Program #1333
Broadcast: February 3rd, 2017

On this week's Consuelo Mack WEALTHTRACK : the "Great Rotation." In an exclusive interview Bank of America Merrill Lynch's Chief Investment Strategist, Michael Hartnett describes the mega changes occurring in the global economy and what they mean for investors.

MICHAEL HARTNETT
Chief Investment Strategist
Bank of America Merrill Lynch

CONSUELO MACK: On this week's WEALTHTRACK, are you prepared for the great rotation? In an exclusive interview the chief investment strategist of bank of America Merrill Lynch describes how the financial ground is shifting under our feet. Michael Hartnett is next on Consuelo Mack WEALTHTRACK.

CONSUELO MACK: Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack. Can you feel the investment ground shifting under your feet? Is your portfolio off balance, even out of whack? If so, welcome to the great rotation. That is how this week's exclusive WEALTHTRACK guest describes the financial sea changes we are experiencing, that go far beyond DOW 20,000 and the presidency of Donald Trump. He is Michael Hartnett, a financial thought leader and chief investment strategist at Bank of America Merrill Lynch Global Research, where he identifies key global market trends and provides strategic insights and solutions for both institutional and individual clients. His research team was named the "Top global research firm of 2016" by *Institutional Investor* magazine for the sixth straight year.

Hartnett and his group are big on themes which put economic, investment, demographic and even cultural and social trends around the world in perspective. And just about everywhere they look, there is a great rotation occurring. The global economy is moving from secular stagnation to cyclical recovery. Deflation is disappearing and inflation is appearing. Central bank stimulus is being replaced by fiscal stimulus. Globalization is being pressured by isolationism. And the winning investments of the last 8 years are being eclipsed. Bonds are falling, commodities are rallying. Growth stocks are now lagging value ones. Large-cap has been overtaken by small cap and technology has ceded its leadership to banks… Why are these shifts occurring? How durable are they and what do they mean for our investments? I started our conversation by asking Hartnett about what he describes as a new era from Davos man to Joe six-pack.

MICHAEL HARTNETT: In the past ten years you've been in an economic environment where there hasn't been a lot of growth. There hasn't been a lot of inflation, and interest rates have come down and down and down. That's been incredibly positive for certain asset classes. It's been great for the one percent. It's been great for capitalists. It's been great for bonds. It's been great for what the rich people buy and own like sort of high-quality.

CONSUELO MACK: Financial assets.

MICHAEL HARTNETT: Financial assets. They've done incredibly well whereas a lot of other stuff that is associated with Main Street, it may be commodities, it may be value stocks, of course the banks have been left behind in their wake. So if suddenly you've got this political revolution that's telling you that all these populist policies are coming along and these populist policies suddenly are going to make growth and inflation and interest rates go in a different direction, you're going to have a different portfolio. So the flip that we're talking about is all these assets, which we dub Davos Man assets, are going to underperform now relative to what we call the Joe Six-pack assets, which are things like commodities, certain equities, value stocks, banks. It could be (Overlap/Inaudible).

CONSUELO MACK: Small cap stocks.

MICHAEL HARTNETT: Some of the small cap which have already done very well. So that's the idea.

CONSUELO MACK: So this great rotation that I described in my introduction to you which comes from a Bank of America Merrill Lynch report, why is it all happening now? I mean what's driving this? In so many areas you're seeing this rotation.

MICHAEL HARTNETT: I think the easy answer is Trump. The second answer is Brexit, but the third answer is that suddenly you have electorates that are saying we're fed up with secular stagnation. We're fed up with not seeing wages go up. We want to vote for people that we hope will make our wages go up, will create jobs and a bigger share of the spoils if you like. So we'll see if that's happened, but the real inflection point last year was also interest rates. Suddenly you saw interest rates perhaps inflect for the first time in 35 years, and that's really, really big for the financial markets, because if interest rates are now going up rather than down, then that brings into play all these assets that were previously uninvestable, or no one really wanted to own, the commodities, certain parts of the equity markets, I said the small caps, the banks, the value, the non U.S. equities and all this sort of stuff because they will benefit from inflation.

CONSUELO MACK: Central banks around the world, their fervent desire has been to move from a deflationary environment to an inflationary one. So eight years from the bottom in 2009, they are finally getting their wish. Why?

