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THE FED RETURNS THE PUNCHBOWL TO THE PARTY

Spotlight

Global Investment Committee

UBP
Union Bancaire Privée

Key points

- *The dramatic Fed pivot from hawkish in September 2018 to now at worst 'neutral' signals that the Fed is reluctant to 'take away the punchbowl' completely from the post-2008 economic expansion*
- *The Fed policy shift does little to improve the modest earnings growth outlook around the world in 2019. As a result, investors should expect single-digit returns absent new catalysts to earnings*
- *Investors can now expect coupon-like returns in corporate credit instead of the 'coupon-minus' returns that characterised 2018*
- *Brazil's real, Turkey's lira, and Russia's ruble and EM debt should generally be beneficiaries of a renewed search for yield*
- *A pivot to dividend strategies in equities combined with a focus on high-alpha strategies should benefit from a pause in Fed policy*
- *Increasingly pro-active China policies improve the prospects for China, Brazil, and industrial commodity-linked equities as the Fed pauses*

The Fed Returns the Punchbowl to the Party

In its January communication, the Fed provided a supportive tone for markets, remaining positive on the economic growth outlook, expecting stable inflation while at the same time pivoting its policy trajectory towards 'patient' and 'flexible'.

The statement formally codifies the retreat from the hawkish tone the Fed Chair adopted as recently as September 2018, which precipitated the sharp declines in global markets throughout 4Q18.

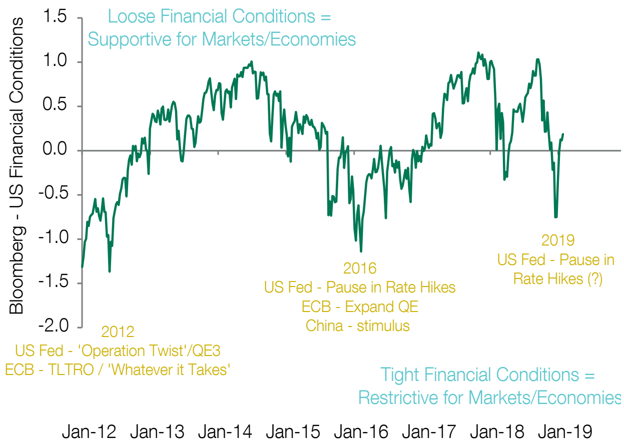
Thus, while the Fed has spent most of 2017–18 gradually removing the proverbial punchbowl from the stock-market party by raising interest rates, its inaugural communication for 2019 suggests that Chairman Powell is not yet ready to fully remove the Fed's support to the economy and markets. Instead, Chairman Powell has set the bar relatively high for additional rate increases.

Indeed, the timing of the Fed's intervention is not coincidental in the context of its policy. Since 2012 (chart 1), levels of tightness in US financial conditions like those seen in 4Q18 have triggered similar Fed policy shifts. That said, the magnitude of the Fed's recent pivot has been more dramatic than seen previously.

From a market perspective, a neutral Fed policy provides some comfort that the downside risk to US, and to a lesser extent, global earnings expectations should be contained, once they better account for the likely deceleration in growth in 2019.

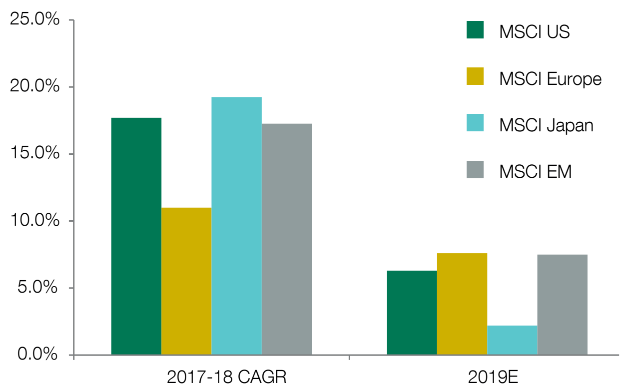
Indeed, 2019 US earnings expectations have fallen sharply since early December 2018 where they sat at over 10%. By mid-January 2019, they had nearly halved to below 6%. Though some downside risk to these revised expectations remains likely, especially in Europe and parts of emerging markets, by late January markets appeared well on their way to re-pricing the more modest growth outlook.

Chart 1. Fed Responses to Tight Financial Conditions Since 2012



Sources: Bloomberg Finance L.P. and UBP

Chart 2. Modest Global Earnings Growth Prospects Should Temper a Market Rebound in 2019



Note: Number of analysts' EPS upgrades versus number of downgrades for the next 12 months.
Sources: Thomson Financial and UBP

Shift in Fed Policy = Shift in Investment Opportunity Sets

This more cautious stance of the Fed towards further tightening suggests a shift in opportunity set for investors.

