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Equities can still flourish in a slowing economy

Economic growth is subsiding, but we don't expect a global recession. The slowdown we see - as well as tepid inflation - has compelled both the Federal Reserve and the European Central Bank to call time on their monetary tightening campaigns. In essence, this removes a significant risk factor for equity markets – if you study past recessions, almost all have been catalyzed by heavy-handed central banks or oil price shocks. The dovish pivot should allow the economic cycle to keep on ageing gracefully – at least for another few quarters.

Regionally speaking, the US economy is proving to be the most robust. Only this week, US ISM manufacturing confidence was shown to have recovered more than expected in March registering at 55.3 as weather-related effects from February faded. Meaningful subcomponents also showed solid gains with employment increasing substantially from 52.3 to 57.5 and new orders from 55.5 to 57.4. With such strength in underlying trends, we remain optimistic on the US, albeit a shade less bullish than before – the US is not an island and is indeed susceptible to external factors.

On the other side of the Pacific, it had been feared that China was on the brink of a major

slowdown that would have a ripple effect throughout the world. But early this week, the Caixin PMI, rose to 50.8 in March from 49.9 in February. This suggests that Government stimulus (e.g. tax cuts, measures to encourage bank lending…) is beginning to bear fruits.

The European economy, on the other hand, looks to be bearing the buds of recession. It is yet to be seen if these will open, but we are not overly optimistic. On Monday, the final PMI reading showed that Germany's manufacturing industry has failed to rise from its slump, coming in below 50 (which draws the line between expansion and contraction) for the third month running. This comes amidst a steep decline in global trade, which is weighing quite heavily on the country's export-driven economy. Europe's saving grace could be consumer demand (boosted by real wages and fiscal policy), a reduction in trade tensions or China's recovery - if it continues to materialize. However, downside risks are still prominent, especially with the UK's one-step-forward-two-steps-backwards approach to Brexit and the prospect of a potential clampdown on US car imports. There is also the danger that wilting PMI data creates a negative feedback loop, whereby fear of recession incites behaviour that, in the end, causes a recession.

As of today, we still carry a significant proportion of equities in our portfolios, as history has shown that risk assets can still flourish at this stage in the cycle. This is especially given the benign policy backdrop, as well as the fact that earnings growth expectations for 2019 have come down significantly. For example, on the S&P 500, in January, earnings-per-share growth for this year was expected to be 8%. This has fallen to 4% today – a lower hurdle reduces the scope for disappointment. In light of our macro assessment, naturally we focus our allocation on US assets which can continue to take sap from the still-strong economic environment.

For more details on our investments, please see our latest BILBoard.

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