The American economy

Powell position

WASHINGTON, DC

Could higher interest rates spoil America's economic boom?

AMENDING a famous metaphor, Janet Yellen once said that the Federal Reserve would "keep refilling the punch bowl until the guests have all arrived". This week investors began to wonder if Jerome Powell, who will shortly succeed Ms Yellen at the top of the Fed, might at last deem the party full. On January 29th the ten-year Treasury yield reached 2.7%, the highest since early 2014. The prospect of tighter money caused stockmarkets to sneeze. On January 30th the S&P 500 fell by 1.1%, its biggest decline since August, before recovering a tiny bit the next day. With unemployment low and tax cuts pending, investors are wondering whether inflation and interest rates might soon surge.

The economy grew by 2.5% in the year to the fourth quarter of 2017. According to Okun's law, a rule of thumb relating unemployment to GDP, falling joblessness explains almost half of this growth. (The unemployment rate fell from 4.7% to 4.1% over the same period.) Early in the year inflation fell short, suggesting that fast growth could continue unabated. But pressure on prices has begun to build. Quarterly core inflation, which excludes volatile food and energy prices, was only just below the Fed's 2% target at the end of 2017. Markets have recently come to believe rate-setters who say that they will tighten policy three times in 2018 (see chart), as happened in 2017.

The prospect of higher rates has bears worried, for three reasons. First, they think asset markets are not ready for higher rates. On January 29th, before the market wobble, an index of financial conditions compiled by Goldman Sachs, which falls as conditions loosen, touched an all-time low. Postponed rate rises have propelled asset prices in recent years; surprisingly tight policy could have the reverse effect.

The second worry is that consumers are unduly exuberant. In October consumer confidence touched highs not seen in over a decade (it has since fallen back slightly). Purchases of vehicles and parts alone contributed 0.4 percentage points to growth in the fourth quarter. Yet it is not wage growth that is fuelling the spending spree, other than in a few low- and middle-income sectors of the economy. Instead, it is that consumers are saving less. In December the personal-saving rate was just 2.4%, the lowest it has been since September 2005. Were falling asset prices to puncture consumers' optimism, growth might suffer.

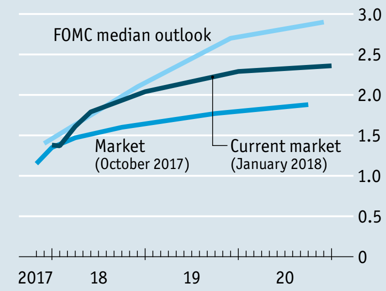
The final worry concerns corporate debt. Last April the IMF warned that indebted firms were exposed to higher borrowing costs. Firms accounting for 10% of corporate assets, they noted, were already struggling to service their debt.

Are these worries reasonable? Asset-price falls are fearsome when people have borrowed too much. But regulatory reforms over the past decade have deterred risky lending. Households may not be saving much, but their balance-sheets are much stronger than before the financial crisis. Corporate debt is a likelier source of trouble, but a rising oil price has eased pressure on indebted energy firms, the most likely to falter. And with bond yields rising globally, the Fed need not worry a strong dollar will destabilise the world economy.

In fact, if Mr Powell can manage the transition to higher interest rates, they will be welcome. The Fed would have more scope to loosen policy during the next recession before rates hit zero. After all, the worst thing that can happen to a party is for the punch bowl to run dry too soon. ■

Looking up

Fed-funds rate, forecasts, %



Sources: Federal Reserve; Bloomberg

Cancer investing

Hunting for a cure

Growing demand for cancer treatments prompts an investment boom

CANCER is a grim sort of growth market. By 2030 there will be over 22m new cases a year, up from 14m in 2012, according to the International Agency for Research on Cancer. But as the world marks World Cancer Day, on February 4th, scientists are speaking of a revolution in the battle to beat it. Money managers' ears have pricked up. Oncology investing is "hot".

The most straightforward way to invest in treating cancer is through shares in companies that sell blockbuster drugs. Alternatively, biotech indices track a basket of companies, of which typically 40% are oncology-related. Big Pharma now buys rather than builds much of its innovation. So backing oncology startups can be an especially lucrative (if risky) approach. According to CB Insights, a research firm, equity investment in cancer-therapeutics startups has grown from $2bn in 2013 to $4.5bn in 2017. Take Juno Therapeutics, founded in Seattle in 2013 to develop immunotherapy drugs. It was acquired on January 22nd by Celgene, a Biotech giant, for a whopping $9bn.

Eric Schmidt of Cowen, an investment firm, believes that oncology offers "the highest returns on investment of any therapeutic category". Three developments explain the frenzy. First, demand for cancer treatments is rising as prevalence increases and the world's middle classes—who can afford insurance—expand. Between 2012 and 2016 the global costs of cancer-related treatments grew from $91bn to $113bn, according to IQVIA, a health-data firm. They are expected to rise to $147bn by 2021.

Second, scientific progress, particularly around manipulating genes and cells, has been astonishing. The pipeline of oncology drugs in clinical development has expanded by 45% over the past decade. Immuno-oncology (IO), whereby the patient's own immune system is used to attack cancerous cells, is particularly in vogue. Goldman Sachs, a bank, values the IO market at around $140bn and, despite calling the field "overhyped", predicts it could grow by another $100bn.

Third, cancer enjoys faster regulatory approvals than other diseases. As Christiana Bardon, of Burrage Capital, puts it, "patients are dying and they are dying now", so regulatory hurdles are lower.

