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TWILIGHT OF THE IDOLS

Nietzsche thought that all ideals—whether religious, philosophical, or political—served the same purpose: to imply that the afterlife is better than life on earth.

According to Nietzsche, Christianity, Romanticism, Communism, and Nationalism are examples of nihilistic “idols” that damage people’s lives by promising them a brighter future—if their behavior aligns with the moral values of the respective ideology.

In his books (including *Twilight of the Idols* published in 1889), he predicts the collapse of idols in favor of the advent of man and his desire for power, beauty, and strength without the promise of a hereafter. In this way, man no longer lives for tomorrow but in the present; no longer for what will be, but is instead motivated by his desire for power. He no longer follows morality or reason; instead, he follows his instinct.

In many ways, the philosopher’s writings were prophetic. In announcing the twilight of idols, Nietzsche simply foresaw the advancement of Western societies. Communism (virtually) no longer exists, Christianity has given way to secularism, and the European Union has abolished borders. As such, grand ideals have gradually disappeared. Things come alive because they are driven by their own strength of will; they no longer tend towards an ideal. Advances in technology and science have made man more productive; performance, youth, and constant optimization are now the economic foundations of developed societies.

Contrary to the changes taking place in Western societies in the early 1980s, the idols—from a financial market perspective—began to grow stronger rather than weaker. Essentially, they were the central banks and the World Trade Organization. But just recently, they seem to be weakening. The election of Donald Trump, Brexit, and the rise of anti-European parties are warning signs that the idols of yesterday are wavering. While it’s still a little early to announce their twilight (that is to say, a significant attenuation of their role in fixing market prices), there is one element that seems indisputable to us: their inevitability has come to an end. This element has two main consequences:

- The end of a low-volatility regime.
- A positive correlation between equities and bonds (the two assets evolve in concert, eliminating part of the benefits of diversification).

What a trade war entails

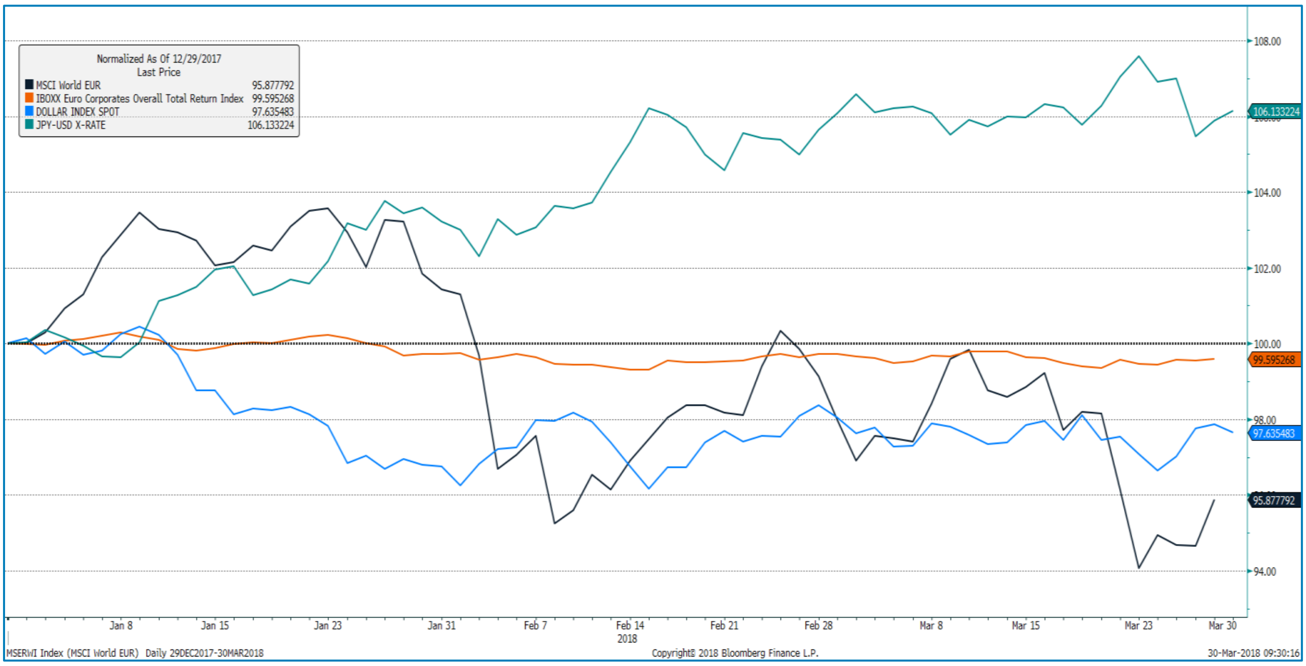
2018 began on a positive note against a backdrop of strong and accelerating growth virtually all around the world, a return to controlled inflation, less dependence of emerging countries on external financing, stability of commodities, low political risk, a positive corporate profit dynamic, and a outperformance of e-commerce stocks.

