The balance is starting to wobble

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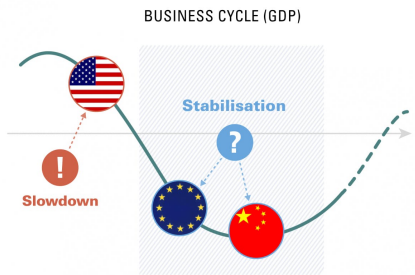
Developments this summer shed considerable light on the equation that has dictated market trends over the past eighteen months. As we previously explained in our April Note, "A return to greater balance", the key force driving equity markets in the first half of the year was a return to a balance, or equality of sorts, between a gradually slowing world economy and a revival of central bank policies geared to sustaining economic activity. That new balance was what enabled stock markets 1) to recover from their state of panic in late 2018 – when the Federal Reserve and the European Central Bank still seemed oblivious to the economic slowdown under way – and then 2) to enter a consolidation phase as from the spring as investors waited to see which way the scales would eventually tip. Following a slew of central bank meetings and twists and turns in the US-China trade negotiations, stock markets ended the month of August at roughly the same level they stood at in May.

China won't be kick-starting the world economy the way it did in 2016. So that leaves the job up to the Fed

But the equation underpinning that balance got shakier over the summer as it became increasingly apparent that the stimulus policies on the agenda wouldn't be enough to counter a global economic slowdown that shows signs of deepening. Leading indicators for the US economy in fact suggest that the global softening has started to spill over to the country, partly because the endless trade war with China has undermined the business confidence of American executives. For the first time since the Great Recession, the Markit PMI survey for US manufacturing dropped below the 50 mark in August. Perhaps even more disturbing, the Markit services PMI fell below the 51 threshold, sinking to its lowest level since 2016. In addition, the big difference with 2016 (and even more so with 2009 and 2012) is that this time China clearly doesn't intend to bear the brunt of powering a worldwide economic recovery. So that basically leaves it up to the Federal Reserve to prevent the global slowdown from getting any deeper. Unfortunately, at the renowned central bank symposium held at Jackson Hole, Wyoming, on 23 and 24 August, Fed chairman Jay Powell didn't express a strong inclination to loosen monetary policy – neither soon enough nor resolutely enough to belie his country's leading economic indicators. Considering the possibility that US monetary policy may increasingly lag behind what the overall macroeconomic outlook currently requires, the bearish mood in equity markets is justified.



Source : Bloomberg, 30/08/2019

The global economic slowdown spills over to the United States

The US economy has unquestionably proved resilient thus far. That resilience owes a great deal, of course, to the inherent strengths shown over and over by a US ecosystem that combines vigorous consumer spending with powerful world-class companies, and that has been further boosted by the 2017 tax reform. But it also has a lot to do with the standard economic stabilisers, first and foremost the accelerating decline in interest rates in 2019. In just eight months' time, 30-year Treasury yields have slid from 3% to 2%. That retreat has obviously buoyed property values and enabled US households to refinance their mortgages, thus putting extra cash in consumers' pockets. At the same time, falling commodity prices have lifted disposable income. And lastly, a strong dollar has lowered the cost of imported goods. But we should also bear in mind that those stabilisers are by definition the reflection of a slowing economy – and will themselves prove detrimental in the medium term. Falling long-term yields drive down banks' profit margins and their willingness to lend while a high dollar hobbles exports, increases deflationary pressure and hurts emerging markets. In contrast to consumer spending, a number of US economic indicators with major ramifications for the future have already lost ground, most notably business spending. Growth in non-residential investment and orders for durable goods has inched its way down to 0% year-on-year, with leading indicators like intention surveys showing sharp decreases. There is reason to fear at this stage that the uncertainty created by Donald Trump's erratic behaviour at the negotiating table with China has done lasting damage to the confidence that US company leaders need to have in their supply chains and export volumes to be willing to invest more. Furthermore, though China and the US would appear to have a mutual interest in clinching a deal swiftly, such an eventuality can hardly provide the basis for an investor's core scenario. Political and geostrategic agendas on both sides suggest that it would be unwise to expect them to reach a broad agreement in the short run.

A struggling Germany

For obvious reasons, contagion from a slowing global economy, particularly in China, has affected Germany much more directly and for longer than the United States, meaning Germany is feeling more of an impact than the US today. The slide in German manufacturing has now spread to the services sector, and the decline in the German IFO Business Climate Index this summer suggests that that trend will get worse in the coming months. Clearly cognizant of the problem, the country's governing coalition is now toying with the idea of a fiscal stimulus plan in the event of a full-blown recession. Unfortunately, both the size of the plan under discussion (1.5% of GDP) and the timetable – which will depend on what happens to the fragile coalition in the run-up to the SPD congress in December – raise doubts about whether the stimulus will soon be implemented – or effective assuming it is. The good news for Europe – i.e., Germany's conversion to a fiscal stance supportive of growth – may well come too late.

