PERSPECTIVES

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Equity markets march on, while bonds call recession

IN SHORT

- Downside risks have risen in light of the ongoing trade war, and the manufacturing sector remains weak, but we believe that global growth points to a stabilisation around trend levels, not a recession.
- Markets present a dichotomy in terms outlook, with equities painting a sanguine picture while bonds are pointing towards recession. For now, we side with equities, expecting them to grind higher as long as growth and earnings hold up.
- Federal Reserve support implies yields will remain low, and having some protection with longer duration makes sense. We maintain our allocation to core markets. While credit is not cheap, we see no systemic risk for now and continue to look for the carry.

OVERVIEW

With both equity and fixed income markets rallying at the same time in June, the question remains who is right? Bonds are pricing a significant deterioration of the global growth picture – recession really – while equities point to an ongoing expansion.

Our base case is for growth across major regions to slow towards trend levels, but not fall into recession. Admittedly though, the longer the US-China trade dispute lasts, or if we see a significant deterioration in global geopolitical tensions, the bigger the risk that the next downturn gets brought forward.

The manufacturing sector continues to contract and the ongoing trade war is likely to weigh on manufacturing further. As a result, PMI numbers could eventually dip below 50, but the services sector has remained robust. Indeed, consumers remain healthy, supported by strong labour markets and a housing market that has help up. The additional stimulus expected from the Federal Reserve has brought rates down sharply since the start of the year, and with them, mortgage rates in the US. In Europe, the latest round of PMIs showed the same divergence, with services still buoyant, while manufacturing remains weak. Chinese data have also pointed towards a stabilisation, with policy measures meant to lessen the impact of trade tensions bearing fruit so far.

Our view has been that the US economy does not need a rate cut today but the Fed might get pressured into cutting rates later in the year if the trade spat lasts. However, it now seems the Fed is stuck with rising risks and ongoing uncertainty, just like investors, and is leaning dovish, so two cuts are likely. We believe, however, that market expectations for four cuts in the coming 12 months are overdone, unless the global outlook takes a marked turn for the worse.

We believe that the US-China standoff will not be resolved until later this year or into 2020, as being ‘tough on China’ is a good political move for President Trump. At the same time, if the US economy weakens too much or markets sell-off as in Q4 2018, the political cost will rise and could force Trump into an agreement. Similarly, President Xi can be patient and continue to add stimulus to the Chinese economy to withstand some of the trade war effects. As such, a status quo scenario implies equity markets can continue to grind higher, provided growth and earnings hold up. An added support comes from the lack of flows into equities, which have only seen a recent reversal from months of outflows thanks to dovish central banks. That being said, we believe that higher short-term volatility should be expected, but we maintain our overall exposure.

The inversion of the US yield curve is a further sign that risks have increased. While a recession is not a foregone conclusion, and a recession would have a lag of 12-24 months anyway, the longer the inversion, the more worrying the signal. For now, sovereign yields appear overly negative given the current scenario, but the backup risk remains relatively contained given very dovish major central banks and a softer growth outlook. We continue to hold core assets as protection as we are not too worried about duration, even from current low yield levels.

ASSET CLASS DETAILS

Equities

We maintain our constructive view on equity markets, acknowledging that risks abound and that corrections are likely, especially given the markets' susceptibility to geopolitical headlines. Nonetheless, we expect risk assets to continue to grind higher, supported by still-solid global growth and accommodative central banks. Recent data points to an ongoing, albeit milder expansion, with the manufacturing sector contracting but services and labour markets still robust. Moreover, depressed earnings expectations mean the bar for upside surprise is lower than in the last quarter of 2018. Some earnings growth will be needed to provide fundamental support to markets, even if earnings are likely to remain capped by uncertainty surrounding trade and growth.

Europe remains stuck in the middle of the US-China trade dispute, suffering the consequences while being unable to influence the outcome. Moreover, with political tensions rising throughout the Old Continent, investor sentiment remains fragile. However, we believe that so much bad news is already priced into markets that the threshold for an upside surprise is relatively low. Over the medium term though, we believe that better US growth and earnings will support outperformance. Emerging markets should do well in a risk on environment, and as long as Chinese growth stabilises and the dollar does not strengthen too much. We believe that Mexico should be a beneficiary of the trade disruptions and supply chain adjustments. With a stronger Yen, Japanese equities might continue to underperform.

Overall, we maintain a rather defensive stance across sectors. We see further upside in the energy sector given higher oil prices and nice dividends. We remain cautious on the automobile sector given ongoing trade concerns and the risk of US tariffs.

Fixed Income

Sovereign yields are painting too negative a growth scenario in our view, and yields have overshot on the downside. Already, we have seen yields retreat somewhat. US 10-year yields are just back above 2% at 2.04% and 10-year Bunds have stabilised around -0.30%. We continue to hold some core assets as protection, as we believe a significant backup in yields is unlikely. Indeed, low and falling inflation expectations and additional central bank support means support for bond markets is unlikely to fade for some time. Nevertheless, we hold a more neutral duration view given already low current levels.

While valuations are not cheap on a historical basis, credit should continue to do well as long as growth holds up and central banks remain accommodative. Indeed, with more than USD12 trillion in negative yielding debt globally, demand for credit and its higher yields is unlikely to wane. Moreover, spreads are still wider than they were in 2016 and in Q4 2018, leaving some room for further tightening, although we look mostly for performance to come from carry rather than significant spread compression.

The more attractive yields in USD debt should continue to appeal to investors, and lower short rates should help ease the hedging burden somewhat for foreign investors. Emerging market debt should also find support, as local currency offers attractive carry and hard currency has proven a relatively stable yield source.

Currencies

With a stronger-than-expected dovish tone from the Federal Reserve, and its openness to cutting interest rates, the US dollar has come under pressure. We expect broad range trading among major currencies as EUR and GBP have their own set of challenges. Mr Draghi was very dovish, promising further action if inflation remains stubbornly below target, including further rate cuts and re-starting its QE program. The Bank of England might have a tougher time given higher inflation, UK growth that is starting to disappoint and ongoing Brexit uncertainty, including a higher risk of no-deal. As such, GBP is likely to remain around current depressed levels. Emerging Market currencies should do well in a softer USD environment as long as risk appetite holds up, as they offer attractive carry, but idiosyncratic risks remain.

Commodities

Oil prices are likely to remain supported in the short term by rising tensions between the US and Iran and further threats to supply. In addition, Saudi Arabia is trying to garner support for extended OPEC production cuts. However, growth concerns imply softer demand over the medium term, including from China. Coupled with the increase in shale production in the US, this should keep prices capped.

Gold has finally caught a bid, as expectations for Fed rate cuts lower the opportunity cost of holding the safe haven asaset, while the more risk off sentiment due to trade tensions and growth fears has helped too. We nonetheless expect prices to remain contained over the medium term, even if short-term upside is still likely. In terms of base metals, concerns over trade and growth should see prices capped, with downside risks.

Alternatives

We continue to see a place for alternatives in portfolios, as we look for decorrelating and diversifying strategies to complement traditional asset classes, particularly with liquid alternatives.

Equity securities are volatile and can decline significantly in response to broad market and economic conditions.
Fixed income securities may carry one or more of the following risks: credit, interest rate (as interest rates rise bond prices usually fall), inflation and liquidity.
Currency exchange rates between the US dollar and foreign currencies may cause the value of investments to decline.
Commodity-related investments, including derivatives, may be affected by a number of factors including commodity prices, world events, import controls, and economic conditions and therefore may involve substantial risk of loss.

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