It would be difficult to find a more conducive environment for investing in risky assets.

Citigroup Economic Surprise Indexes: Globally (solid curve) and in the United States (black line): in both cases, positive levels signal economic publications that exceed expectations.
Source: Bloomberg, Edmond de Rothschild (Monaco)

The United States' unilateral decision to apply tariffs on steel and aluminum imports suddenly raised the risks weighing on this rosy scenario. Although many countries have subsequently been exempted (Europe, Canada, Mexico), it seems that the United States is firmly committed to renegotiating free trade agreements with its usual partner countries. In turn, many countries have threatened the United States with trade retaliation—applying tariffs on imports of US goods (Europe has targeted peanut butter and motorcycles, in particular).

Following these announcements, the main asset classes fell (equities, corporate bonds, and US currency).



Progression of the MSCI World Indexes in Euro (shares), Iboxx Euro Corporates (European corporate bonds rating investment grade), DXY (Dollar index), and the dollar/yen rate in base 100 since the beginning of the year. Only the Yen in increasing.

Source: Bloomberg, Edmond de Rothschild (Monaco)

The reduction—or even the elimination—of customs duties is the bedrock of the World Trade Organization and the main ingredient of the long period of disinflation that we have experienced for almost 40 years.

A trade war between the world's various countries is a game in which all players lose. It has repercussions in terms of growth, inflation, and monetary policies, and increases the risk level of investments.

Transfer of wealth and change of power

Taxing imports results in higher product prices for the entire population. This amounts to transferring a portion of consumer wealth to the state, and to local companies manufacturing products targeted by customs duties.

A positive effect of higher tariffs is the possibility that these companies will become more competitive on their home soil than their foreign counterparts. Renewed competitiveness can lead to the creation of new jobs, but only on the condition that product demand remains vigorous despite a higher selling price (inelastic demand).

At the macroeconomic level, inflation is rising; as a consequence, purchasing power is declining, and growth is decreasing. This is called stagflation, and is rarely a sign of an environment that is favorable to investment.

As you will have understood, this is a much gloomier risk scenario than the one mentioned above. It is reminiscent of the investment environment of the 1970s, which were characterized by a rise in interest rates, a fall in the stock market, and a weak dollar.

By and large, there is a common theme between the United States unilaterally questioning the rules of free trade, Brexit, and the rise of anti-European parties.

It is clear that the living conditions of the middle and lower classes in developed countries have improved very little.

- Technological progress and the departure of entire industrial sectors to emerging countries have caused various professions to disappear; the affected population hasn't been successful in finding alternative permanent employment.
- The central banks' retention of zero-interest rates over a significant period of time has contributed to significant wealth differentials between financial asset holders (equities and bonds) and traditional savers who receive only low interest payments without capital growth (bank savings accounts).

It is likely that this feeling of unease has led to the rise and accession to power of leaders with iconoclastic ideas and personalities.

These elements, if substantiated and strengthened, will have major economic, societal, and financial implications:

From 2009 to 2017	2018 and beyond?
Deflation	Inflation
Accommodative monetary policy	Standardized monetary policy
Restrictive fiscal policy	Accommodative fiscal policy
Rate cuts	Rate hikes
Globalization	Nationalism and bilateral agreements
Quality stocks	"Value" stocks
US equities	Emerging market equities
Rise in PER	Drop in PER
Profit stability	Profit increase
Bonds	Commodities
Over performance of long-duration bonds	Over performance of short-duration bonds
Financial assets	Real assets
Increase in wealth inequalities	Standardization of inequalities
"Buy the dip"	"Sell the rally"

These destabilizing changes contribute to creating an environment of increased volatility on the financial markets.

