Low rates need to deliver soon or will merely fuel a bubble



Michael Mackenzie

The Long View

Watching financial markets at the moment triggers questions about the wisdom of the crowd.

Record-breaking equities appear at odds with the gloomy message from the bond market, with 10-year government bond yields loitering within sight of all-time lows. Sharply lower industrial metal and oil prices hardly paint a picture that a V-shaped global recovery beckons in the coming months.

The coronavirus outbreak has replaced last year's rumbling trade war as the darkest storm cloud bearing down on markets. Investors can only wait to see whether a China growth scare takes hold from here, or whether this hurricane warning is downgraded to a passing bout of turbulence.

The divergent messages from different asset classes show how a fear trade feeds on itself and ultimately results in record highs in equities, led by quality and growth companies.

Meanwhile, quality companies with strong cash flows are a neat alternative for fund managers tired of government bonds' meagre fixed rates of interest. Popular investment strategies such as risk parity, which combines bonds and equities, intensify this phenomenon.

Passive investing flows also pump up the value of large companies compared with their smaller peers, as highlighted by higher returns generated since January and over the past year for the Nasdaq 100 and S&P 100 in contrast with their broader benchmarks. In effect, both government bonds and high-quality stocks are fear trades.

Alberto Gallo at Algebris Investments describes the present situation as one of investors "hiding in assets which benefit from central bank liquidity while shunning what depends on growth".

That's all well and good for investors who have enjoyed the ride so far. But there is a long-term cost. Mr Gallo identifies how years of easy money from central banks have created a "winner-takes-all" climate.

"Large firms in a leadership position are able to tap cheap capital and can easily implement consolidation strategies and buy out their competitors. In turn, lower competition reduces economic dynamism and productivity," he said.

These well-entrenched macro trends fan concerns that crowding further into a narrow cohort of quality and growth companies represents a financial stability accident waiting to happen. The longer bond yields remain stuck in the basement, the more that growth and quality stocks extend their rise. As investors are well aware, this is fine until it is not. The reckoning, whenever it comes, will be painful.

> One source of optimism is the hope China and other countries deliver smart and vigorous support

Lisa Shalett, chief investment officer at Morgan Stanley Wealth Management, worries that current market positioning "belies a cynicism about the ability of the Federal Reserve to reflate the economy and drive lasting improvements in the business cycle". This, she argues, leaves investors "entering uncertain territory where only the cyclical stocks are valued for the risks of policy failure".

With that in mind, aside from the health crisis here, which fund managers of course do not ignore, just how do China and other countries respond as the coronavirus growth shock fully registers in economies and markets in the coming weeks?

Given how unreliable leading equities benchmarks are as a gauge of global economic health, riskier and more macro sensitive assets, such as commodities and emerging-market currencies, will probably offer a more useful guide. So far, rebounds in those markets have been rather more shallow.

One source of optimism is the hope that China and other countries in the region will deliver smart and vigorous packages of support. If they do, then mix in the soothing in trade tensions, and the hope the virus subsides, and on paper at least, things look brighter.

Patrick Zweifel, chief economist at Pictet Asset Management, expects a V-shaped recovery in China after a first-quarter decline, with tax cuts for sectors hurt by the coronavirus a likely policy response. That sets the stage for a rebound across emerging markets and a weaker US dollar as the year lengthens.

Such an outcome would hopefully provide a foundation for stronger capital expenditures and provides companies geared towards the economy with much needed leverage to boost their earnings growth and absorb higher input costs.

The alternative, and arguably more scary scenario, is that interest rates will be held "lower for longer" but they will support only an expensive niche of equities. That is not a comforting situation, for 2020 or beyond.

The longer this risk runs on, the more urgent it becomes for policy to deliver real-life results.

As Ms Shalett argues: "This is no longer 'Goldilocks'. Either low rates and excess liquidity make their way into the real economy, driving an uptick in growth rates or cyclical stocks, or they feed an increasingly fragile and risky asset bubble."

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Reasons to be cynical about the US-China trade deal rally

Michael Mackenzie
The Long View



Financial markets continue to live up to their reputation for getting ahead of themselves. This week's catalyst was the trade armistice between the US and China, which helped push global equity indices further into record territory.

But investors should not dismiss the prospect of renewed skirmishes between the two powers. Nor can they rule out more aggressive posturing from Washington towards other trading partners that run large trade surpluses.

Truces can be fragile. The primary consideration for investors is whether the "phase one" deal fosters greater confidence among global businesses and spurs higher levels of investment and economic activity. The bullish sentiment prevailing in the markets mainly reflects how central banks — channelling the mantra "if you build it, he will come", from the US baseball movie *Field of Dreams* — have done their job of crushing market volatility through low interest rates, and have laid the ground for an economic rebound.

Investors need to see more than just green shoots and bullish analyst forecasts of stronger earnings growth.

Faultlines in global trade are still discernible. The White House is not rolling back the full existing tariffs on $360bn of Chinese products until the agreement of a phase two deal. Investors will probably have to wait until after the US elections in November, and probably into next year, before that is sealed.

There will also be losers from this preliminary deal should China purchase an additional $200bn of US goods over the next two years as agreed.

George Saravelos at Deutsche Bank observes that "China will have to shift existing and future demand for goods towards the US . . . The US trade deficit could improve at the expense of others." German manufacturers and Brazilian farmers, in particular, stand to lose out, he thinks.

Meanwhile, the US Treasury will keep up its campaign against potential currency manipulators, with the likes of China, Japan, Korea, Germany, Italy, Ireland, Singapore, Malaysia, Vietnam and Switzerland all sitting on its monitoring list. All in all, "further actions by the US on trade risk harming an already soft outlook for global trade growth in 2020", said Win Thin at Brown Brothers Harriman.

A possible trigger for future trade conflict is that Chinese subsidies and alleged cyber theft were not addressed in this week's treaty, because they are seen as part of the phase two agreement. The prospect of two separate technology systems in the US and China, as companies decouple their supply chains, remains firmly in play. It puts Europe and many global-orientated companies in a tough spot.