MICHAEL HARTNETT: Poor things. None of them are around to sort of congratulate themselves because no one's talking about the central banks. The great irony is that the year in which they could actually say mission accomplished is the year that they're getting pushed to the side of the stage so to speak.

CONSUELO MACK: The stage. But why is this? So this secular stagnation that we've had now for the last decade, why has it suddenly turned into this cyclical recovery? I mean is it because of what the central banks did is finally kicking in, or what is it? Why is this happening?

MICHAEL HARTNETT: But remember it hasn't yet necessarily. This is an expectations game.

CONSUELO MACK: I see.

MICHAEL HARTNETT: One of the things I think that one of the things clearly that's happened is that all the things that people were really, really worried about last year: China blowing up, the energy market blowing up, high-yield blowing up, that fear has vanished. Then along comes these elections and suddenly everyone's talking sort of fiscal stimulus.

CONSUELO MACK: Fiscal stimulus.

MICHAEL HARTNETT: That's why the central banks are sort of being pushed to the side of the stage. But it also is that one of the great healers of any recession is time, and this recovery has been going on for quite some time.

CONSUELO MACK: Eight years. I mean we're getting into record long recovery territory.

MICHAEL HARTNETT: It's been a very slow one and a sluggish one and not a particularly exciting one, but you finally got both in the U.S. and perhaps also Japan to full employment, and that means that wages begin to pick up. So it may just be time as well as the introduction of populist fiscal measures as well as sort of all these terrors sort of vanishing.

CONSUELO MACK: You mentioned that it is a cyclical recovery that you expect. So you don't see it happening yet? This is not yet real? It's not happening?

MICHAEL HARTNETT: I think the last couple of months you've begun to see economic data that tells you that firstly even before Brexit, there was momentum gathering in the global economy. Again that was really everyone a year ago was positioned for a bankruptcy, some to do with China, some to do with energy. It didn't happen. So thereafter, you had an easing of policy. The ECB, the Chinese, even the Fed really sort of easing in terms of their dollar policy, and you saw the economy begin to pick up. The momentum continued. Really what's happened the last couple of months is because you've had a lot of politicians being voted in and say, "We're going to cut taxes, deregulation. We're going to come through with infrastructure spending," animal spirits have got juiced up, and what we've seen is a lot of survey data that's telling you that the economy is now moving from second gear up to third, maybe even fourth gear. So the timing of it has been beautiful really.

CONSUELO MACK: You talked about we've come from a period of secular stagnation, and secular connotes longer-term structural, to a cyclical recovery, which again cyclical sounds like a quick rebound. It might not last. When are we going to see these animal spirits actually translate into hard evidence?

MICHAEL HARTNETT: I think there's already evidence in wages. If you can average out the earnings in the U.S., they're close to three percent now.

CONSUELO MACK: In the U.S.

MICHAEL HARTNETT: Whereas they've been roughly two percent for much of the past five to ten years. Japan you're also beginning to see a pickup in wages. Living as I did in Japan in the 1990s, what you saw was a deflation that they just couldn't get rid of, and really that was because you never got the housing market picking up, the bank lending market picking up and the small business sector picking up. I think that's really the last couple of months what I think people have been very impressed with. Small business confidence has jumped very sharply in the U.S.

CONSUELO MACK: In the U.S.

MICHAEL HARTNETT: It looks as though bank lending is beginning to push higher, and certainly what the bank stocks have done recently would suggest that they're going to be more in the mood to lend money going forward. Then thirdly the housing market also in a much more uncertain way looks as though it's picking up despite this move higher in interest rates. So if you get that holy trinity of real estate, small businesses, bank lending clicking in, then the deflation story really is over, and you've got a good one or two years of cyclical inflation picking up I think.

CONSUELO MACK: So the U.S. has been the global leader in recovery. So after years of stagnation, what you just described, we definitely are starting to see a pickup in activity. But at

Bank of America Merrill Lynch you're saying that this is not where the action's going to be investment-wise. Right? That in fact...

