic downturn, it is important to note that it has been declining since 2000 (from a peak of 67.3%) as a result of the aging demographics of the US population. Based on the decline in the participation rate of 0.2% per annum from 2000 to 2007, it would be reasonable to expect demographic trends may have reduced it from around 66% in 2007 to around 64.8% in 2013, irrespective of the downturn.

Furthermore, a recent paper published by the Federal Reserve Bank of Philadelphia argues that the increase in non-participation since the financial crisis was primarily due to combination of three factors - an increase in retirements since 2010, a steady increase in disability, and a sharp increase in other reasons for non-participation including discouraged workers who gave up looking for work. These factors also offer a partial explanation for the fall in the employment-to-population ratio, which has improved only marginally from its

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2010 low of 58.2% (of 16+ year olds) to 58.6% in November 2013, after peaking at 63.4% in 2006.

2.2. Housing will help drive the economy

Further signs of the US recovery can be seen in housing market data:

- The recovery in house prices is continuing, as demonstrated by the S&P/Case-Schiller 20-City Composite Home Price Index, which rose 13.8% over the twelve months to 30 November 2013.
- Housing starts have recovered from a post-financial crisis low of 478,000 starts in April 2009 to 999,000 in December 2013.
- Mortgage debt rose by 0.3% in the third quarter of 2013.
- Private residential fixed investment remains depressed at around 1.5% of GDP below its long-run level, excluding multiplier effects. This highlights the potential for the housing sector to make a material contribution economic growth going forward.
- The housing ATM, whereby households draw down on home equity to fund consumption, may be on the verge of restarting, as the share of residential mortgages in negative equity has fallen by 8.5% since 2012 to reach 13% of mortgages in Q3 2013.

We believe it is inevitable that housing starts will revert to more normal levels (around 1.3 million to 1.4 million per annum, close to the average since 1959) over the next one-and-a-half to two years. This will provide a significant further boost to the US economy and overall employment levels.

2.3 Credit conditions are favourable

Favourable credit conditions also point towards a stronger-than-expected US recovery, including:

- Aggregate household debt has fallen from 96% of GDP in 2009 to 77% of GDP in 2013.
- The aggregate common-tangible-equity-to-common-tangible-asset ratio of major US banks has approximately doubled since 2008.

2.4 The competitive position of the US is improving

- The US trade deficit is falling. It is currently 2.8% of GDP, almost half of 2006 levels, with the decline having been partly driven by a rapidly shrinking deficit on petroleum products.
- The US has become more competitive internationally as US manufacturing hourly

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labour costs have fallen significantly relative to other countries, in USD terms, since 2002.

- The US has developed a massive energy cost advantage over foreign competitors, partly as a result of its shale boom. As well as the direct benefit that lower gas and electricity prices allows the wider US economy, the boom is expected to lead to the creation of 1.7 million permanent jobs, as well as 1.6 million temporary jobs and $1.4 trillion in investment. The result is an expected boost to GDP by between 2-4% by 2020.

2.5 Fiscal drag is decreasing

- The government expenditure share of GDP has been contracting in recent years following the large stimulus provided during the financial crisis. A dramatic recovery in the federal budget deficit, from around 10% of GDP at its nadir in 2009 to around 3.3% in December 2013, suggests there is declining pressure for further near-term budgetary cuts.
- Economists estimate that government expenditure cuts and payroll tax increases reduced GDP growth by between 1.5-2.0% in 2013. However, with the deficit falling faster than expected, pressure on Congress to force further near-term expenditure cuts is diminished. As a result, we expect the fiscal headwind to amount to just 0.5% of GDP in 2014.

2.6 Other indicators

- Average weekly earnings increasing 1.5% in the year to December 2013 (to a level 9.4% higher than in December 2009).
- Annualised automotive sales of over 15 million in 2013, the highest since 2007.

Because of these signs, it is our view that, in the absence of a material negative shock, the US economy will experience accelerating economic growth over the next 12 to 24 months.

3. WHAT DOES A US UPSIDE SURPRISE MEAN FOR MARKETS?

Stronger-than-expected GDP growth in the US presents a tailwind for companies positively exposed to a domestic US recovery. However, a faster-than-expected US economic recovery will place accelerating upward pressure on US interest rates. It could also increase the risks associated with the exit of QE. As noted above, there are a number of other important factors that influence aggregate equity market performance. Key among these is interest rates, which have historically been more important for equity prices than GDP growth.

As Figure 1 below shows, from 1965 to 1981, during a period of 3% real GDP growth and rising interest rates punctuated by the start of the Volcker era at the Federal Reserve, the S&P 500 index increased by just 1.8% per annum. In contrast, the period of falling rates from

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1981 to 2007, with similar GDP growth, delivered a far greater 10.0% yearly increase in the S&P 500 index. This was followed by a five-year period of weak growth, poor equity returns and falling interest rates as the Fed commenced its unprecedented QE programme following the financial crisis. More recently, as the Fed has begun to wind down its QE programme, yields have risen from their 2012 lows of near 1.4% to around 2.6% at the end of January. This compares to average US 10-year Treasury yields of 4.8% in the pre-crisis period from 1997 to 2008.

It is highly likely that US 10-year treasury yields will materially increase over the next few years, as the economic recovery accelerates and the Fed ends QE. As discussed below, this risk is exacerbated by the massive pool of excess reserves (a bi-product of the Fed's QE programme) held by the Fed on behalf of the US banking system.

Figure 1: Interest rates can be more important than growth

	1965-1981	1981-2007	2007-2012	2012-
Real GDP growth p.a.	3.0%	3.2%	0.7%	2.5-3.5%
10 year govt bond yield change	+9.3% pts	-9.9% pts	-2.3% pts	↑
S&P 500 index change p.a.	1.8%	10.0%	-0.6%	?