But as with any hot commodity, the line between well-founded excitement and unfounded giddiness is thin. Andy Smith, from Edison Investment Research, points out that it is still early days for treatments like CAR-T (a specific type of IO). He worries about an "implied halo", comparable to the one that now benefits cryptocurrencies. Investments in oncology and in biotech more generally can also resemble cryptocurrencies in their wild price swings (see chart on next page). Another risk is that new treatments, however brilliant, may never be cheap enough to sell. CAR-T could well be game-changing but only a handful of treatments (which cost around $500,000 per patient) have reportedly been sold.

Iain Foulkes, director of research at Cancer Research UK (CRUK), a charity, worries that much of the welcome inflow of capital into cancer research is chasing similar opportunities. Rarer types of cancer may get neglected. Partnerships between investors and research institutes can help overcome this. A recently announced tie-up between Merck, a pharmaceutical giant, and CRUK is an example. The drug company will have the right to develop ▸▸

Shock therapy

NYSE Arca Biotechnology Index

October 18th 1991=200

Source: Bloomberg

products from any discoveries made; CRUK will share in profits and royalties.

A surge in "ethical" investment, blending financial returns with doing good, will also help. One initiative is a $550m Healthcare Innovations Fund, from Deerfield, an investment firm, a good chunk of the profits from which goes to underserved research areas. Another is a $470m Oncology Impact Fund, raised in 2016 by UBS, a bank, for early-stage oncology research. A sizeable share of the profits go to neglected research areas and to improving access to cancer treatment in poor countries. Already, early successes have allowed the fund to "give back" $2.5m. Its greatest potential lies in future royalties from drugs that make it to market.

Mark Haefele of UBS thinks drug companies should consider similar structures. He notes a desire among clients for more than just financial returns. But he adds that it starts with a compelling investment opportunity—and "few fields are as compelling right now as early-stage oncology." ■

NAFTA

Rule brakers

The car industry may decide the future of North American trade

ROBERT LIGHTHIZER, the United States Trade Representative, wants renegotiation of the North-American Free Trade Agreement (NAFTA) to speed up. When the sixth round of talks ended on January 29th with only three chapters agreed, he griped: "We owe it to our citizens, who are operating in a state of uncertainty, to move much faster." But given the changes he wants, any more speed risks a crash.

One of the biggest fights is over Mr Lighthizer's desire to rewrite NAFTA's rules about cars. Seen one way, the deal has been a boon for the industry. Trade in vehicles and their parts accounts for a quarter of America's two-way trade with Mexico and Canada. But NAFTA's critics see it as a big reason for America's trade deficit with Mexico, and for its falling share of car assembly (see chart). Rules riddled with holes should be rewritten, they think, to yank back American jobs.

Any amendments would be to NAFTA's rules of origin, which define what counts as a North American car—ie, one that can take advantage of zero tariffs. If the rules are too strict, car companies face a nasty choice between overhauling supply chains or absorbing the non-NAFTA tariffs of 2.5% for cars and 25% for light trucks. Too lenient, and foreign parts-producers will sneak their wares into North American cars, benefiting from tariff-free access that their governments did not negotiate.

The current rules specify that at least 62.5% of a car must come from within the region, excluding costs such as marketing or shipping. Tougher standards apply to parts on a special "tracing" list, such as axles, brakes and tyres. For them, only the regional value-added can contribute to the 62.5%. Items left off this list are easier to count as North American, as only minor processing will be enough for them to be deemed as originating from the region.

The Trump administration wants three big changes: a higher regional-content requirement of 85%; a new requirement that 50% of content is American; and a vast expansion of the tracing list to include everything. The higher content requirements should shelter local component-makers from foreign competition, and could encourage companies like Toyota, Nissan and Volkswagen to source more of their parts regionally. Updating the tracing list to include steel and electronic components, which are mostly made in Asia, should also encourage regional sourcing. The American-content requirement is supposed to ensure that any returning jobs do not flow to Mexico, where wages are lower.

Canada and Mexico have greeted these proposals with derision. An America-specific content requirement is politically impossible. And including all of a car's thousands of components in the tracing list would be a bureaucratic nightmare and is "absolutely unrealistic", says Eduardo Solis, president of the Mexican Association of the Automotive Industry. For components where the car industry makes up only part of overall demand, as with lithium-ion batteries, extracting the necessary information from suppliers could be tough. Flavio Volpe, president of the Canadian Automotive Parts Manufacturers' Association, an industry group, points out that it could lead to "absurd" questions. "Is the raw material petroleum? Or do you have to know where the dinosaurs died?"

Ramping up regional-content requirements quickly would wreak havoc on the industry's supply chains, especially given how tight the existing rules are. The costs of compliance already mean that 20% of drive-axles and 25% of radiators by value of imports move within the region without NAFTA benefits they are in theory entitled to. A severe tightening would make it harder for North American carmakers to compete with Asian exporters, who were responsible for 15% of American car sales in 2014. American-negotiated deals since NAFTA have involved less stringent rules.

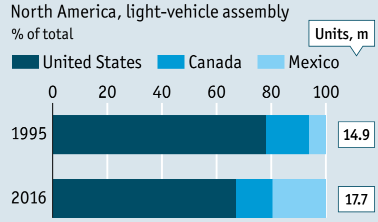
Spot the American job

Keen to keep the talks moving, the Canadian side at the sixth round suggested the "creative" solution of expanding the scope of regional content to include things like research and development. By drawing high-value-added investments to the region (and probably to America) that could entice good jobs. But Mr Lighthizer rejected this gear shift as "the opposite of what we are trying to do". He warned that by allowing new things to count towards the regional-content requirement, the old criteria could become less onerous, making it easier for Chinese exporters to suck away North American jobs. He later added that he was "always one to talk". With such high-level disagreements remaining, progress towards sealing a deal this year is, in effect, parked. ■

Detroit's demise

North America, light-vehicle assembly

% of total



Sources: WardsAuto; Federal Reserve Bank of Chicago