



THE DRIVE YOU DEMAND

LOOKING FORWARD FROM 4Q18 VOLATILITY

Spotlight



Key points

- ◆ *A foundation has been laid for more fundamentally driven returns to emerge with the unwinding of premium valuations across asset classes in 4Q18.*
- ◆ *Investors should expect overall returns to be modest and characterised by recurring bouts of 4Q18-style volatility across markets.*
- ◆ *Further downgrades to earnings expectations remain the key headwind to global equities in early-2019 while government bond yields appear overly compressed entering the new year.*
- ◆ *US Investment Grade bonds, Japanese Equities and select US equities appear to have already priced in the prospect of a significant slowdown in global growth.*
- ◆ *Chinese, emerging market and global industrial commodity-linked equities present good value opportunities but are likely to require more proactive Chinese stimulus as a catalyst.*

Framing the volatility of 4Q2018 and looking forward

With the 17% peak-to-trough decline in global equities in the 4th quarter of 2018 followed by a 7% rebound into the new year, investors have been on a harrowing ride over the past several months.

However, putting the declines into context, the decline in US equities is similar in magnitude moves seen in previous, post-2008 corrections (Chart 1). Similarly, the widening in investment grade credit spreads has reached comparable proportions to moves seen in previous, post-2008 corrections (Chart 2) and previous US recessions (excluding 2008-98).

As we highlighted in our October Spotlight, *Five Triggers for a Market Bottom*, December and January saw four of the five catalysts emerge in a relative short span of time to bring stability in late-2018 (see pullout).

An additional positive trigger emerged on January 4, 2019 with a surprisingly strong US non-farm payrolls report on January 4 allaying (unfounded in our view) growing fears of an imminent US recession which had built during the market declines.

Thus, with important headwinds including a hawkish Federal Reserve, excessive valuations, and overly optimistic sentiment unwound through end-December, a foundation has been laid for more fundamentally driven returns to emerge in the market, we expect.

Volatility similar to what was witnessed in 4Q18 however, will remain a facet of markets looking ahead, requiring risk management to remain an important characteristic of decision making looking forward.

Five Triggers for a Market Bottom (October, 2018)

TRIGGER 1 – FED TONE TO NEUTRAL

The Fed initially shifted its tone to neutral in late-October in the face of the initial leg of this decline. However, the November-December leg led the Fed to become more overtly signal its willingness to pause both its rate hiking cycle as well as its shrinking of its balance sheet should market conditions warrant.

TRIGGER 2 – VALUATIONS

As noted in October, a move to below 15x forward earnings would begin to signal a mild recession (as in 2001-02) or something more severe such as a deep US recession (1990-91 or 2008-09) or a global crisis (Mexico in 1995 or Eurozone in 2011-12). With the December fall in particular, US valuations breached the 15 times threshold even in the face of falling earnings expectations.

TRIGGER 3 – EXCESSIVE FEAR

A spike in the market's 'fear gauge', the SPX Volatility Index above 30 signaled an end to both the 2011-12 and 2015-16 corrections. On December 24 and 26, 2018, this trigger level was finally breached.

TRIGGER 4 – AGGRESSIVE POLICY ACTION IN CHINA

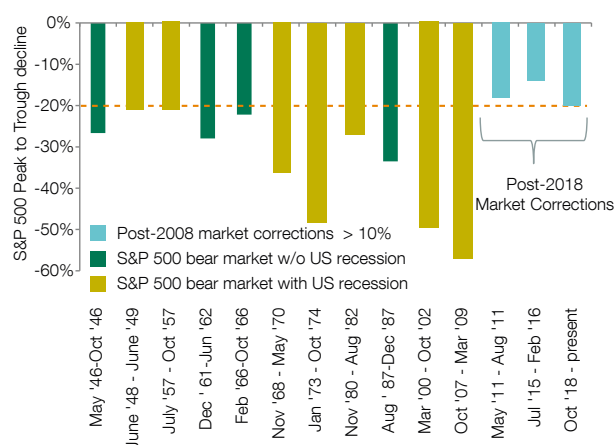
This is the only catalyst that has not been triggered from our October report. While progress on trade negotiations is encouraging, a long-term pause in new tariffs is unlikely to re-start China growth. Instead, domestic policy action to re-accelerate domestic growth is the more important catalyst for the global economy and markets.