> Chinese subsidies and alleged cyber theft are seen as part of the phase two agreement

For broader market sentiment, one of the most important developments over the past few months has been a steady appreciation in the value of China's currency. The renminbi has quietly returned to a level last seen in July, and more importantly has appreciated through the Rmb7 per dollar level that caused angst when it was breached last August.

A world where the renminbi rallies and the dollar depreciates is good news for emerging markets, as higher local currencies improve returns.

Investor enthusiasm for EM is strong. BNY Mellon notes substantial demand for Chinese equities at the moment, as many investors consider valuations on the S&P 500, the major US equity index, as stretched.

EM equities have outperformed rivals since October, led by Asia. An MSCI index of global companies reliant upon significant revenues from China has also enjoyed a near 20 per cent bounce since October.

Such a performance whets the appetite of investors who anticipate a prolonged rotation from expensive US equities towards emerging markets, which have long been cheap and for good reason.

For all their recent strength, EM equities remain a good margin below their 2007 peak. Declining global trade volume has been accompanied by a commodity bust, and a much firmer US dollar in recent years.

Many emerging economies have endured slowing growth and a more challenging demographic backdrop, highlighted by China's birth rate falling to a record low last year.

But investors also need to assess the limits to the current EM rally. An easing in trade tensions between the US and China, alongside recent dollar weakness and infusions of liquidity from global central banks can certainly sustain further gains.

But how long that will last depends largely on Beijing and whether it adheres to the demands of the truce. A stronger currency and the retention of US tariffs would be further headwinds for China's slowing economy.

Investors should be alive to signs of the ceasefire breaking down. As TS Lombard analysts highlight, "currency stability and the expansion of bilateral trade are the most important for assessing the deal's short-term durability since any non-compliance on these will be evident immediately".

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Investors grapple with indefinite monetary support



Michael Mackenzie

The Long View

One striking aspect of 2019 is that it marks the fastest pace of central bank easing since the financial crisis.

This support has crushed government bond yields and cushioned the blow of contracting global manufacturing activity, faltering business confidence and falling capital investment. Nascent signs of a bottom in the global economy suggest that the central bank easing campaign has stemmed the risk of a harder landing in the coming year.

The robust recovery in equities (led by the US and Europe) and most areas of corporate debt in 2019 give the strong impression that sunnier times loom for economic activity and corporate profits. But the role played by the support from central banks cannot be overstated.

Whether central banks are ultimately successful in their aim of extending the business cycle and affirming rising equity market valuations remains a point of some conjecture among economists and investors. Clarity over US-China trade and Brexit this week propelled global equities beyond their peak set in early 2018. But macroeconomic uncertainty stemming from the US election cycle, a slowing Chinese economy and trade rivalry will not fade as issues during 2020. And global disinflationary pressure remains a concern among policy officials, as indicated by the latest meetings of the US Federal Reserve and the European Central Bank this week.

Both central banks sent a message that monetary policy will stay in easing mode for the foreseeable future, supported by their expanding balance sheets. Investors have been left in little doubt that central banks, led by the Fed, are reluctant to tighten policy and that, in fact, the door remains open for further easing.

When questioned during his press conference Jay Powell, the Fed chair, pushed back against the notion that he had embarked on a repeat of the Fed's 1995 and 1998 "mid-cycle" easing campaigns, each of which was followed by a resumption of rate rises within six months. Now, Mr Powell said, the modest level of inflation, which persists in spite of an unemployment rate stuck at its lowest level in half a century, means the lower-for-longer mode must remain in place.

But big central banks have largely done what they can. As they head for the sidelines, investors face the challenge of putting money to work amid signs that risk outweighs opportunity in a world of slumbering yields.

The strategy is familiar. "With lower-for-longer rates and bond yields firmly entrenched, investors are forced to take more risk to meet their return targets," said David Riley, chief investment strategist at BlueBay Asset Management.

> It may be time to seek out alternatives to fixed income as the bedrock of an investment strategy

A sustained low-yield environment favours equities and riskier areas of credit, and also a strategy of selling market volatility. This entails picking up insurance premiums from other investors who are nervous about the old age of the cycle and keen to protect themselves against the risk of a sharp decline in asset prices. Over the past decade, harvesting this premium has generally been rewarding given the supportive stance of central banks that has helped to limit bouts of market turmoil.

With little sign of the central bank safety net failing any time soon, stretching for returns and selling volatility appears well entrenched and that naturally arouses concerns about financial stability. This point has recently been addressed in financial stability reports from both the Fed and the ECB. The latter noted: "Equity and credit valuations in the euro area seem increasingly contingent on and sensitive to changes in the benchmark yield curve, whereas nominal growth and earnings expectations have played a less prominent role in explaining the equity price increases observed in recent years."

True, there is a broad recognition that equity and credit markets reflect plenty of good news, while government bond yields are very low and therefore vulnerable should growth and inflation pressure pick up. In contrast, equities and credit appear rich in the event that growth falters and, more importantly, the recent pressure on corporate margins does not abate.

One other big question is whether investors truly believe in the new reality of meagre or even negative yields. David Jane, fund manager at Premier Miton Investors, suggests that some may still see this as a passing fad rather than the new bedrock for portfolio construction. Markets may not have "fully discounted this ongoing environment", he said.

The upshot: it may be time for investors to seek out alternatives to fixed income as the bedrock of their strategy. "No longer can investors buy longer-dated bonds to get higher returns and higher yields. Equity markets have a good number of growing dividends in excess of current bond yields, perhaps because equity investors still haven't fully adjusted for the government bond yield environment that persists," he said.

All of this explains the common refrains in strategy outlooks for the coming year: cautious optimism, "limited upside" and at most modest growth in corporate earnings.

