THE DRIVE YOU DEMAND

KEY QUESTIONS FROM THE ROAD

Spotlight

Global Investment Committee

Union Bancaire Privée

Key points

- *Having spent the first two months of 2019 travelling to see clients across Asia, the Middle East and Europe concern among clients remains and is surprisingly consistent across regions of the world despite one of the strongest rallies in global equities to start a year in the past 30 years. We address the three most asked questions:*
  - *Question 1: Should we worry about a recession? A sharp pivot from global central banks increasing fiscal stimulus in China and key European countries should stabilise growth following a weak 4Q18-1Q19.*
  - *Question 2: Does more upside remain in equities following their strong start to 2019? The dramatic change in Fed policy in 2019 suggests that even following the nearly 11% rally in global equities, further upside remains looking through 2019. Investors should look to add to equities especially on any pullbacks.*
  - *Question 3: Has the rebound in Chinese equities already priced in an end to the US-China trade war? The overhang of a US-China trade war has been unwound with the rally year-to-date. However, further signs of a more durable rebound in Chinese economic activity should provide investors with attractive opportunities to add to existing positions in China in the months ahead.*

Should investors worry about recession?

With economic data disappointing across almost every region of the world in 4Q18 and in early-2019, unsurprisingly concerns about an imminent recession have been growing in spite of the rally in global equities.

However, investors should view the US slowdown in particular as a 'mini-cycle' (as highlighted in our Spotlight, Navigating the coming mini-cycle in the US Economy, May 2018) rather than being a sign of a recession on the horizon.

In particular, using our UBP Recession Watch Framework (See table 1), while data indicates that both manufacturing AND employment/consumption data have softened, the backdrop looks more similar to slowdowns or 'mini-cycles' seen going back to the early-1990s.

Admittedly, the tightening in US lending conditions plus a challenging US financial backdrop in late-2018 present a risk that overall constraints on access to credit could transform this slowdown into an outright recession.

This is the same situation faced by policymakers in both 2011-12 and 2015-16 – when the US economy saw signs of decelerating growth as well as tightening credit conditions. Once again, the US Federal Reserve in particular has responded in a similar fashion to avert recession.

In 2011-12, economic slowdown in the US following the Eurozone Sovereign Crisis was met by policy easing at the Fed via QE3. This move loosened financial conditions meaningfully both across US bank lending as well as financial market channels.

Similarly, in 2015-16, economic slowdown – driven by a sharp contraction in the energy sector of the economy – was met by a pause in the Fed rate hiking cycle (begun in 2015) and assisted with global support via the European Central Bank's expansion of its own quantitative easing programme. Though more measured, the results were similar as financial conditions eased across US bank lending and financial market channels.

In January, as the Fed overtly reversed its previous hawkish bias on US interest rate policy resulting in the money markets unpricing the prospect of Fed rate hikes in 2019.

More importantly, the Fed began signalling in February that it will end the wind down of its balance sheet, built up via quantitative easing bond purchases, later in 2019. So, in contrast to the modest measures taken in 2015-16, the moves signalled in Jan-Feb represent a substantial shift in the policy regime for the US Fed which should stabilise US growth, as we move through mid-2019.

Looking globally, investors are similarly concerned about the slowdown seen in Europe and China. China began to reverse its own tightening policy in 3Q18 and more recently has started to expand its easing measures. We expect this should become visible in economic data by 3Q19 given the lags typically associated with such a policy stimulus.

However, the European Central Bank is more constrained. The ECB recently announced a new round of its Targeted Longer-Term Refinancing Operations (TLTRO) designed to provide liquidity to eurozone banks. Its impact should help provide stability though only limited stimulus to the eurozone economy.

Instead, investors should expect fiscal policy in the eurozone to loosen in the months ahead as both Germany and France should see fiscal deficits expand to address domestic needs (See chart 1).

Table 1. UBP Recession Watch Framework

		1980 Recession	1981-82 Recession	1990-91 Recession	2000-01 Recession	2008-09 Recession	2019 Recession
Manufacturing	ISM Mfg < 50	YES	YES	YES	YES	YES	
	Industrials Sales Growth (< 0% YoY)	YES	YES	YES	YES	YES	
	IP Growth (< 0% YoY)	YES	YES	YES	YES	YES	
Employment /Consumption	Non-Farm Payrolls (YoY < 0%)	YES	YES	YES	YES	YES	NO
	Jobless Claims (YoY chg > +60k)	YES	YES	YES	YES	YES	NO
	Retail Sales Growth (< 2.5% YoY)	NA	NA	YES	YES	YES	
Credit	Tightening Lending Conditions	NA	NA	YES	YES	YES	YES
	Tightening Financial Conditions	NA	NA	YES	YES	YES	NO

Sources: Federal Reserve Bank of St. Louis, Bloomberg Finance L.P. and UBP

Moreover, given their large export economies, stabilisation and re-acceleration in China and the US should help underpin the admittedly fragile eurozone economy.

