CROSSBRIDGE CAPITAL

Market Viewpoints

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Madness is rare in individuals - but in groups, parties, nations, and ages it is the rule.

- Friedrich Nietzsche

There is evidence to suggest that the “middle class” has been massively squeezed over the last few decades, with more middle income families dropping into the lower income set and with less of the national aggregate income accruing to the middle class. This shrinking middle class has a vast impact on consumption and ultimately on economic growth, corporate profitability and inflation. When middle income families can no longer afford to buy the goods and services that businesses are selling, the entire economy is dragged down from top to bottom. In Middle America, Middle England, Middle France, and just about everywhere there is disappointment with the state of things and the free market economy. If left unaddressed, this could prove destabilising. Perhaps a little “redistribution of wealth” might improve the quality and quantity of economic growth—and reduce the demand for more aggressive state interventions (or even dare I say a revolution) later. So what will 2016 be like? In short, it will be more of the same: Low growth, low inflation and low asset price increases. The Fed may have raised rates and projected four additional +0.25% rate increases next year, but in my view, they will be lucky to pull off two increases. Disinflation (if not deflation) is the bigger fear. Viewing the current global economic malaise as cyclical, is a mistake, as there are powerful structural forces at work.

The shrinking middle class

“It was the best of times, it was the worst of times...”

Thus begins *A Tale of Two Cities* by Charles Dickens. While this famous opening line refers to the year 1775, it also strikes a chord with us today. On the one hand, despite left wing protests, the people (of the developed Western economies) today enjoy a living standard vastly superior to the harsh realities faced by young David Copperfield in Dickensian England. On the other hand, it is also true that a great number of people feel that, over the last decade, their wages and living standards have stagnated (or fallen) and that the economy is in the worst possible shape as inequality has grown. The data suggests that the “middle class” has been massively squeezed over the last few decades, with more middle class families dropping into the low income set and with less of the national aggregate income accruing to the middle class.

A report from the non-partisan Pew Research Center earlier this month found that, for the first time since the 1970s, families defined as “middle income” are actually a minority in the US:

- The middle class is getting squeezed from both ends: In 1971, there were 80 million households in the US defined as middle income – compared with a combined 52 million in the groups above and below. Now, there are 120 million middle-class families, but 121 million rich and poor – “A demographic shift that could signal a tipping point”
- A lower share of income accruing to the middle class: The share of US aggregate household income accruing to middle-income households is down substantially from 62% in 1970 to 43% in 2014. On the other hand, the share held by upper-income households climbed sharply, from 29% in 1970 to 49% in 2014

The shrinking middle class has a vast impact on consumption and hence economic growth, corporate profitability and inflation. Bearing in mind the plight of middle class, it would not be too hard to link the emergence of Jeremy Corbyn, Marine Le Pen and Donald Trump as a mere flash in the pan. The insecurities they are playing on are real. In Middle America, Middle England, Middle France, just about everywhere there is disappointment with the state of things and the free market economy. When middle-class families can no longer afford to buy the goods and services that businesses are selling, it drags down the entire economy from top to bottom. That’s why a CEO like Henry Ford made it his mission to pay his workers enough so that they could afford to buy the cars he made.

Greek philosopher Aristotle (b. 384 – d. 322 BCE), in his book *Politics,* argued about the importance of the middle class and its effect on the stability of a country. He said that the best nation is one controlled by a numerous middle class that stands between the rich and the poor. For those who possess the goods of fortune in moderation find it “easiest to obey the rule of reason." They are accordingly less apt than the rich or poor to act unjustly toward their fellow citizens. A constitution based on the middle class is the mean between the extremes of oligarchy (rule by the rich) and democracy (rule by the poor).

It is very rare that I feel the need to quote philosophers Karl Marx and Friedrich Engels. It is perhaps the first time in my working life that I do. Marx and Engels argued that Capitalism would eventually divide the society into two classes: the prosperous bourgeoisie, who owned the capital, and the impoverished proletariat, who contributed their labour. They also believed that the industrial production would inevitably depress the living standards of the proletariat and in turn increase the power of the proletariat as they suffered. Thus, having created a form of slavery, capitalism would be overthrown by its slaves.