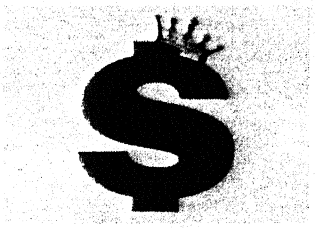
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American economic power

Spooked by sanctions

America has weaponised the dollar. In the rich and emerging world, the search is on for an alternative

ON JANUARY 15TH America and China signed the first phase of a trade deal that eases tensions, with China agreeing to buy an additional $200bn of American products over two years. It may look as if peace is breaking out in global economic relations, but beneath the surface the tectonic plates of commerce are shifting (see Briefing). America's financial muscle-flexing—through the use of sanctions, tariffs and bans on blacklisted firms—has not escaped the attention of other countries, which have been intensifying efforts to avoid the global dollar-based financial plumbing. Though these could herald a more balanced international monetary system, they also carry risks for the world economy.



The Trump administration has turned its financial might on not only China but also Iran, Russia and a host of others—including even allies such as the European Union and Turkey. The latest Iranian sanctions, announced last week, will heap more pain on an economy already pummelled by economic missiles aimed at banks, oil production and shipping. So dollar-centric is global commerce that other countries have long found it difficult to trade, even among themselves, without recourse to America's currency, banks and payments infrastructure. At least half of all trade invoices are in dollars. A majority of cross-border transactions are ultimately cleared through New York.

America started using the dollar system as a geopolitical weapon in earnest after the attacks of September 11th 2001. President Donald Trump has taken this policy to a new level of intensity, using sanctions as his main foreign-policy tool and even targeting allies with "secondary" sanctions that punish anyone who trades with states in America's bad books. America's power ultimately stems from its ability to prohibit firms from using its financial system, in turn leaving them isolated and unable to interact with most counterparties. Often the effect is fatal.

The moves to explore alternatives to dollar-dependence in the face of this bellicosity are varied. Russia has substantially dedollarised its trade flows, foreign debt and bank assets. Its energy giants have started switching contracts to roubles. Russia, China, India and others are discussing—and signing—bilateral or wider deals to settle trade in national currencies. They are also exploring alternatives to SWIFT, the dominant payments-messaging network, over which America holds sway. Europe, meanwhile, has built Instex, a clearing-house, that could allow its firms to trade with Iran while bypassing America's financial cops.

The search for workarounds has been given further impetus by the technological revolution sweeping through finance. Central bankers from Europe to China are stepping up work on public digital currencies. These could help bring down the cost of electronic cross-border payments, which is still relatively high. Some foresee the creation of cryptobaskets of reserve currencies.

It would be overdoing it to say these initiatives pose an immediate threat to the dollar. Instex has yet to be used; the SWIFT alternatives have yet to gain traction. The dollar's share is holding ▸▸

▸ up on most measures (though in forex reserves it has slipped from around 70% to 60% since 2000). It continues to enjoy strong network effects. The most complex bits of global finance, including a huge mesh of derivatives, are generally dollar-based.

Moreover, potential rivals have drawbacks. The euro is hobbled by structural and governance problems, not least the lack of a proper banking or markets union in the euro zone, and a dearth, relative to America, of risk-free financial assets such as German bunds. Blockchains alone cannot overcome such flaws. The yuan, too, has had false dawns. The tightening of capital controls after a financial crash in 2015 put paid to brash predictions that it would overtake the dollar by the early 2020s.

Nevertheless, an inflection point has been reached. Since Mr Trump began firing off financial ordnance, his targets have gone from merely musing about breaking free from the dollar to doing something about it, albeit tentatively for most. It is hard to see those efforts being wound down, even if America eases up.

A world in which the dollar is tested from several sides will be unpredictable. In the longer term, more balance among global reserve currencies may make the global monetary system less vulnerable to shock. And the dollar's current pre-eminence is not an unalloyed good for America: it distorts the currency's value (upwards) and market interest rates (downwards).

In the interim, however, the new era of monetary experimentation carries three big risks. First, a further escalation of sanctions could cause a financial shock, for instance if China's giant banks, which together have over $1trn of dollar assets, were targeted. The second worry is that the more politicised America's financial hegemony becomes, the less reliable it will be in its longstanding role as a lender of last resort to offshore dollar-based financial markets and banks. The third is that transitions in the global monetary order are inherently unpredictable. Some economists believe the Depression was partly caused by the absence of a hegemon to steady the world economy. Mr Trump's upping of the financial pressure will have repercussions far beyond Tehran or Moscow. ■

Disease and growth

Viral slowdown

How China's epidemic could hurt the world economy

WHEN SHOCKS hit the global economy, Wall Street looks to history to see what will happen next. The outbreak in China of covid-19, a respiratory disease, invites a comparison to the last one, SARS. In that outbreak in 2003 China suffered a sharp hit to its growth, followed by a strong rebound. Although covid-19 has now claimed more lives than SARS, investors remain optimistic that its economic effects will follow a similar path.

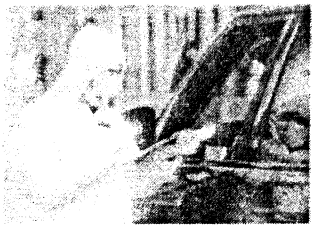
On February 13th Hubei province, centre of the outbreak, announced 14,840 new confirmed cases, a sharp rise. That was because it suddenly started including CT-scan diagnoses, not just specific tests for the virus. Although the statistical fog is thick, indicators such as the fall in new cases outside Hubei and the total of suspected cases suggest that the rate of fresh infections may be trending lower.

Most economists have thus only nudged down their forecasts for full-year global growth. Chinese stocks and commodities, which track economic prospects, have clawed back ground after initial falls. Global stockmarkets are higher than they were in January, when the severity of the outbreak became clear. We hope their optimism is justified. Yet the comparison makes two assumptions: in supposing that containing the virus maps neatly onto a better economic outlook; and in thinking that the world ▸▸

▸ still works as it did when SARS was a threat.

There is an inherent tension between China's apparent success in containing the epidemic and its growth prospects. Though less lethal, covid-19 seems more infectious than SARS. China has slowed its advance only by severely limiting people's movement and closing businesses. If the government were to relax these controls too hastily, progress could stall or even go into reverse. So far, officials have erred on the side of caution. Provinces accounting for more than 90% of Chinese exports have kept factories either shut or running at low capacity since January 31st, when the lunar new-year holiday was due to end.