Investment strategy

Markets must mediate between a benchmark scenario based on the current economic dynamism and a risk scenario based on the return of stagflation; radically opposite trajectories that involve fundamentally different financial market behaviors. The gradual end to the central banks' central role in determining asset prices, and above all, the possibility that customs barriers will be reinstated are generating a lack of confidence. In financial markets, this lack of confidence implies the end of the long period of continuous decline in volatility and a now positive correlation between equities and bonds.

Our investment strategy aims to create more robust portfolios that will evolve in this more complex period. This entails:

1. favoring for low-duration bonds
2. Having an opportunistic approach to equity markets
3. Searching for assets whose returns are negatively correlated with the returns of risk-asset markets as an insurance policy

1. As a general rule, short-maturity bonds usually earn lower yields than longer-term bonds. On the other hand, risk is lower, since in the event of an interest rate hike, short bonds decline very little compared to the long ones.

Although the US Central Bank plans to raise its key rates 3 to 4 times in 2018 and we are beginning to see the European Central Bank departing from its ultra-accommodative policy, we believe that a position on short bonds is the most relevant. Especially because in the United States, the yield spread between short and long bonds is narrow (only 0.49% between 2-year and 10-year government bonds). In Europe, the spread is more pronounced, but government bonds still don't offer any return and pose a significant risk. Thus, without taking our eyes off our exposure to duration, we continue to favor niche markets (financial bonds, hybrid bonds, and emerging countries' government bonds in local currency) that still offer satisfactory remuneration and a potential for appreciation.

2. Returns on shares comes from two main sources: dividends and the expansion of valuation multiples, i.e. the fact that the market values a company at 10, 15 or 20 times its earnings (currently 15 times in Europe). This concept covers the notions of profit growth as well as that of determining a fair, more unpredictable price. While dividends have some predictability over the coming year (around 3%), the multiple that markets will apply to companies remains unknown. On this particular point, the evolution of inflation plays a significant role. Small changes in inflation tend to increase multiples; distinct upward or downward movements tend to bring them down.

The establishment of customs barriers leads to inflation and a drop in multiples. If these customs barriers ultimately don't see the light of day, the market will have the latitude to continue to grow.

Our strategy aims to strike the right balance between the main scenario and risk occurrence probability. Thus, on the off chance that large-scale customs duties are implemented, we prefer small and mid-cap companies with more local geographic exposure.

3. Traditionally, bonds and equities move in opposite directions. Bonds act as a shock absorber in the event of an equity market downturn. This is the benefit of diversification. However, when the threat of inflation appears, these two traditional assets correlate, transforming the advantage of diversification into a handicap. To regain some balance, it is necessary to include assets that move in the opposite direction of the portfolio's primary asset. As of now, the only one with this attribute is the Yen. The Japanese currency has a safe haven status because of the country's political stability and its exportation of products with very high added value. Thus, the country is able to maintain a current account surplus over the rest of the world, which tends to support its currency—especially during a downturn.

Rafa's forehand, Roger's backhand

Rafael Nadal and Roger Federer have been playing against one another in every tennis tournament around the world for over 15 years, and they regularly compete for the number one spot. In all their matches, their movements are a model of precision, power, and elegance.

It takes fierce drive and unwavering determination to stay at this level for so long. This is what Nietzsche calls the will to power. *“Life is, to me, instinct for growth, duration, accumulation of strength, power: where the will to power is lacking, there is decline.”*

The latter is manifested in economic circles through the United States’ desire to rebalance trade rules that seem unfair to them.

This American will to power will also bring about a will to power and a response from other countries in the world. The idols (central banks and free trade) are disappearing, and markets will have to get reaccustomed to the fact that fiscal and trade policy will have a much greater impact in the future.

Idols fall. Portfolios adjust.

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