MICHAEL HARTNETT: Certain U.S. investments will work. Small caps work. The banks have worked and of course the U.S. dollar because, as you say, the U.S. dollar as the leader of the story should also work. But where you've got more distressed value is clearly overseas. So the U.S. is no longer priced for deflation. Europe is. Japan is. China is. So you've got more upside there if the story truly is inflation. I mean that makes perfect sense to me, and particularly in areas like the financials over there.

CONSUELO MACK: Are you seeing inflation picking up in Japan?

MICHAEL HARTNETT: Yes, a little bit on the wage side. You definitely are in China because if you remember recently the Chinese actually raised interest rates because their produce price inflation is running at about five percent, and consumer price inflation has picked up to about three percent. So inflation certainly has picked up in China. Europe is a little bit more fragile, the environment there, but even so inflation has stopped going down and it's turned positive again.

CONSUELO MACK: Is this the time to invest in Japan?

MICHAEL HARTNETT: I think there's no doubt that both the individual investor and the institutional investor are giving Japan a very hard look right now, and we've certainly seen inflows into the equity market. A lot of it is driven by the idea that the dollar's going up and the yen is going down. If the yen goes down, the export companies pick up. So people are still looking at Japan in a slightly old-fashioned way that it's just a yen trade effectively. If this really is the story of the end of Japanese deflation, of course Japanese deflation has been going on for 20, 25 years, there is big upside of the Japanese equity market, and the equity market upside is going to driven by areas like small cap and the financial stocks within Japan. So you want to play domestic Japan, not overseas Japan if you like.

CONSUELO MACK: So in local currency. You wouldn't do the translation. You wouldn't do hedged, dollar hedged.

MICHAEL HARTNETT: I think initially you would be hedged because the yen still has to go down and the dollar still has to go up a bit, but I think as we approach 125, certainly 130 yen, you don't need to hedge because I think that ultimately again, what is the end of Japanese deflation? It's when the equity market goes up without requiring the currency to go down because they're generating enough sort of good stuff internally that they don't need the currency to go down. Does that make sense?

CONSUELO MACK: Mm-hm.

MICHAEL HARTNETT: But I do think Japan generally as an investment, I would argue, is more crowded today than Europe and certainly China. I mean China really is the one that if you were looking out a year or two offers the biggest upside, again if you truly believe that we're shifting from a deflationary to an inflationary environment.

CONSUELO MACK: How does one invest in China as an individual investor? What are the China plays? Are they commodities again as they have been in the past?

MICHAEL HARTNETT: Yes. I mean I think there are material companies to a certain extent. The energy complex because China is still a big consumer of those things. There is the Chinese stock market itself. Now obviously there are restrictions as to what foreigners can buy locally in China, but of course there are now structured products that you can use that deliver equivalent upside or downside in terms of Chinese assets. So I think there are ways to play it. The other way that people like playing it and probably is the consensus way of playing it right now is that, just like the yen has gone down, just like the euro has gone down, there are a lot of bets being placed that the renminbi is going to go down. Certainly that is one of the more consensus positions out there today.

CONSUELO MACK: So take us to Europe, Michael, which has been lagging. Not Germany per se but the euro zone certainly has. What is the story with the euro zone and the opportunities that you see there, investment opportunities?

MICHAEL HARTNETT: Well, the investment opportunity is driven by the fact that people aren't there. They're not there primarily because of what's been happening in Europe the past five years which is not a lot of good news, but also you've got in 2017 a pretty heavy political schedule. Clearly the new U.S. administration and the German administration have not exactly got to a good start.

CONSUELO MACK: A good start.

MICHAEL HARTNETT: So there are issues there that people are worried about, but the big issue is still the banking system in Europe, and what I would argue...

CONSUELO MACK: Has it been reformed? Has it been restructured? I mean we certainly did a good here in the U.S.

MICHAEL HARTNETT: No. I don't think as...

CONSUELO MACK: Thoroughly or...

MICHAEL HARTNETT: ...thoroughly, aggressively, completely as was the case in the U.S., but yet there is this sort of interesting statistic. If you look back in the past five years, what is the best U.S. equity sector? It's actually the financials despite...

CONSUELO MACK: It's the financials, which is stunning.

MICHAEL HARTNETT: Stunning if you think about the regulation and the fines and the general climate.

CONSUELO MACK: And the volatility in the last five years in the sector has been incredible.