It is hard to overstate the effect on the economy. Coal consumption is more than a third lower than the average for this time of year. Property sales are down by more than 90%. After the holiday some 200m people usually leave their home towns to return to work. This year the trains that carry migrants have been nearly empty. Cities have warned outsiders that they might face 14-day quarantines. Nine out of ten companies surveyed by the American Chamber of Commerce in Shanghai have employees working from home. Couriers still zoom around on their electric motorbikes, but the takeaway trade is not saving restaurants because people fear eating meals prepared by strangers who may be infected. Grabbing a latte is a risk too far. Starbucks has shut half its 4,000-plus cafés in China.



The second doubt is over the relevance of SARS as a comparison. The global economy has changed since 2003, when SARS struck. China now accounts for 16% of global GDP, up from 4% back then. And it is the world's second-biggest importer, so any weakness, however temporary, is felt far and wide. Already, some of its firms are trying to get out of contractual commitments to import copper and liquefied natural gas. And its tourists, who spend $250bn a year on overseas travel, are staying at home.

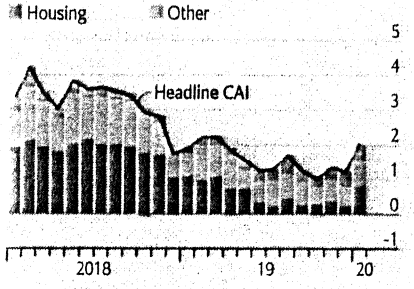
Accounting for China's increased size is easy. But the economy has not just grown since 2000; its manufacturers have also become enmeshed in supply chains of mind-boggling complexity. A factory in Wuhan may provide parts to a firm elsewhere in China, which in turn supplies a factory in Stuttgart, with the final product emerging in Michigan. Just-in-time production leaves little room for delays. Many firms cannot trace all their suppliers, making it hard to predict the impact of work stoppages in China on their output, let alone on global GDP (see International section). History provides little guidance on the effects of disrupted supply chains, because the world economy has not been organised around them for long.

Some problems have already emerged. Hyundai has halted some car production in South Korea because parts are short. So has Nissan in Japan. Facebook has stopped taking orders for its new virtual-reality headset and Nintendo has delayed shipments of new gaming devices. Foxconn, which makes smartphones for Apple and Huawei, has restarted its factories but with skeletal staffing. And these are just the brands you have heard of. China churns out a third of the world's chemicals, half of its LCD screens and two-thirds of its polyester. Companies that think they are isolated from China could be in for a surprise.

It is also possible that the virus spreads rapidly outside China. Infections in developing countries may be going undetected. Vietnam has quarantined 10,000 people, but most governments could not enact the measures that China is using to slow the disease, so covid-19 could yet become a pandemic. Wall Street's optimism, in other words, is premature. If economists have a bias, it is to focus on things that are measurable and quantifiable. Alas, the covid-19 outbreak brings many risks that are not. ■

Exit, pursuing bears

United States, sector contribution to Current Activity Indicator*, % change on a year earlier



Source: Goldman Sachs Global Investment Research

*Incorporates 37 economic indicators

index of capital-expenditure plans, which combines various indicators, moved up in January after falling for seven straight months. The bank's economists attribute this capex revival in part to "more positive headlines on global trade".

Jonathan Golub of Credit Suisse, an investment bank, argues that if the expansion since the global financial crisis of 2007-09 is measured not in time but in GDP, which has grown unusually slowly by historical standards since 2008, it may have life in it yet. The business cycle is not dead, he says. But it is "elongated". Economists scoff at such simplistic metrics, but a version of this argument is an increasingly common refrain among bulls on Wall Street. Their poster child is Tesla, an electric-car manufacturer whose market value nearly quadrupled in four months.

Lest the bulls get carried away, they should consider the three risks facing America's Goldilocks market. First, the coronavirus from Wuhan is infecting American firms' Asian supply chains—and global confidence (see Finance section). Manufacturers in particular are vulnerable to contagion. Most economists, pointing to the modest global impact of outbreaks such as SARS in 2003, remain cautiously optimistic. But if the Wuhan virus turns into a deadlier global pandemic equity markets would invariably suffer.

Another worry is that the entire stockmarket is skewed by Big Tech. Apple, Microsoft, Amazon, Alphabet and Facebook account for 18% of the S&P 500. Cassandras note that in 2000, on the eve of the dotcom bust, the giants of the day—Microsoft, Cisco, GE, Intel and ExxonMobil—also made up 18% of the index. Because of their exposure to other tech firms, including frothy startups, Microsoft, Intel and especially Cisco were brought low by the crash rather than being a counterweight to it.

Mr Kostin notes that today's big five are different. They trade at lower multiples of annual earnings than the big five of 2000 did (30 now versus 47 then) and reinvest more capital into the business (48% against 26%). The implication is that today's giants have room to grow. Even so, their shares are looking pricey; Tesla's plunged by 17% on February 5th. The companies remain vulnerable to antitrust action, privacy regulation, uncertain succession (see next article), as well as the health of their myriad Asian suppliers.

The final bear case has to do with potential weakness in American household consumption. Ellen Zentner of Morgan Stanley notes that real personal consumption spending grew at an annualised rate of 1.8% in the fourth quarter, down from 3.2% in the third. She calculates that the annualised growth in spending on non-durable goods last quarter was only 0.8%, down from 3.9% in the one before. Spending on food and beverages fell by 0.5% on an annualised basis in the fourth quarter of 2019, down from an increase of 5% in the previous three months.