This of course did not happen. Instead, the bourgeoisie grew so large that it became the property owning broad-shouldered "middle class" which carried the burden of the society. Both the US and the UK in the eras of Ronald Reagan and Margaret Thatcher created this "middle class" and stopped "Communism" from spreading into the West. Privatisation and property ownership served the middle class very well and Marx and Engels' prophecy of a proletariat revolution proved wrong. However, all this seems to have reversed over the last decade and the problem is accumulating. If left unaddressed this could prove destabilising. Perhaps a little more "redistribution of wealth" now might improve the quality and quantity of economic growth - and reduce the demand for more aggressive state interventions (or even a revolution) later.

2015, the year in review

As we countdown to Christmas and the New Year, the S&P 500 Index (SPX) is headed for a flat (to slightly negative) finish. Yet, this "no change" hides a volatile year, which many investors will be only too happy to say goodbye to (or good riddance to if you own energy and mining businesses).

There are five main factors that have dogged the stock market this year:

- Continued decline in commodity prices, particularly Oil. An oil price decline of over -40% in 2014 didn't preclude another -30% decline in 2015, to around $35 per barrel
- Continued strength of the US Dollar. The US Dollar (DXY) gained over +10% in 2015 on top of +12% gain in 2014
- Failure of easy money policies to create growth. Global growth remained subdued +3.1% (+3.4% in 2014). Growth in the US averaged +2.5%, about the same as the year before. The Euro area did slightly better +1.9% (last year +1.5%). Growth in Japan and Emerging Markets (except India) disappointed
- Inflation failed to pick up. Inflation has averaged close to zero (+0.2%; expectation of +1.5%) in the G7 countries despite on-going Quantitative Easing (QE)
- Currency devaluation in China. A mere -3% devaluation of Chinese Yuan caused extreme market volatility in August. We may not have seen the last of CNY devaluation. China however continued to avoid a "hard landing "with growth rate of +6.8% (+7.3% in 2014).

Last week, the US Federal Reserve (Fed) finally felt confident to begin raising interest rates. They increased the Fed Funds rate by +0.25%. Twelve months ago, many in the market were expecting that to happen as early as the first quarter of 2015.

The S&P 500 index is about -6% below its 2015 high and the equity market still looks to be in an anxious state even as the Fed reiterates a "gradual" increase in interest rates. The best sector performer this year is Consumer Discretionary (XLK), up +7.2%— largely due to Amazon (+114 % YTD) and Netflix (+145% YTD). The worst sector—no surprises there—Energy (XLE), down -26%, following a -10% drop in 2014.

2016, the year ahead

So what will 2016 be like? In short, it will be more of the same: Low growth, low inflation and low asset price increases.

The Fed may have raised rates and projected four more +0.25% rate increases next year, but, in my view, they will be lucky to pull off two increases. Disinflation (if not deflation) is the bigger fear. Viewing the current global economic malaise as cyclical is a mistake because there are powerful structural forces at work.

Global growth over the last two decades and more has been supported by some key factors:

- Defeat of communism and post-1990, the opening up of the global economy which led to rapid global economic growth
- A dramatic fall in inflation from double digits that led to the easing of rates and a rapid expansion of private credit that allowed demand to lead supply with a boom in asset prices
- A technological boom that followed the development of the Internet and other related innovation
- Broad geopolitical stability underpinned by US leadership and dominance

It all looks very different now as growth slows and signs of disinflation (if not deflation) abound:

