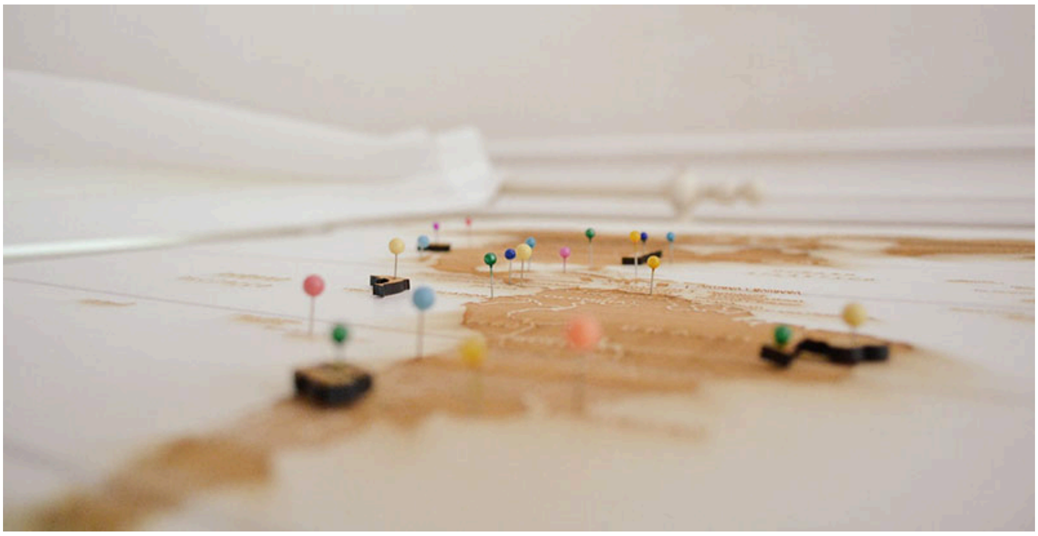
January 16, 2019

BILBoard January 2019 – 2019: Out of sync



Our expectation for the 2019 global macro landscape in a nutshell? Divergence. The previous theme of 'synchronised global growth', one that has been repeated to the point of seeming like a broken record, has played out. Now a gulf is forming between the growth prospects of the major economies, presenting an ever-more complex investment landscape.

The consensus estimates growth of 2% for the G10 collective this year, with China expected to register 6%, the US 2.6 % and Europe 1.6%. Our economists think 6% for China is fair, but believe that the US has the potential to surprise on the upside, whilst Europe will be hard pressed to live up to these expectations.

Though it has switched out of the fast lane, the US economy is still moving forward at a decent pace. Underlying its strength is a sturdy labour market (the latest jobs report showed that 312k jobs were added in December, while previous months were revised upwards too) and ebullient consumer sentiment. Headwinds exist, especially in the manufacturing sector, due to trade tensions as well as higher borrowing and wage costs: we have seen investment cool after a string of strong quarters as fiscal stimulus fades. However, current conditions should allow for stabilisation from here on out. Dedicated to prolonging the cycle, the Federal Reserve (Fed) has adopted a more dovish tone with regards to its tightening campaign, saying that it will 'continue to monitor global economic and financial development and assess their implications for the economic outlook' along the way. For now, the market doesn't expect the Fed to go ahead with either of the two rate hikes that are inked on the dot-plot for 2019. It is too early to surmise about how the US-Sino negotiations will conclude on 2 March 2019, but initial press coverage has had an optimistic tinge to it. Fear of a full-blown trade war has lathered up anxiety amongst investors, seducing them towards the safety of the US dollar. An agreement on trade could therefore be a catalyst for a weaker dollar.

The EU's saving grace is the fact that the economy is still generating jobs – unemployment fell to a ten-year low in November of 7.9%, which should keep consumption from collapsing. Aside from this, data has been disappointing, with even Germany exhibiting a more prolonged slowdown than anticipated. In view of the data, the likelihood of an ECB rate hike in 2019 is becoming increasingly remote.

Japan can only be described as 'muddling along', and we expect this to continue, with the consensus foreseeing just 1% growth for the year. Emerging markets have a lot of pent up potential, but ultimately, their future path will be defined by trade developments and the strength of the greenback. Whilst China's economy is indeed slowing, we must bear in mind that the government is intervening to prop up the economy (with measures such as cutting reserve requirement ratios for banks). It should also be remembered that consumer confidence is holding up, and that if an economy worth $12 trillion in terms of GDP grows at a pace of 6%, this is still quite substantial.

So, on the whole, whilst we acknowledge that downside risks are increasing, we still believe that on aggregate, growth is still strong enough to merit an equity overweight, with a US tilt. As noted in our previous BILBoard, equity markets seem to have been over-pessimistic, and we expect that in 2019 they will become more calibrated against the still-benign macroeconomic backdrop. In fact, empirically speaking, in the late stages of the cycle – which we have entered – equities typically have a good run. It is also worth highlighting that global liquidity is still intact, and though the availability of credit is becoming more vulnerable to swings in sentiment, we don't anticipate any liquidity crunch for the time being.

Equities

Equities have attempted a resurgence in the new year. At first, it was unclear if this was the result of bottom-feeding, or indeed a renewed appetite for risk. The outperformance of cyclicals suggests that the latter may have been driving markets.

