

Reflections on Global Macro: Position for Higher Rates

Published June 10, 2015

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*Last week I chatted with Jawad Mian, the author of a macro advisory letter called *Stray Reflections*. We talked about his process of approaching macro research from the perspective of valuations, growth, liquidity and technicals.*

Macro Positioning In assessing the likelihood that the Federal Reserve (Fed) will raise rates, Mian asks if the world economy is ready for its first Fed rate hike in nearly a decade. He recalls that prior to 2015, world growth was imbalanced: U.S. growth was in full throttle, while China faced the fear of hard landing, Europe grappled with recession and investors questioned the sustainability of Japanese growth. In contrast, Mian believes 2015 is characterized by a much more balanced growth picture, with Europe and Japan providing positive momentum to global growth and China experiencing a stabilizing property market. As a result, he is bullish on non-U.S. stocks and bearish on bonds.

Higher Bond Rates Coming? The stronger jobs report pushed the German bund up toward 1%, and long rates in the U.S. rose closer to 2.4%. Mian believes rates are going to continue to rise from here, calling for the 10-year U.S. rate to rise to 3.2% in 12 to 18 months as deflationary fears dissipate and bond yields reconnect with economic fundamentals. He attributes higher rates to a re-pricing of macro fears and re-rating of global growth.

What Rate Cycle Means for Stocks Mian believes that turning points in interest rates are a strong cyclical trigger for U.S. equities. His favorite macro chart depicts the secular downtrend in U.S. yields from 1980 onward. According to Mian, historically speaking, cyclical peaks and troughs in rates represented good buying and selling opportunities for U.S. equity markets. Sell signals were triggered prior to previous stock market crashes, ahead of the 1987 "Black Monday" stock market crash, the 1990 crisis led by higher oil prices, the 1994 Mexican peso crisis, the 1997 Asian financial crisis, the dot-com crisis in March 2000 and the 2007 and 2008 financial crisis. Mian believes the next sell signal will be triggered at the 3.5% range in 10-Year Treasuries. One fundamental reason Mian sees for the secular downward trend in yields and lower trigger points for selling equities is rising U.S. debt, making the country less able to endure a crisis. He adds that as long as nominal gross domestic product (GDP) stays above 10-year yields, all is well, as the cost to finance the corporate sector is easily managed. As yields rise, investors ought to be more cautious.

Riding the Secular Bull: Japan and China Mian designates March 2009 as the start of the secular bull market in the U.S. Similarly, October 2012 signaled the start of a secular bull market for Japan—one that he anticipates will last many years. Japan's prime minister, Shinzo Abe, has been given a significant mandate to bring about change, and Mian is encouraged by land prices bottoming out and the banking sector starting to recover as credit growth picks up and deflation abates. While exporters are at the forefront today, he anticipates Japanese financials will do well in the future as bank lending starts to accelerate. Mian also believes 2014 was that moment for China. In his analysis, Chinese stocks

are the least crowded trade and could present a good risk/reward opportunity. He is not in the camp that prescribes to China employing a one-time FX devaluation to give a boost to its exporters, nor does he believe that China is experiencing a credit bubble. **He also thinks that emerging markets have become more diverse, with a preference for the following:**

- Reformers such as India that are not populist
- Asia in the likes of Japan, Korea and Taiwan and not LATAM
- Services sector and not cheap manufacturing goods

2015 is a wider European moment, as risks of breakup recede and growth is expected to resume. European stock prices are at a 60-year low compared to stock prices in the U.S. Mian believes that Greece will remain in the eurozone and that it is not in the best interest of either Germany or Greece to risk an exit given cheap euro valuation and the pain Greece has undertaken over the years via austerity. **The Tale of the USD—Hedging Currencies in Europe and Japan**

Mian is a proponent of currency hedging in both Japan and Europe. When asked about his longer-term views on the U.S. dollar, he presents the following thoughts:

- Since 2011, there has been one big macro trade on global deflation. August 2011 marked the bottom of the U.S. dollar, which coincided with the S&P downgrading U.S. debt. By the same token, global inflation was falling, and investors were confronted with sluggish growth worldwide. Unsurprisingly, U.S. stocks outperformed handsomely.
- However, Q1 of 2015 marked the end of the deflation trade, and Mian believes that we are bound to see an unwinding of these trades. He believes that when the Fed embarks on its tightening cycle, the dollar may be more vulnerable.

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