TRIGGER 5 – ITALY RESOLUTION

Though we feared that a spike in Italian yields might be necessary to force a budget compromise between the Italy and the European Union, cooler heads instead prevailed on December 19.

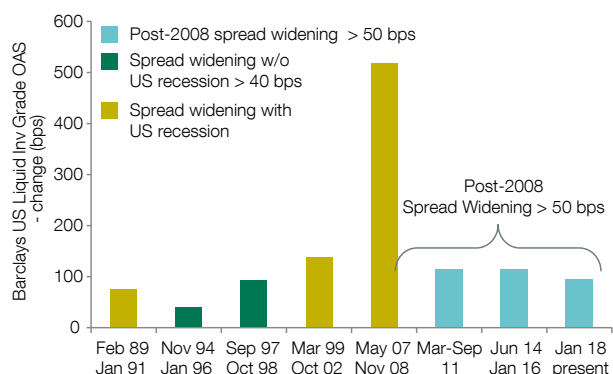
Framing the volatility of 4Q2018 and looking forward

1. Putting 2018 into the context of historical bear markets



Sources: Bloomberg Finance L.P. and UBP

2. US Investment Grade Spreads widened as in a recession



Sources: Bloomberg Finance L.P. and UBP

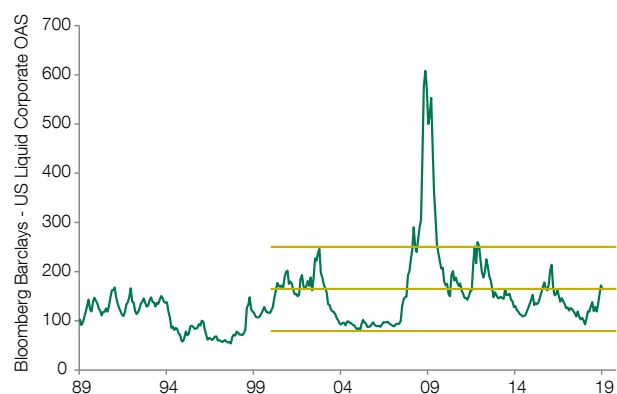
Look for opportunities in US IG credit, Japan equities and select US equities

While the sell-offs across asset classes have been broad-based, the emergence of fundamental value has been more selective.

In the fixed income sphere, US investment grade bonds have seen a widening in spreads that has been consistent with not only post-2008 market corrections but also comparable to the widenings seen during the 1990 and 2001-02 US recessions as well as the 1997-98 Asian Financial Crisis (Chart 2).

Admittedly, in absolute terms, US Investment Grade spreads have only returned to historical average (Chart 3). Despite this, US Investment Grade risk-reward is now more balanced than at any time since 2015.

3. US Investment Grade Spreads back to historical average



Sources: Bloomberg Finance L.P. and UBP

Bond investors should still remain wary of excessive exposure to interest rate risk as compressed US 10-year

yields leave them susceptible to a repricing especially as recent jobs data suggests few signs of an outright recession in the US economy.

Following weak performance in 2018, Japanese equity price in a dire outlook for 2019 as outlined in our 2019 Investment Outlook. Valuations in Japan sit at lows only seen during the depths of the Global Financial Crisis despite the fact that Japanese equities have earnings and dividend growth which has outpaced that of both their US and European counterparts over the past five years.

UBP's strong yen outlook does pose a headwind for Japanese corporates. However, for non-JPY investors, we anticipate that the prospect for FX gains should serve as a positive contributor to total returns.