US equities are still the best-in-class, boasting attractive earnings growth without the risk factors faced by Europe and Emerging Markets (EM). Q4 2018 earnings season is about to kick off, and analysts currently predict EPS growth of 11.4% on the S&P 500. It is true that this is a far cry from the ≈25% achieved in the past three quarters, but lower expectations leave less room for disappointment, while also bringing US equities into a more affordable price range.

We also give preference to Emerging Markets (EM). After underperforming throughout most of

2018, EMs are now beginning to outperform. Trade war worries are baked into prices, making for compelling valuations. At the same time, we see promising earnings prospects. Latin America is becoming particularly interesting, and has performed in line with the broad EM index as of late. This region benefits from having a more US-oriented economy, whilst other EMs that are inextricably linked to China are more at the mercy of any tariff truce that might be reached.

The macro picture in Europe is unappealing; on top of that you have Brexit, trade tensions (which will have an enlarged impact on a bloc so heavily dependent on exports), as well as the uncertainty surrounding Italy. Italian credit spreads affect the financial sector, which makes up 25% of the European equity market. For this reason we are content to maintain an underweight on the continent.

In terms of sectors, we favour Energy and Materials, as they usually have a good run at this stage of the cycle, when the economy is slowing; furthermore, they currently exhibit compelling valuations. Technology is also eye-catching given that valuations have come down at a time when the sector is outperforming the broad index in terms of earnings growth. With regard to style, we favour Growth, Quality and Momentum stocks, with a preference for Large Cap and low risk. These style biases will be embedded in individual stock selection.

Fixed income

Taking a bird's eye view of the fixed income market, we do not feel compelled to increase our underweight on bonds. Yields are still expected to tick upwards – our fixed income specialists see the US 10-Year Treasury yield at 3.5% over the next 12 months, and their target for the Bund is 0.75% over the same time horizon. When yields go up, prices go down.

That said, in our lower risk profiles which have little to no equity exposure, we opt to overweight corporate investment grade (IG) bonds, preferring higher quality paper with a shorter duration. In the European market, fundamentals are still strong and interest coverage is still quite good, whilst at the same time, valuations (spreads) have approached attractive levels, above their own historical average. That said, caution is warranted due to the headwinds from the end of the ECB's QE purchasing programme and the outflows that this is causing. With regard to sectors, we give preference to industrials over financials. Any future swivel into financials would be largely dependent on whether the ECB clarifies its tone with regard to fresh TLTRO.

Given the current level of short-term risk-free rates in dollars, we are less optimistic about US IG, where the curve pick-up is unappealing. Unfortunately for European investors, hedging costs above 3% tarnish the attractiveness of this option. European sovereigns are less tempting but we do maintain an exposure to core and semi-core government bonds inside of the bloc, as they are still the best cushion against market volatility in times of uncertainty.

All in all, growth is slowing – more markedly in some places than in others. It is important to bear in mind that a slowdown is not synonymous with a recession, and that in today's macroeconomic environment, we can still expect equity investments to bear some fruit. We believe that equity investors jumped the gun towards the tail-end of 2018, resulting in asset prices that implied we were in the clutches of an economic downturn. In 2019, we expect equity investors to re-focus on the fundamentals, which are still sturdy in select regions. Of course, as the major economies fall out of sync with one another, a nuanced allocation becomes more relevant that ever.

Strategic Asset Allocation

	09/01/2019	DEFENSIVE		LOW		MEDIUM		HIGH	
		Stance	Change	Stance	Change	Stance	Change	Stance	Change
Global Allocation	Equities	🟡	➡	🟢	➡	🟢	➡	🟢	➡
	Bonds	🟡	➡	🔴	➡	🔴	➡	🔴	➡
	Commodities	🟡	➡	🟡	➡	🟡	➡	🟡	➡
Currencies	EUR	🔴	➡	🔴	➡	🔴	➡	🔴	➡
	USD	🟡	➡	🟢	➡	🟢	➡	🟢	➡
	Other	🟡	➡	🔴	➡	🔴	➡	🔴	➡
Equities	Europe	🟡	➡	🔴	➡	🔴	➡	🔴	➡
	USA	🟡	➡	🟢	➡	🟢	➡	🟢	➡
	Japan	🟡	➡	🟡	➡	🟡	➡	🟡	➡
	Emerging Markets	🟡	➡	🟢	➡	🟢	➡	🟢	➡
Bonds	Government Bonds - Developed	🔴	➡	🔴	➡	🔴	➡	🔴	➡
	Corporate - Investment Grade	🟢	➡	🟢	➡	🟡	➡	🔴	➡
	Corporate - High Yield	🔴	➡	🔴	➡	🔴	➡	🔴	➡
	Emerging Market Debt	🟡	➡	🟡	➡	🟡	➡	🟡	➡
	Total Return	🟢	➡	🟢	➡	🟡	➡	🟡	➡
Commodities	Oil	🟡	➡	🟡	➡	🟡	➡	🟡	➡
	Gold	🟡	➡	🟡	➡	🟡	➡	🟡	➡

[French version]

[German version]

As economic conditions are subject to change, the information and opinions presented in this outlook are current only as of January 9th 2019.

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