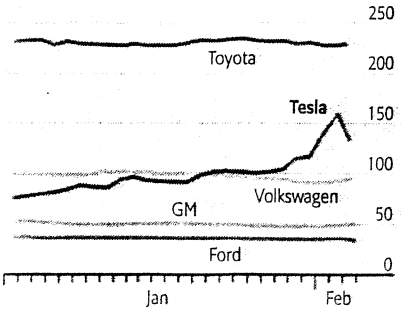
The profits just reported by big banks, which owe their strength in part to credit-card spending and mortgages, suggest that consumers are in a buying mood for now. Bosses have reason to kick back and relax. Farsighted ones know that this warm feeling will not last for ever. ■

Fast and furious

Small startups' market value has been known to soar by 50% in a few days. It is almost unheard of for $100bn companies to gain that much so fast. Unless you are Tesla. Since we wrote about Elon Musk's electric-car firm's performance last week, when it reported a quarterly operating profit of $359m, its market capitalisation swelled by nearly $60bn—never mind that it still lost money for the year as a whole and makes one car for every 30 produced by Germany's Volkswagen (with a market capitalisation of $95bn). On February 5th it shed some $30bn. The reasons for the volatility remain as mysterious as Mr Musk's mood swings.

Nought to $60bn

Market capitalisation, $bn



Source: Datastream from Refinitiv

Technology C-suites

Time for an update

SAN FRANCISCO

Talk of succession atop Big Tech grows louder

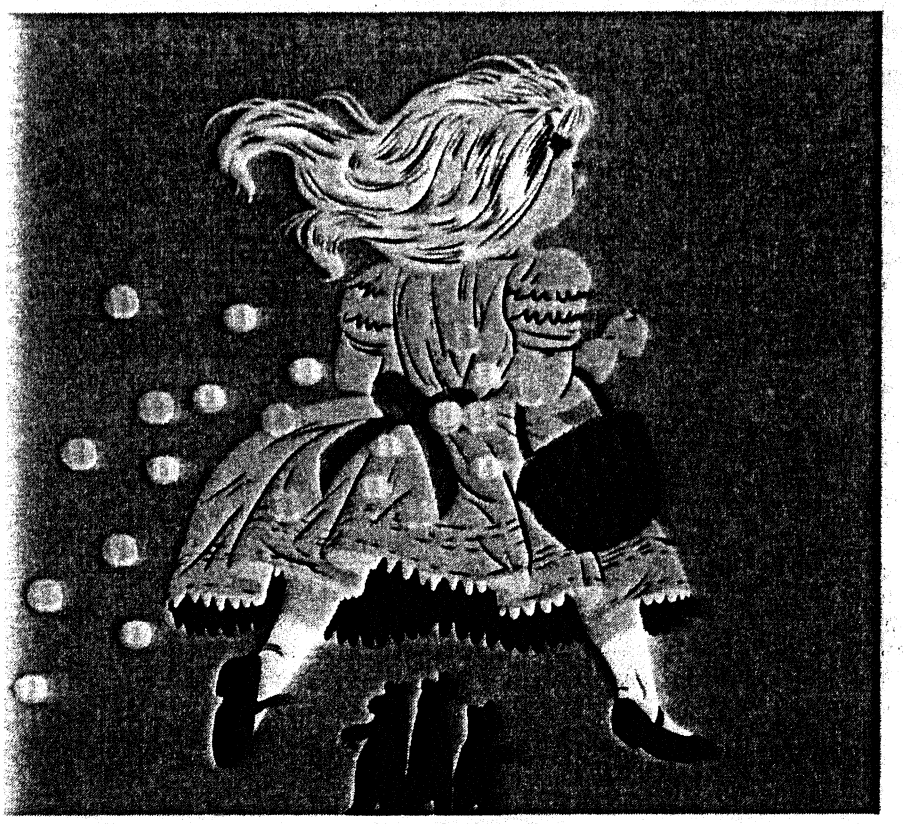
MOST BOSSES, even of multibillion-dollar businesses, are anonymous to anyone who is not their employee or an equity analyst. Except, that is, technology bosses—and not just founders like Amazon's Jeff Bezos or Mark Zuckerberg of Facebook. Many bystanders are familiar with the bespectacled visages of Satya Nadella, who runs Microsoft, or Tim Cook, from Apple. Over the next year or so people may need to learn some new faces.

The first notable tech succession of the decade was announced on January 30th, when IBM said that Arvind Krishna will take over from Ginni Rometty, a rare female Big Tech boss, in April. Two days later Sandeep Mathrani was named as the chief executive of WeWork, a troubled pseudo-tech firm which rents office space. In December Google's founders, Larry Page and Sergei Brin, handed control of Alphabet, the search firm's parent company, to Sundar Pichai, who ran its core business.

More turnover is afoot. Marc Benioff, founder and co-CEO of Salesforce, which sells cloud-based business services, is expected to step down this year. Some Uber investors and executives wonder if Dara Khosrowshahi is the right person to bring the ride-hailing giant to profitability. Questions are even being raised about superstars like Mr Cook, who turns 60 in November and will then have run Apple for nearly a decade, and Mr Nadella, a 52-year-old who has been in the top job for six years. Who takes their place will say a lot about America Inc's sexiest sector.

The names bandied about share a lot in common. For one thing, they are all male. Mr Cook's heir-apparent is Jeff Williams, currently in charge of the iPhone-maker's operations. Mr Nadella's likeliest replacement is Kevin Scott, Microsoft's chief technology officer, whose upcoming tome, "Reprogramming the American Dream", looks like a book-length job application. Mr Benioff is expected to hand over his co-CEO role to Bret Taylor, Salesforce's president and chief operations officer.

Ms Rometty's departure leaves only two prominent female leaders in tech: Lisa Su at AMD, a chip-design firm (who was reportedly considered for the IBM job) and Safra Catz at Oracle (though Larry Ellison remains the power behind the throne at the business-software giant he founded). Microsoft has nurtured a generation of impressive female talent, including Lila ▸▸



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USA Inc

Goldilocks and the three bears

NEW YORK

After a nervy year American companies are feeling more confident

IS THE EARNINGS recession over? Many observers of corporate life have been asking this question as America's listed companies report last quarter's results in January and February. The omens going into the decade's first earnings season did not look good. The current expansion is the longest in American history, so a downturn seemed inevitable. Indeed, the first three quarters of 2019 saw year-on-year declines in earnings for the S&P 500 index of leading firms. Financial analysts had forecast another drop, of 2% or so, in the fourth, marking the first such prolonged malaise since 2015-16, when America suffered a manufacturing slump.