Opportunities awaiting a Catalyst – US, China/EM and Industrial Commodities

Valuations in US equities have begun to overprice the prospect of a dramatic slowdown in US economic growth, having seen P/E multiples fall below 15 times. Despite, downgrades in recent weeks, we continue to believe that earnings expectations remain overly optimistic for 2019 as evidenced by recent downgrades from high profile corporates in recent weeks. We expect this trend to continue moving into late-January's earnings season and present a headwind for the new year rally. As earnings are revised to more sustainable levels, investors should look to stock selection as the key driver of returns in the broader US equity market.

Valuations in both China and broader emerging markets have long been attractive in both absolute terms and relative to developed market equities. The challenge has been that the slowing economic and earnings growth profile and an unsupportive macro policy backdrop left nothing in the way of catalysts to crystallise the value present in these markets.

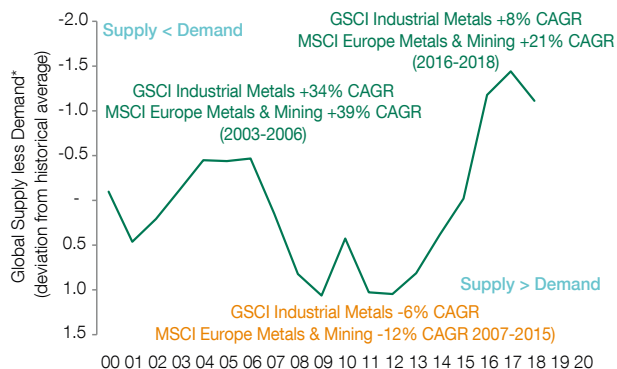
Though a truce in the ongoing trade conflict between the US and China in the coming months may serve as a boon to sentiment in China and the broader emerging markets complex, a ceasefire alone without more stimulative domestic policies may serve only to stabilise the slowing trend in the Chinese economy. However, should the economic slowdown of 2018 continue unabated in 2019, China would need to increase its efforts to support the economy and provide the catalyst awaited by markets.

In the broader emerging markets complex, Brazil's new government may seek to use its early days in office to replicate the 'Start-Stop' approach of US President Donald Trump (please see UBP Spotlight Navigating a Trump

Presidency, February 2017) and seek pro-cyclical policy measures initially before pursuing the challenging reform issues outlined during the campaign. Similarly, in India, with elections scheduled for May, pro-cyclical policies may be on the cards to buoy the economy looking ahead.

Should such pro-cyclical policies begin to appear in the largest emerging economies, the valuation discounts in place for the EM asset class may begin to reverse both in absolute terms and relative to Western markets. Such pro-cyclical policies should also return focus to the growing supply-demand imbalances emerging in key industrial commodities around the world (Chart 4) and the opportunity these present for industrial commodities prices and European metals and mining firms over future months.

4. Industrial commodity supply–demand imbalances



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

Tight Financial Conditions = Risk of Volatility Spikes

Although investors should take comfort from the emergence of the catalysts needed to stabilise markets, the fundamental backdrop of a decelerating global economy and a more modest outlook for earnings remains in place. Markets may now be buffeted by less extreme valuations across asset classes but still have to contend with tighter financial conditions than seen at any time during 2017 or 2018.

Therefore, with only moderate return expectations expected across most asset classes, these tighter financial conditions suggest that episodes like the volatility spike of 4Q18 should not be viewed as just a one-off affair. Instead, they should be seen as a new and likely persistent feature of the market backdrop looking ahead.

As a result, we continue to believe investors should look to pivot portfolios from directional opportunities and instead consider alternative strategies which should help to cushion returns through these periodic episodes of elevated volatility. In addition, opportunistically, strategies which offer asymmetric exposure – capital protected or de-leveraged downside risk against upside participation in markets – can offer similar benefits to investors in such volatile markets.

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