50 shades of black

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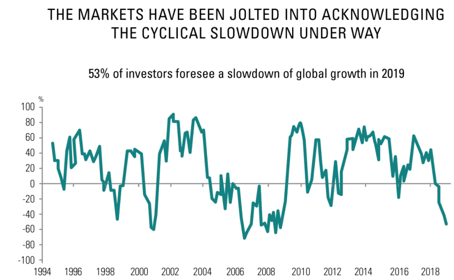
Our take on financial markets for this new year hasn't changed since the round-up we offered in our December Note titled "2019, or the conclusion of the three-way collision". As we pointed out at the time, "A mere change of calendar year in no way signals the end of our three-way collision scenario" (involving concurrent monetary, economic and political shifts). We argued that, as before, "considerable caution [was] called for", while also mentioning "upside opportunities that shouldn't be left unexploited".

Financial markets have a habit of gyrating around basic trends, with what is often herd behaviour driving investors from caution to ambition, or from denial to high hopes. Viewed in that light, the start of 2019 is a good example of how an underlying trend that is still gloomy – due to the continued deterioration in economic and monetary fundamentals – can unfold in subtle ways. Such intermediate movements can even pick up sufficient steam to make it worthwhile for active fund managers to take advantage of them – as long as they don't stray off course in the process.

The global economic slowdown has become both synchronised and unquestionable

As 2019 gets under way, even the most bullish economists feel compelled to admit that the cyclical slowdown is now broad-based. The J.P.Morgan Global Manufacturing PMI slid 0.5 points in December to 51.5, with all major world regions contributing to the decline. The ISM Manufacturing Index in the US remains high in absolute terms, but still sagged in December from 59.3 to 54.1, while the equivalent index for services dropped from 60.7 to 57.6. In China, the Markit–Caixin PMI continued on its year-long slide, this time to below 50 (49.7). That figure confirms the view that the country's manufacturing indicators have entered recession territory. Not unrelatedly, Germany's Manufacturing PMI provided evidence of a 12-month retreat, ending at 51.5 a year that had begun with a 63.3 reading. Elsewhere in Europe, the same trend could be seen in France, where the "yellow vest" protest movement played a role in driving down the Manufacturing PMI to below the 50 mark (49.7), and in Italy, where the PMI remained stuck in recession territory at 49.2.

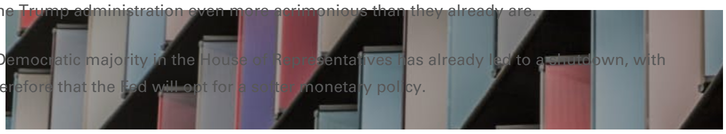


Source: 12/2018. % of respondent expecting a stronger economy. Survey realised by BofA Merrill Lynch Global Fund Manager Survey.

There is very little space for stimulus policies

It's hard to imagine the European Central Bank rushing to the rescue of Europe's economy just when it has wound up its asset purchase programme. Nor will there be a great deal of help forthcoming on the fiscal front, with Italy and France constrained by deficits that are already slipping off-limits.

In China as well, the government has only limited room to manoeuvre. Its policymakers have certainly taken a number of steps to prop up the economy, including a recent substantial reduction in reserve requirements for banks. But the obstacles to greater stimulus are becoming more serious all the time. The government's publicly acknowledged priority today is to deflate the credit bubble (it is worth remembering that the country's debt burden now stands at 270% of GDP). Furthermore, China is no longer running a current account surplus. That means two things: not only would too much deficit spending thwart the government's strategic drive to reduce imbalances, but it would also raise pressure on the national currency, immediately making China's trade negotiations with the Trump administration even more acrimonious than they already are.



In the United States, the lack of progress in talks between President Trump and the new Democratic majority in the House of Representatives has already led to a shutdown, with ordinary Federal government operations no longer being funded. The only hope left is therefore that the Fed will opt for a softer monetary policy.

Can the Fed kick-start financial markets again?

Fed Chairman Jay Powell created quite a surprise with his comments on 4 January. Strong employment figures had just highlighted the spectacular resilience of the US economy, which would seem to warrant an upbeat, unwavering stance at the central bank. But the tone struck by Powell marked quite a departure from statements he made as recently as 19 December. In particular, rather than depict the run-off of the Fed's balance sheet as a process well under way and non-negotiable, he signalled a willingness to adjust the pace. More generally, he mentioned that market risk would be factored into his view of what monetary policy is appropriate. Investors promptly drew the inference – one uncontested by Powell – that there were similarities with the situation in early 2016. Back then, as financial conditions worsened due in part to persistent market doldrums, the Fed finally scaled back its monetary tightening targets, with the result that markets rebounded sharply.

If, moreover, such a return by the Fed to a more "flexible" response to financial market behaviour were to occur concurrently with progress in trade negotiations between the US and China, the equity market sell-off at the end of 2018 could well be followed by a significant rally. Let's not forget that in the fourth quarter of 2018 alone, the Euro Stoxx index and the S&P 500 gave up between 12% and 15%.