With firms accounting for two-thirds of S&P 500 earnings out of the way, the mood has shifted—and then some. American bosses have unfurrowed their brows. A survey of big firms' chief executives by the Conference Board, a business think-tank, showed a rebound in confidence from a ten-year low in the third quarter. The latest poll of smaller firms by the National Federation of Independent Business, a trade group, also recorded greater optimism. Equities may be headed for what Michael Wilson of Morgan Stanley, an investment bank, calls "a Goldilocks environment".

America's biggest firms are leading the charge. Apple's net income grew by 11% to a record $22.2bn thanks in part to surprisingly strong iPhone sales. A surging cloud business boosted Microsoft's net income by 38% to $11.6bn. Even Amazon, renowned for profitless growth, increased net income by a tenth, year on year, to $3.3bn. But Big Tech is not alone. Industries from utilities to banks to health care appear to be back in business—prompting analysts to revise upwards their forecasts for 2020. Jill Casey of Bank of America expects profits to rise by 8% this year, compared with the latest estimate of about 1% for last year.

What happened? For a start, fears of a recession have not materialised. If anything, America's economy is perking up. In January the IMF forecast that American GDP would grow by 2% in 2020, faster than the euro area (1.3%) or Japan (0.7%). The "current activity indicator", an aggregate of 37 economic metrics compiled by Goldman Sachs, an investment bank, rose sharply in January (see chart on next page). Even manufacturing, where activity had been slowing since mid-2018, looks in better nick. A survey published on February 3rd by the Institute of Supply Management points to the first expansion in months.

America's commercial truce with China announced in December played a role. Most bosses know that this "phase one" deal is imperfect. China's commitment to purchase $200bn of American agricultural and other exports in 2020 and 2021 is widely seen as unrealistic. But the deal did make clear that President Donald Trump is willing to avoid an all-out trade war with America's Asian rival, at least for the time being.

Mr Trump's massive corporate tax cut continues to be a source of bosses' contentment, as are low interest rates. So too is the absence of wage inflation—a big concern in boardrooms last year. David Kostin of Goldman Sachs argues that it should not be. He calculates that for the median stock in the American market, labour costs (including everything from salaries to share options to health insurance) are stable at around 13% of revenues—despite record-low levels of unemployment. Overall wage growth has been stuck around 3% a year for a while.

A balmier business climate is encouraging companies to invest. Morgan Stanley's ▸▸

Monetary policy

Why Ben Bernanke is wrong

The former Fed chief is optimistic that monetary policy can fight the next recession. Don't count on it

THE BIGGEST challenge economists face today is how to deal with downturns. America's expansion is the longest on record; a slowdown at some point is inevitable. The fear is that central banks will not have enough tools to fight the next recession. During and after the financial crisis they responded with a mixture of conventional interest-rate cuts and, when these reached their limit, with experimental measures, such as bond-buying ("quantitative easing", or QE) and making promises about future policy ("forward guidance"). The trouble is that today across the rich world short-term interest rates are still close to or below zero and cannot be cut much more, depriving central banks of their main lever if a recession strikes.

Fear not, argues Ben Bernanke, who led the Federal Reserve through the crisis. In a speech on January 4th he said that the lesson of the past decade is that QE and forward guidance can provide substantial stimulus—equivalent, he calculates, to rate cuts of about three percentage points. That provides at least half the firepower the Fed has typically used to fight recessions. So long as interest-rate cuts can provide the other half—ie, if rates can still fall two to three percentage points—monetary policy will retain its potency. As a result, Mr Bernanke says, calls for a bolder overhaul of the toolkit "seem premature". ▸▸

Mr Bernanke is right that QE and forward guidance have been effective economic stimulants, although judging their exact impact is tricky. But he is too sanguine, for three reasons. First, among the big economies only America looks remotely close to passing his firepower test. In the euro zone and Japan, safe ten-year debt yields a return of less than zero. That suggests short-term rates are unlikely to rise much in the 2020s. It also means that QE and forward guidance, which are supposed to work by lowering long-term interest rates, could run out of room—since they cannot fall much below zero. Other central bankers are sounding the alarm. This week Mark Carney, the outgoing head of the Bank of England, warned that the global economy faces a liquidity trap in which monetary policy loses its bite.

Mr Bernanke acknowledged that Europe and Japan will need fiscal stimulus, rather than only monetary policy, to fight a downturn. But he also implied that all that might be needed is a one-off blast of spending or of tax cuts, after which central banks would be back in control. In fact in Japan decades of deficits have pushed public debt to nearly 250% of GDP without interest rates rising much. Instead of a one-off boost, the low-rate rich world needs fiscal policy to be more active over a long period.

Second, even America, where interest rates are higher, passes Mr Bernanke's health check only if you squint very hard. The short-term interest rate languishes at 1.5-1.75%, beneath his mooted zone of safety. Mr Bernanke draws comfort from the fact that economic models—and Fed policymakers—expect rates eventually to settle at a higher "natural" rate of interest. But investors are more pessimistic. America's ten-year bond yield is only 1.8%. Even the 30-year yield is only around 2.3%.

The models may be right (although those who estimate the natural rate warn that their work is "highly imprecise"). But a downturn could strike before rates have recovered to their natural level. Just look at Britain. One of the papers which Mr Bernanke cites suggests that Britain's natural rate is fully 3.4%, more than four times the yield on its ten-year bonds. The Bank of England is far likelier to have to fight a recession in the 2020s than to raise interest rates that high.

Third, and most important, interest rates have been in long-term decline. This fall is usually portrayed as having started in the 1980s. But new research suggests it is a much longer-run phenomenon, and that the period of high rates around that time was a historical peculiarity (see Finance section). Fed officials have spent years lowering their estimates of where rates will settle. Although it is not certain that such estimates will continue to fall, it would be brave to assume otherwise. The belief that rates will rise substantially has ruined many investors in recent years; in Japan a bet in that direction is nicknamed "the widow-maker".