China is no longer a lifeline for the West

At the beginning of the summer, there were grounds for hoping that, boxed into a corner by Trump, the Chinese government would be forced to introduce new policies to stimulate the domestic economy and thereby also revitalise global growth. Sad to say, but that hasn't happened to date. Credit expansion in the country has even cooled further. Our interpretation of Beijing's attitude is that China has less scope for stimulus today than in the previous soft patches. Moreover, in the tug-of-war with Washington, both sides feel that the strategic and political stakes are sufficiently high to make it worth taking the risk of having to pay a high economic price in the short term. The turmoil in Hong Kong hasn't set off an alarming degree of capital flight (at least so far), and China has taken only small steps to "weaponise" its currency. So it looks like a fairly high "tolerance for pain" will continue to characterise Chinese policy for a while.

Further hesitation at the Fed

Now that no major stimulus plan of the kind seen in previous economic slowdowns can be expected from China, the Fed is the only institution that has sufficient ammunition to – perhaps – keep the current slowdown from getting much worse. But that brings us to the second major disappointment of these [illegible]. The Fed's working hypothesis is apparently still that the latest rate cut was a mid-cycle adjustment similar to what was done in 1995, and that the current state of the economy in no way calls for an extended easing cycle. The Federal Reserve is clearly in no mood to give in to the President's bullying.

Consequences for investment strategy

Market behaviour already reflects the worsening economic outlook

The outlook taking shape thus seems to include an ongoing slowdown in the global economy that won't trigger powerful countercyclical policies until late in the game. Accordingly, market behaviour over the last few months can be characterised as quite efficient. The worsening global economic outlook has been adequately reflected in falling long-term interest rates, while equity investors have evinced a strong preference for defensive stocks and stepped up their cash holdings. Consequently, and assuming the newsflow from Beijing and Washington allows it, some technical upside opportunities may even work to the advantage of equities at a time when bonds have just got even more expensive. However, the worldwide private- and public-sector debt pile is so large that a major economic slowdown has the potential to do serious damage. It follows that maintaining a strategically cautious stance is warranted. In fixed income, that will in particular involve low exposure to duration risk. In the equity market, it makes sense to keep portfolios focused on growth sectors and consumer staples. In light of the superior performance achieved by the latter, what is required is careful stock-picking. But provided that asset managers proceed in a disciplined fashion, they can still dig up stocks with good earnings prospects that will translate into rising share prices.

Source: Bloomberg, 30/08/2019

Investment strategy

Equities

Equity markets corrected over the summer as increasing risk aversion led investors to prefer long-dated bonds. The situation thus justified our caution, with more defensive sectors like consumer staples and utilities outperforming commodities and financials. The chipper mood seen since the start of the year eventually caved in to the uncertainty surrounding trade negotiations, concerns over global economic growth and the Federal Reserve's muted intervention. However, stock market investors seem to have at least partially priced in those sources of worry. They have kept their equity exposure low and cyclical sectors have underperformed for several months.

The current technical configuration of financial markets points to an opportunity for equities to recover modestly at the expense of bonds. We have accordingly maintained our moderate equity exposure, paying close attention to portfolio construction. To manage our portfolio's beta, we have steered clear of riskier names, limited the size of each conviction and reduced our exposure to highly valued stocks such as Worldpay. In the tech sector, for example, we are above all invested in names with either attractive valuations or defensive profiles like Google's parent company Alphabet. Google has proved resilient due to its monopoly status among search engines. In addition, YouTube, Maps and Android are as yet barely monetised, and we feel that YouTube could outdistance Facebook in terms of user numbers and become the most promising online platform.

Fixed income

The ongoing worldwide economic slowdown is now spreading to the United States. At the same time, the commotion caused by the trade war and Brexit has continued to stoke investors' fears. As a result, long-term government bond yields have sagged, particularly in the United States and Germany. That trend has been accentuated by doubts as to whether central banks will be able to counter low inflation and feeble growth. Be that as it may, the huge bond rally under way calls in our view for caution, particularly in Europe.

We therefore favour strategies geared to tightening spreads on investment-grade government paper in Europe. We are also invested in a few non-core European countries like Greece, which remain attractive. Our cautious take on US economic growth and our expectation that the Fed will eventually change its tune have led us to buy bonds in the 5-year part of the yield curve. In corporate credit, we have held onto a number of idiosyncratic opportunities like Pemex. The Fed's ultimate decisions on interest rate cuts between now and the end of the year will have a decisive impact on emerging-market sovereigns, as lower rates in the US would most likely enable central bankers in many EM countries to lower their real interest rates from a level that seems inordinately high at this stage of the business cycle.

Currencies

The dollar stood its ground this summer despite mounting imbalances in the US economy and expectations of a rate cut by the Fed. That resilience was due in large part to the Fed's postponement of kicking off an easing cycle. Moreover, like the yen, the US currency arguably benefited this summer from what is left of its safe-haven status at a time of increasing risk aversion. The growing pressure on the US central bank to announce the start of an extended easing cycle, together with an expensive greenback, has encouraged us to favour yen holdings in order to balance our portfolio risk.

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