> Fed Chairman Jay Powell importantly mentioned that he might be more flexible on policy, but he made no commitment to do so

Should that lead us to expect a lasting market recovery?

Jay Powell hinted that he might be more flexible on policy, but he made no commitment to do so. In fact, he didn't seem even mildly convinced that balance-sheet shrinkage at the Fed had contributed to market instability. In addition, US economic indicators, like the ISM indices, are themselves sensitive to the direction in which markets are moving. Market rallies help to steady these economic indicators – and thereby weaken the case for monetary policy easing. Last of all, the Fed's dashboard for the US economy still shows full employment and 2% inflation, which is in line with the central bank's statutory objectives. In a word, there are no compelling grounds today for the Fed to "capitulate" on monetary policy. At the same time, the increasingly tight labour market is gradually pushing up wages and thus beginning to eat into profit margins. That suggests that disappointing corporate earnings are in the offing – particularly as the economic slowdown discussed above gains traction.

In conclusion, a "technical" market rebound is a distinct possibility. Depending on political developments in the coming weeks, such a rebound could even take on enough scope to be worth "playing". Quality cyclical stocks, many of them badly battered over the past few months, clearly offer the best vehicles for gaining exposure to such bull forces.

> The current 8% forecasts for corporate earnings growth in 2019 will most likely be revised downwards. It's also too soon to anticipate a genuine turning-point in monetary policy

However, the underlying issues still haven't been addressed. As the new year gets going, we will most likely see downward revisions to corporate earnings estimates, both in Europe and in the United States. Instead of the 8% growth still being forecast, we can even reasonably expect an absolute decline in earnings from their 2018 level as a result of lower sales and dwindling margins. The earnings releases and commentary that will soon be issued for Q4 2018 should provide us with greater clarity on this point. At the same time, there is nothing forcing the Federal Reserve as yet to abandon its goal of normalising monetary policy. As for the European Central Bank, it has little ammunition left. A turning-point in monetary policy could conceivably occur in 2019, but would require greater pressure from financial markets or the real economy. So even if events bear out the current murmurs of a market recovery, it would likely be more of a temporary rebound than a genuine reversal of the trend that got going close to a year ago. Such a rebound should be faded by prudent investors.

Source: Bloomberg, 31/12/2018

Investment strategy

Equities

In 2018, equity markets made a wrenching adjustment to the three-way collision between macroeconomic, monetary and political cycles. That shift accelerated in December, reflecting reduced corporate earnings expectations for 2019. Through at least the first half of this year, the effects of the collision will continue to be felt in the form of a downward, but not necessarily consistent, pressure on stock prices.

We are accordingly maintaining our investment focus on growth stocks that look good from both the financial and the valuation perspectives. We have therefore continued to scale back our exposure to hyper-growth stocks, particularly in the software industry. During the years when improving fundamentals helped them outperform, they fetched high prices that make us wary in the current environment. Our strong investment convictions are currently balanced out by significant cash holdings that give us the leeway we need to take advantage of attractive points of entry. As of early 2019, for example, the share price of JD.com – China's second-biggest online retailer after Alibaba – had lost half of its value in less than a year, although the company boasts high-quality fundamentals and sales numbers that are fairly close to previous guidance.

On the whole, we believe the current bear trend has led to technical overselling of specific stocks. We therefore see a need for agile management of our equity exposure and an ongoing cautious approach to portfolio construction.

Fixed income

Safe-haven bonds chalked up their best monthly performance of the year in December, as investors fled to what they considered quality assets in order to deal with mounting uncertainty about the health of the world economy.

In contrast, the grief continued for corporate credit. High-yield paper in particular got dragged down by the severe stock-market sell-off. We moved in a timely fashion to mitigate risk in our fixed income portfolio.

We have continued to actively manage the overall modified duration of our Funds, which we recently increased in response to stock-market volatility and the economic slowdown observable in Europe and China. At the same time, we are uncertain about where US Treasury yields are heading. Though the Fed has adjusted its language, the American economy is still going strong, and for the time being the central bank still shows no signs of rethinking its balance-sheet trimming programme (which has withdrawn $50 billion in cash a month since October). We therefore plan to tread cautiously with respect to US bonds and give precedence to Asian and European debt.

With the global economy losing momentum, we are maintaining only moderate exposure to emerging-market bonds despite the attractive valuations in specific sectors. We would rather wait until those economies stabilise – and until the trade negotiations between the Trump and Xi Jinping administrations show tangible signs of progress.

Currencies

The exchange rate between the two main currencies, the euro and the US dollar, stayed within a narrow band throughout the quarter. In managing our portfolio risk, we have continued to favour the euro and, to a lesser extent, the yen over the dollar.

The greenback is hampered, as before, by a rising fiscal deficit and the first signs of a slowing US economy. The Fed's recent signals of a more flexible approach offer additional evidence for that view. Meanwhile, EM currencies remain a relatively vulnerable asset class as the global economy slows further and the Federal Reserve forges ahead with its drive to deflate the liquidity bubble.