MICHAEL HARTNETT: I think it happened because the housing market got better, and it happened because people were allowed, therefore, to think that the economy was going to get better. And in Europe right now you have very distressed valuations in the financial stocks. I could give another statistic. I mean right now Google and Amazon together, their market cap exceeds the market cap of every single European and Japanese financial institution put together. I mean it just blows your mind if you think about it.

CONSUELO MACK: That's out of whack.

MICHAEL HARTNETT: So the value is there. What there isn't there yet is a belief that the economy is going to get better. If the economy is going to get better and suddenly all these negative interest rates in Europe turn positive, the banks have the biggest upside to that.

CONSUELO MACK: That's starting to happen. Right?

MICHAEL HARTNETT: I think so.

CONSUELO MACK: So the trillions of dollars in negative interest rates, sovereign debt, is still trillions but it's...

MICHAEL HARTNETT: It was 13 trillion in July.

CONSUELO MACK: It's 13 and it's now ...

MICHAEL HARTNETT: It's now six or seven.

CONSUELO MACK: Oh, huge. I mean that's a big change.

MICHAEL HARTNETT: I mean that's been a big, big change.

CONSUELO MACK: So part of your professional portfolio is that you also are on the committee that oversees asset allocation with the Bank of America Merrill Lynch retail clients. So tell us about the asset allocation. I'm going to ask you specifically. Certainly if your clients are like any other investors, they've been very much looking for yield over the last eight years, and so they've been in investment-grade bonds and high-yield bonds. They've been in dividend-paying stocks.

MICHAEL HARTNETT: REITs.

CONSUELO MACK: They've been in REITs. What are you telling your clients to do with those assets in their portfolio?

MICHAEL HARTNETT: Well, reduce them.

CONSUELO MACK: Reduce them.

MICHAEL HARTNETT: I mean if there was a slogan, really it would be down in quality in equities and up in quality in fixed income or bonds. You want to be in the less high-quality, high-growth equities because the economy is picking up and that's when you want to be in value and companies that have a little bit more debt and so on and so forth. They work when inflation is becoming a little bit more ample, but in fixed income you've got a problem. It's the end of a 35-

year bull market. Everyone's up to their gills in high-yielding product and the ability for inflation and interest rates to surprise on the upside is quite high as we've seen in the past six months. Clearly if you've been long bonds for ten, 20 years, it's very difficult to give up that.

CONSUELO MACK: It is, and they've done extremely well as a matter of fact.

MICHAEL HARTNETT: So you understand that it takes a little bit of time, but I still think it's the right to do. You want to go up in quality in fixed income. You want to have a little bit less in some of the higher beta, junkier areas of fixed income which I think people have now, the investment grade, the high yield. I think you want to be more in the safer investments in fixed income.

CONSUELO MACK: And how radical a change are you advocating that we make? Because again I go back to earlier in the interview, when we talked about this cyclical recovery and rebound. So again cyclical to me connotes it could be short-lived.

MICHAEL HARTNETT: I think the problem that we've got is that everything is at such hyper speed now. Yes, this is a new secular theme, the fact that interest rates will go up rather than go down. My suspicion, though, is that it will get priced in very, very quickly. So tactically one of the 2017 trades that we have or themes that we have is called the Icarus trade; that you're already eight years into this bull market. It's not just beginning. The valuations are not exactly super, super cheap, but this rotation that we talk about from deflation to inflation, Davos Man to Joe Six-pack, you could see a real capitulation into it, and that drives markets. They sort of melt up in a very sort of certain way and of course ultimately that is going to drive interest rates either to a level or up by a speed which can either hurt the economy or actually cause a financial event. Again I don't think that's anything to worry about in the next six to nine months, but certainly in the next six to nine quarters it will be something to worry about.

CONSUELO MACK: So we actually could see the central banks respond. I mean the Fed has responded extremely slowly, but it has signaled again that it’s going to raise interest rates several times this year. This could happen globally.

MICHAEL HARTNETT: That’s right.

CONSUELO MACK: You mentioned China’s central bank already did it, and of course that can cut off growth.