Source: Magellan Asset Management. Note: 10-year Treasury yields peaked at 15.84% in September 1981 and bottomed at 1.43% in July 2012.

3. INTEREST RATE RISK IN THE QE EXIT

We continue to view the Fed's exit from QE as the major current investment risk, especially given the stage in the bond market cycle and the large pool of excess reserves in the US financial system. The strengthening of the US economy will require the Fed to reduce the unprecedented monetary policy support it has provided since the financial crisis, in order to ward off excessive risk taking in the financial system and to protect against future inflation risks. We believe this will signal the start of an interest rate normalisation process with long-term bond yields eventually moving closer to pre-crisis levels.

The Fed's exit from QE poses risks for equity and other asset markets (particularly currency and bond/credit markets) due to the likely redistribution of global money flows and rising

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bond yields.

The critical issue is that there are now in excess of US$2.4 trillion of excess banking reserves on deposit at the Fed. This represents 14% of US gross domestic product and 17% of total US bank assets. To mitigate the potentially adverse effects of these excess reserves on inflation, the Fed would either have to substantially reduce the size of these reserves or somehow neutralise their impact. While it has a number of tools that could be used to accomplish either of these goals, there are no reliable historical precedents that can guide investors (or the Fed itself) as to what will happen to markets as QE unwinds.

The three principal policies the Fed could implement to reduce or neutralise excess banking reserves are:

1. Increase the interest rate payable on excess reserves.
2. Sell longer-term Treasuries or mortgage-backed securities in the open market.
3. Raise the reserve requirement.

There are two main scenarios that could play out.

3.1. An orderly unwinding of QE

This scenario is predicated on a steady, but not sharp, US economic recovery with a gradual increase in the demand for credit. Against this backdrop, it is likely that the Fed could gradually reduce excess banking reserves by employing a combination of policies without any real threat of materially higher inflation expectations.

Under this scenario, we would expect US short-term interest rates to rise to around 2% to 3% and the US 10-year Treasury yield to rise to around 4.5% to 5.5% over the next one-and-a-half to two-and-a-half years. We would expect elevated market volatility and, potentially, some dramatic re-pricing of certain asset classes as this unfolds.

We view this as the most likely scenario and one that does not overly concern us from an investment perspective.

2. A disorderly unwinding of QE

This scenario could be triggered by a sharp US economic recovery, coupled with strong demand for credit. Such a scenario could be driven by a strong improvement in US house prices and a significant increase in demand for consumer credit, such as home equity loans. Under this scenario, longer-dated bond yields could start increasing rapidly as the markets lose confidence in the Fed's ability to exit QE in an orderly manner. In this environment, it is not unthinkable that US 10-Year Treasury yields could hit 8% to 10% over the next one-and-a-half to two-and-a-half years. Note, US 10-year bonds peaked at over 8% in the last bond market crisis in 1994.

The good news, in this scenario, is that highly-elevated US Treasury yields are unlikely to

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prevail for an extended period of time. The Fed is likely to take strong action against any inflationary threat and it is probable that global investors, banks and central banks would be attracted "like bees to a honey pot" to US 10-year Treasuries yielding 8% to 10%. As buyers enter the market, yields would fall back to more normal levels.

The bad news is that a rapid rise in the US 10-Year Treasury yield to 8% to 10% is likely to cause massive market dislocations and increase global systemic risk. We could see large and rapid falls in asset prices, major moves in currency markets and massive global monetary flows.

Furthermore, liquidity could be rapidly withdrawn from certain emerging markets, possibly triggering an event similar to the 1997 Asian crisis. We consider the following major emerging markets to be particularly vulnerable to this scenario: Turkey, South Africa, India and Indonesia. These countries are vulnerable due to a combination of budget and current account deficits, significant foreign debt exposures (especially short-term and foreign currency debt), significant growth of domestic credit, and modest foreign currency reserves. Other countries to watch include Brazil and Mexico.

We also believe that a rapid rise in longer-term US interest rates is highly likely to drive up longer-term interest rates around the world. This could place enormous pressure on certain European countries and could re-ignite the sovereign debt crisis (we estimate the total sovereign debt funding requirement for the next two years for Portugal, Ireland, Italy, Greece and Spain is approximately €1.4 trillion). We consider that Portugal, Italy and Spain appear to be the most vulnerable European countries, each with annual funding requirements of around 20% of GDP. A crisis that affected multiple Eurozone countries would be beyond the capacity of the European Stability Mechanism, which has approximate existing available lending capacity of only €260 billion. This could force the European Central Bank to intervene in certain European sovereign bond markets, possibly on a massive scale, and would test the veracity of both its Outright Monetary Transactions policy and the political will of Eurozone members.

Overall, we assess the risk of a disorderly unwinding of QE to be a fat tail, or low-probability, scenario. Unfortunately, as we have repeated on many occasions, low probability does not mean zero probability. Therefore, we continue to monitor economic data and asset markets for signs that a disorderly exit might be forthcoming.

In conclusion, we believe the ingredients are in place for the US economy to surprise on the upside over the next two years. However, a faster-than-expected US economic recovery will place accelerating upward pressure on US interest rates. It could also increase the risks associated with the exit of QE. We note that economic growth is not the only or most important determinant of equity market returns. Given the historical importance of interest rates, the Fed's extraordinary easing of monetary policy and the stage we are at in the bond cycle, we believe a return to yields of around 5% is the most likely scenario going forward.

The question that investors should be asking themselves is: What effect will higher interest

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rates have on markets? We are paying very close attention to this critical question as it has significant implications for the positioning of global equity portfolios.

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