Where fixed income investors had to face headwinds from the Fed rate hikes throughout 2018, resulting in 'coupon-minus' and negative returns overall for many bond investors, a pause in rate hikes should remove this headwind. With spreads wider, especially in the investment-grade segment, our multi-year caution in credit is no longer warranted.

Instead, with spreads near historical averages, investors can more comfortably expect coupon-like returns in the USD and EUR investment-grade credit segments. In the high-yield space, though spreads remain short of historical averages, even here our long-standing caution in the segment warrants a revisit. We see opportunities once again to begin building positions to benefit from the expanded carry especially against non-corporate carry strategies such as insurance linked strategies.

In addition, historically, a pause in the Fed's rate-hiking cycle has meant that the ensuing flattening in the US yield curve will likewise pause and likely reverse. Looking back to the 1994–95 soft landing of the US economy, the pause in the Fed's rate-hiking cycle resulted in the US yield curve steepening by almost 60 bps from a nearly flat 11 bps, just below the 16 bps currently

Weak USD to Spur Carry Opportunities in EM FX and Debt

The pause in the Fed's rate-hiking cycle will similarly bring a more durable end to the strong dollar regime seen through much of 2018. Interestingly, despite weakening domestic economies and political uncertainties in Europe, we expect the European Central Bank to face a stronger euro even as data deteriorates due to the limited policy options available.

A weakening US-dollar environment should bring back the search for yield, with Brazil's real, Turkey's lira, and Russia's ruble as the most attractive beneficiaries, we expect. As with high-yield, though spreads have rebounded smartly in January, investors should seek opportunities in emerging market USD debt as the impediments of 2018 – strong USD, high oil prices, and rising US interest rates – fade.

Dividend, Alternative, and Asymmetric Strategies are Preferred Equity Exposures

With only moderate, earnings-driven (equities) or coupon-driven (bond) return expectations across most asset classes in the face of a Fed pause, we continue to believe investors should look to pivot portfolios away from overtly directional opportunities and instead look to high-quality dividend strategies to lean more heavily on income in 2019 for equity portfolios. In addition, high alpha and alternative strategies should help to cushion returns in the periodic episodes of elevated volatility that should emerge through the course of the year. Opportunistic strategies which offer asymmetric exposure – capital-protected or de-leveraged downside risk against upside participation in markets – can be of similar benefit to investors in such volatile markets.

More Proactive China Policies could 'Fill' the Punchbowl

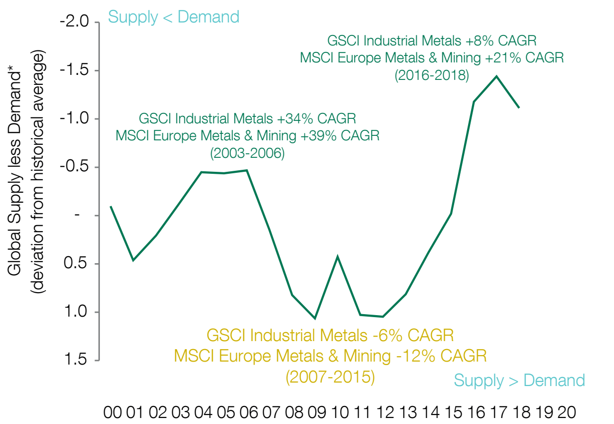
While limited earnings growth suggests that investors should remain cautious on absolute equity return prospects following the market's 8% rally in January, a potential catalyst to extend the January rebound of global equities may be a policy shift from China.

The world's second-largest economy continues to see growth slowing down as it enters 2019, and while the prospect that a truce in the US–China trade war may bring some respite, weak domestic demand remains a more pressing concern for the economy as a whole. Though China was proactive in late 2018 by reducing reserve requirements and providing liquidity for its banking system, the policies appear to have only served to slow the deceleration of Chinese growth.

In the past week, however, China has enacted its own version of quantitative easing that indirectly serves to recapitalise its banking system. Should this policy expand in scale, in combination with the liquidity provision of late 2018, renewed lending activity and an easing in historically tight financial conditions across the Asian region can serve as a catalyst to upside surprises in both global growth and earnings expectations, and in segments sensitive to China's demand.

With policy momentum building in China, should this inflection in Chinese growth emerge, we see opportunities in Chinese, Brazilian as well as global industrial commodity-linked equities. Indeed, a tight supply–demand backdrop (chart 3) combined with positive cyclical economic momentum has historically translated into attractive total-return prospects for both industrial commodities and global metal and mining stocks.

Chart 3. Tight Supply + Chinese Stimulus Creates Opportunities in Industrial Commodity-linked Plays



Sources: World Bureau of Metal Statistics, Goldman Sachs, Bloomberg Finance L.P. and UBP, *** Aluminum, Lead, Nickel, Tin and Zinc

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