MICHAEL HARTNETT: I think 2017 you’ve still got the lingering effect of monetary excess, monetary easing, but when you move into 2018, it’s over. It’s gone. This is the year of peak central bank liquidity, and 2018 really will be the first year since, I don't know, 2005, 2006 that the central bank is not your friend.

CONSUELO MACK: Recession, bear market. Are these conversations you’re having with your team for 2018?

MICHAEL HARTNETT: With the team, yes. Not with clients. I think right now, this is early in 2017. People want to try and get 2017 right before they start worrying about 2018, but I think that the more you think about 2017, the more bullish we generally feel, and again as I said, I think the gains are going to be frontloaded, but nonetheless they could be quite substantial. 2018 I think is a different story. There you really could have the first time in many, many years where you’ve got higher interest rates taking place at a time of peak positioning but also peak macro bullishness, and I think that would make me much more bearish on the 2018 outlook.

CONSUELO MACK: Two more questions. One is, where do I go for income, which is still scarce?

MICHAEL HARTNETT: I think people still like REITs, and I do understand that. I mean I know that they are a yield product and, therefore, if interest rates go up too quickly they can get hurt, but I do like the underlying asset itself. I think there's a lot of real estate in the world that has room to go higher. It may not be Manhattan. It may not be Mayfair. It may not be sort of where the one-percenters are, but I think there's a lot of real estate around the planet that still has a ways to go. So we don't dislike REITs. It's just one of our less favorite areas, but it's not as bad as I think the corporate bonds will get for example.

CONSUELO MACK: And hard assets. When you're talking about moving from financial assets to hard assets, what kind of hard assets should we be owning? I mean you just mentioned REITs, real estate, that's one, but is there... ?

MICHAEL HARTNETT: Real estate would be one. Oil we think will go to $70 this year. I still like gold. I mean I think that it doesn't work every quarter, but nonetheless I think that if you've got higher inflation ahead of you, I think gold is an asset that will work. Of course it encapsulates a lot of if something goes wrong, gold goes right. So I think gold sort of works as well. I think those are three good areas. Obviously you've got to be careful where the real estate is, but I think residential real estate, I think gold, I think oil sort of makes sense.

CONSUELO MACK: The final question which we always ask everyone at the end of every WealthTrack is: one investment for a long-term diversified portfolio. What should we all own some of in a long-term diversified portfolio?

MICHAEL HARTNETT: My gut feel is China's not going away. I mean when I hear the question, it's sort of like what don't you own that's going to remain relevant over the next ten years or so. The way I would answer that is a very contrarian way. I mean what do people really despise? I think anything to do with China right now is the case. So I think the Chinese equity market would be mine.

CONSUELO MACK: Michael Hartnett, always a treat to have you on WealthTrack. Thank you so much.

MICHAEL HARTNETT: Pleasure.

CONSUELO MACK: at the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term. This week's action point is: **Make sure you have some inflation protection in your portfolio**. With inflation making a comeback, even modestly, investments that benefit from rising prices or provide protection from them are a logical choice. We have talked about treasury inflation- protected securities, known as tips, many times on WEALTHTRACK. Their rate of interest is fixed but their principal is adjusted to inflation, so the amount of interest paid adjusts too. What we haven't discussed as much are real or hard assets including commodities such as industrial metals, agricultural products and fuels. There are index funds that track commodities but we couldn't find one that was large and diversified enough to suit our tastes so we found one of Morningstar's favorite ETFs that invests in a broad selection of natural resource companies. It is the SPDR S&P Global Natural Resources ETF – symbol (GNR). It invests in the world's 90 largest stocks in the energy, agriculture, and metals and mining sectors and makes equal weightings in each, thus avoiding the heavy energy positions found in many other natural resource funds. Commodities are extremely volatile and speculative, but a small exposure to them certainly adds inflation sensitive diversification to a portfolio.

Next week, in another WEALTHTRACK exclusive we will talk to a great small cap investor, Charlie Dreifus, founding portfolio manager of the Royce special equity fund about the rebound in small cap stocks and the treasures he is still finding among them.

In this week's extra feature on our website, Michael Hartnett addresses more of the dramatic chances affecting global markets and economies.

And for those of you connecting with us on Facebook and Twitter, keep the messages coming. Thank you so much for taking the time to visit with us. Have a great weekend and make the week ahead a profitable and a productive one.