- Global demand is constrained due to the lack of growth in wages in real terms. Add to this the demographic pressure of a shrinking working age population and a shrinking middle-class
- A peak in globalisation. World trade is not outpacing GDP growth as it did in the past. Emerging Markets (EM) economies built on rapidly expanding trade expectations are in for a surprise. The EM economies (India, China, Mexico) that can boost consumption and maintain current accounts in balance, will fare better than the rest (Turkey, South Africa, Brazil)
- Technological innovations of today kill more jobs than they create. Unlike the technological innovations of the past – the wheel, steam power, the printing press, electricity, and the Internet which gave us completely new things to do, thereby expanding the labour force and growth; the innovation of the current age represents improved ways of doing existing tasks. We live in a world of – Instagram vs. Kodak, Uber vs. Taxis and AirBnB vs. Hotels, to name a few. Prices for the same service have been reduced by -20%, if not more. It has also meant slower job growth, less investment spending and the second round effect of less consumption. This is disinflationary
- Monetary policy exhaustion looms. Monetary policy has largely achieved all it can in terms of boosting asset prices

and growth. There is little more it can do to stoke inflation and nominal growth. A fiscal response is now needed

Despite seven years of near-zero interest rates, three rounds of QE, and an expressed goal of returning inflation to 2%, the Fed has fallen short of its goal for nearly four years. Yet the Fed, trapped by its rhetoric, went ahead and raised rates last week. The current generation of central bankers have had their views formed during the inflationary period of the 1970s and they are determined not to lose control of inflation on their watch. If the world goes into deflation, then the next generation of central bankers will have a different reference point and priorities. I therefore feel we will have to suffer a painful disinflation (or even deflation) before the current monetary policy orthodoxy is discredited. As for politicians, the opposition to fiscal stimulus of the good kind (infrastructure spending) borders on lunacy. Attitudes toward fiscal stimulus will change in the event of another recession when it becomes apparent monetary policy is powerless to help. We will then see debt monetisation and expansionary fiscal policies, but it will come late after a lot of damage has been done.

The inflation-deflation debate is a big topic that will need reams of pages to address. I look forward to writing more on it throughout the next year. Now, let me translate my thoughts into some numbers and list my performance expectations for various asset classes and economies for 2016:

- The US economy will remain stuck in a +2-2.5% growth range and inflation will continue to disappoint. Therefore the Fed is unlikely to raise rates more than twice next year
- US Oil production has already fallen by over 650,000 barrels per day (b/d) from its April peak and more cuts are coming. Non-OPEC offshore productions have been trimmed too due to high Capex versus current oil prices. Iran will likely boost production by 1 million b/d following removal of sanctions. Therefore Oil is not going to find a balance until Q3-Q4'16. It will likely stay in the $30-35 range until then
- China will continue to avoid a hard landing and its transition from an export driven to consumption and service driven economy will continue. China has plenty of policy room to manoeuvre, with sovereign debt to GDP at 43% and borrowing rates still at a high
- EUR/USD is likely to stay where it is now. The issue of divergent monetary policies between the US and the Eurozone looks overdone. While a dip to parity cannot be ruled out, the chances are that it will not stay there and it will bounce back to stay in the 1.05-1.10 range
- The USD is likely to gain further against EM currencies and commodity currencies
- Bonds may not offer great return but Developed Market sovereign bonds are still worth holding as a hedge against downside risk – recession and disinflation
- S&P 500 Index (SPX) reached a high of 2130 this year and languishes at 2000 now. I don't expect SPX to see a new high in 2016. The return for next year will be limited to +4-5%
- Finally, one can't talk about 2016 without talking about Donald Trump and the US Presidential election. Here's what I think. First, the impact of American politics on the economy is overestimated and we saw this in the 2008-15 cycle. Despite Obama and the Congress stalling each other, the economy has continued to grow and equity markets have reached new highs. If Donald Trump wins the GOP nomination, he is unlikely to win the White House. The small percentage of American voters who really decide the US Presidential election are centrist and independent. Trump will not win them over, and if he tries to, he will lose his right wing votes. Therefore we will likely see a Democrat White House and a Republican controlled Congress again. Only this time with Obama gone, we will see a more conciliatory tone between the White House and Congress. The alternate scenario is of a centrist Republican winning the White House. Either way, the US election result will be less alarming than anticipated.

On the cautious note that the world is faced with disinflation and low growth with asset prices unlikely to increase much, I take this opportunity to wish you a Merry Christmas, Happy Holidays and a very Happy New Year!

Best wishes,

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