Governments and central banks need to redesign their toolbox to deal with a low-rate world. This means finding ways to bridge the shrinking gap between monetary policy, which is set by technocrats, and fiscal policy, which is set by politicians. It could even require the careful use of a radical new tool like "helicopter money"—a handout to the public funded by the printing presses. In the past Mr Bernanke debated these bolder ideas, earning himself a nickname. Where is "helicopter Ben" when you need him? ■

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Poles apart

The planet's biggest break-up is under way. It will reshape the world economy—and cost a fortune

ON JANUARY 15TH, after three years of a bitter trade war, America and China are due to sign a "phase one" deal that trims tariffs and obliges China to buy more from American farmers. Don't be fooled. This modest accord cannot disguise how the world's most important relationship is at its most perilous juncture since before Richard Nixon and Mao Zedong re-established links five decades ago. The threat to the West from China's high-tech authoritarianism has become all too clear. Everything from its pioneering artificial-intelligence firms to its gulags in Xinjiang spread alarm across the world.

Just as visible is America's incoherent response, which veers between demanding that the Chinese government buy Iowan soyabeans and insisting it must abandon its state-led economic model. The two sides used to think they could both thrive; today each has vision of success in which the other lot falls behind. A partial dismantling of their bonds is under way. In the 2020s the world will discover just how far this decoupling will go, how much it will cost and whether, as it confronts China, America will be tempted to compromise its own values.

The roots of the superpower split go back 20 years. When China joined the World Trade Organisation in 2001 reformers at home and friends abroad dreamed that it would liberalise its economy and, perhaps, its politics too, smoothing its integration into an American-led world order.

That vision has died. The West has faced a financial crisis and turned inward. China's behaviour has improved in some ways: its giant trade surplus has fallen back to 3% of GDP. But it has an even bleaker form of dictatorship under President Xi Jinping and has taken to viewing America with distrust and scorn (see China section). As with every emerging great power, China's hankering to exert its influence is growing along with its stature. It wants to be a rule-setter in global commerce, with sway over information flows, commercial standards and finance. It has built bases in the South China Sea, is meddling with the 45m-strong Chinese diaspora and bullying its critics abroad.



President Donald Trump has responded with a policy of confrontation that has won bipartisan support in America. Yet the China hawks thronging Washington agencies and corporate boardrooms share no consensus over whether America's goal should be the mercantilist pursuit of a lower bilateral trade deficit, the shareholder-driven search for profits in American-owned subsidiaries in China or a geopolitical campaign to thwart China's expansion. Meanwhile, Mr Xi oscillates between grim calls for national self-reliance one day and paeans to globalisation the next, while the European Union is unsure if it is an estranged American ally, a Chinese partner or an awakening liberal superpower in its own right.

Muddled thinking brings muddled results. Huawei, a Chinese tech giant, faces such a disjointed campaign of American pressure that its sales rose by 18% in 2019 to a record $122bn. The EU has restricted Chinese investment even as Italy has joined China's belt-and-road trade scheme. China spent 2019 promising to open its big, primitive capital markets to Wall Street even as it undermined the rule of law in Hong Kong, its global financial hub. The phase-one trade deal fits this pattern. It mixes mercantilist and capitalist goals, leaves most tariffs intact and puts aside deeper disagreements for later. Mr Trump's tactical aim is to help the economy in an election year; China is happy to buy time.

Geopolitical incoherence is neither safe nor stable. True, it has not yet inflicted a big economic cost—since 2017 bilateral trade and direct investment flows between the superpowers have dropped by 9% and 60% respectively, but the world economy still grew by about 3% in 2019. Some businesses, such as Starbucks's 4,125 cafés in China, need never be affected. But confrontation is constantly spreading into new arenas. America's campuses are convulsed by a red scare about Chinese spying and intimidation (see Briefing). Rows blaze over athletes kowtowing to China, naval docking rights and alleged censorship on TikTok, a Chinese app used by teenagers worldwide. In the background is the risk of a confrontation between the superpowers over Taiwan, which holds elections in January (see Asia section).

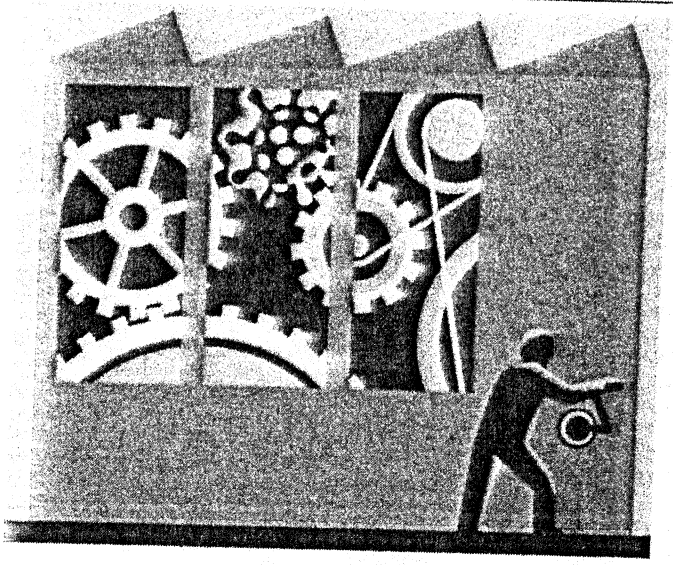
Each side is planning for a disengagement that limits the other superpower's day-to-day influence, reduces its long-term threat and mitigates the risk of economic sabotage. This involves an exceptionally complex set of calculations, because the two superpowers are so intertwined. In technology, most electronic devices in America are assembled in China, and, reciprocally, Chinese tech firms rely on foreign suppliers for over 55% of their high-end inputs into robotics, 65% of those into cloud computing and 90% of those into semiconductors. It would take 10-15 years for China to become self-sufficient in computer chips and for America to shift suppliers (see Technology Quarterly). Likewise in high finance, which could serve as a vehicle for sanctions. The yuan accounts for just 2% of international payments and Chinese banks hold over $1trn in dollar assets. Again, shifting trade partners to the yuan and winding down the banks' dollar exposure will take at least a decade, probably longer. And when it comes to research, China still trains its best talent and finds its best ideas in America's world-beating universities—at the moment there are 370,000 mainland students on campuses in the United States.

Were the superpower rivalry to spiral out of control, the costs would be vast. To build a duplicate tech hardware supply-chain would take $2trn or so, 6% of the superpowers' combined GDP. Climate change, a great challenge which could provide a common purpose, would be even harder to cope with. Also at stake is the system of alliances that is a pillar of America's strength. Some 65 countries and territories rely on China as their largest supplier of imports and, asked to choose between the superpowers, not all of them would opt for Uncle Sam—especially if it continues to pursue today's policy of America First. Most precious of all are the principles that really made America great: global rules, open markets, free speech, respect for allies and due process. In the 2000s people used to ask how much China might become like America. In the 2020s the bigger question is whether a full superpower split might make America more like China.

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Free exchange | Shock therapy

The covid-19 outbreak presents policymakers with a new sort of economic threat



THE ONLY thing we have to fear is fear itself, or so reckoned Franklin Roosevelt. In many an economic downturn that is true—an anxiety-induced reluctance to spend is the main threat to prosperity. For now, the world is treating the outbreak of covid-19, a disease caused by a coronavirus that is now responsible for more than 2,000 deaths, as no exception. Central banks across Asia are easing monetary policy while governments prepare spending programmes to limit the economic damage.

Covid-19, however, is not a conventional economic threat. Efforts to contain the virus are limiting activity by shutting factories and disrupting supply-chains. Such shocks to supply are harder to manage than anxiety-induced frugality among firms and investors. When people stop spending, growth slows and inflation falls. But when supply is constrained, prices can accelerate even as the economy wobbles. Economists first grappled with supply shocks in the 1970s, when reductions in food and oil supplies ended three decades of unprecedented growth and ushered in "stagflation". Supply shocks divided the profession. Predictably, there was a row over whether governments should prioritise fighting rising unemployment or high inflation. In a victory that would shape central banking for decades, the inflation hawks eventually won.

Like the oil and food shocks of the 1970s, the covid-19 epidemic poses an unexpected threat to a mainstay of global production. For as long as the mobility of Chinese workers is limited, shops, offices and factories in the world's largest exporter will sit idle. As a result, firms dependent on supplies from China are running down inventories and curtailing operations. On February 17th Apple warned investors that supply-chain problems were limiting iPhone production and would reduce its revenues (see Business). Hyundai, a carmaker, has cut production in South Korea because of parts shortages. On February 18th Jaguar Land Rover, a British carmaker, said that it could start to run out of parts in two weeks' time, and that it had flown in emergency supplies from China in suitcases.

But whether the understanding of supply shocks forged in the 1970s still applies is unclear. In practice, the distinction between shocks to demand and those to supply is fuzzy. In a paper published in 2013 that revisited the era of stagflation, Alan Blinder of Princeton University and Jeremy Rudd of the Federal Reserve argue that supply alone cannot explain the soaring unemployment of the 1970s. In fact, they say, price increases had demand effects that mattered more. They raised uncertainty, reduced households' disposable income and eroded the value of their savings.

Subsequent experience supports this more nuanced view of the effect of supply shocks. Soaring oil prices in 2007 gutted household consumption in America and helped push its economy into recession. The earthquake, tsunami and resulting nuclear disaster that struck Japan in 2011 dealt a blow to Japanese industry which, like China's, occupies important supply-chain niches. The catastrophe led to a sharp decline in output and exports (and a long-term shift in economic activity away from the most affected regions), but despite the disruptions Japan remained in deflation. Higher tariffs should, in theory, disrupt supply and boost prices. But to date the main economic effect of the trade war being fought by America and China has been dented confidence, derailed business investment and tumbling interest rates. The covid-19 outbreak is hitting China's demand for commodities and its tourists' travel plans. Both effects drag down global demand in a conventional way, as they did after the outbreak of SARS in 2003.

Circumstances today are also very different from the 1970s. Crucially, global inflation remains oddly subdued. That means policymakers can provide stimulus without exacerbating an ongoing inflation problem. Support seems warranted in China, where lost sales could give way to lay-offs, further cuts to spending, and a deep slump. Economies with close links to China are also moving, rightly, to shore up spending. Japan's decision to raise consumption tax last year, a move that contributed to an annualised decline in GDP of 6.3% in the fourth quarter of 2019, looks spectacularly ill-timed in hindsight.

Should covid-19 sweep across the world, the global economy as a whole will surely need a dose of stimulus, much as China does today. The main complication then would be a lack of central-bank ammunition, as interest rates are already low. But even if the virus stays contained, governments of less affected countries could have their hands full. Policymakers facing temporary supply shocks must reassure the public that growth and inflation will eventually return to normal—as modern central banks now try to do when oil prices spike. Continued disruption, though, requires adjustment. New suppliers must be tracked down, new contracts written and new customers found. Frustrated firms could decide the time is right to wash their hands of China. The effects of such changes are hard to predict.

Ill at ease

If China's economy slumps further in response, it could exert a deflationary pull on economies in the West. But if decades of economic integration, which many economists credit with holding down global inflation for the past two decades, goes into reverse, then dormant price pressures could awaken. Macroeconomic policymakers could once again be confronted with the painful decision of whether or not to fight rising inflation during an economic downturn.

For policymakers beset by unknowns, both overreaction and underreaction present serious risks. The time to build more resilience into production chains and financial systems has sadly passed. Perhaps the most important lesson of the 1970s is one the world ought to have appreciated before the arrival of the epidemic—shocks happen, and can transform well-worn economic terrain into something less familiar with frightening speed. ■