Does more upside remain in equities following their strong start to 2019?

As highlighted in our early-February Spotlight, The Fed Returns the Punchbowl to the Party, the removal of the overhang of potential Fed rate hikes created an opportunity that was further constrained by the lack of growth momentum in the global economy. Historically, a pause in Fed rate hiking cycle allows PE multiples to expand, restoring a driver to returns absent since 2017.

However, with the Fed not only concluding its rate hiking cycle but also adding to its easing bias by ending the shrinkage of its balance sheet later in the year, it may well be replicating the strategy last seen in previous pauses like in the rate hiking cycle of 1994-95.

As the Fed ends the other leg of its policy tightening approach later in the year, market benefits should come as the US (and global) economies stabilise and, as seen following the end of its rate hiking in 1994-95 (Chart 2), additional PE expansion can be expected moving into the 2nd half of 2019.

So, with earnings expectations having been revised down to a more reasonable 5% growth for 2019, this combined with the prospect for additional PE expansion as the Fed continues its easing tilt shifts risk-reward in favour of equity investors looking ahead, especially should markets correct following their year-to-date rally.

Has the rebound in Chinese equities already priced in an end to the US-China trade war?

With a 15% rally in offshore Chinese equities in the first two months of 2019, Chinese H-shares have only now recovered back to the levels seen as the US-China trade war heated up in June, 2018.

Investors will recall that 1H18 was a period in China where policy was tightening and the economy slowing, weighing on both earnings and valuations. With earnings expectations having fallen sharply as with other markets around the world, valuations have rebounded to near their mid-2018 levels.

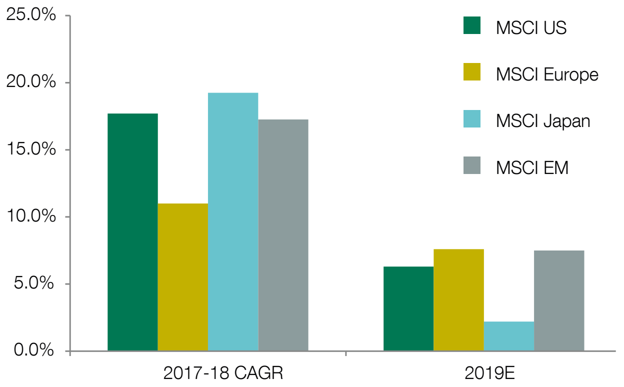
However, in contrast to the tight policy and economic slowdown that characterised China during mid-2018, policy is now easing and the slowdown is likely to be nearing its end.

In particular, looking at the ‘credit impulse’ measure of activity in China, the credit induced slowdown that typified 2017 and 2018 has shown its first sign of reversal in January, 2019.

Historically, a reversal from tightening to loosening credit conditions as we have begun to see in January improves the risk-reward investors face (Chart 3). However, confirmation of economic expansion and maturity in the economic cycle would provide higher conviction opportunities across China.

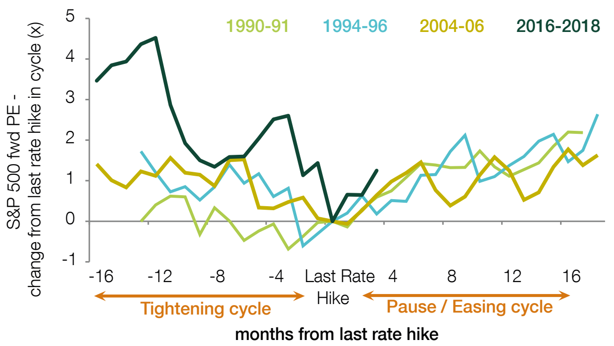
Thus the overhang of a US-China trade war has substantially been unwound with the rally year-to-date. However, further signs of economic stimulus and credit expansion will establish a more durable rebound in Chinese economic activity which should provide investors with attractive opportunities to add to existing positions in China over the months ahead.

Chart 1. Fiscal policy loosening to expand globally



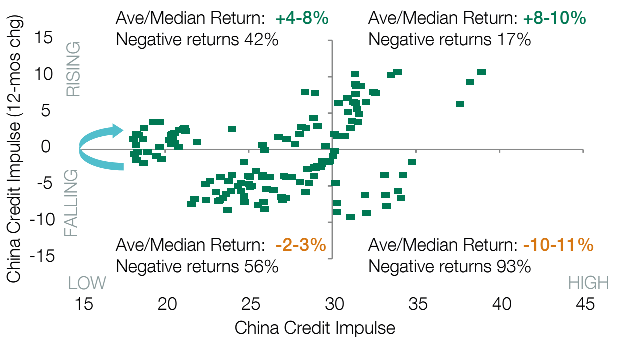
Sources: OECD, IMF and UBP

Chart 2. The end of the 1994-95 hiking cycle suggests more PE expansion ahead



Sources: Standard & Poors, Bloomberg Finance L.P. and UBP

Chart 3. China equity risk-reward improves as credit momentum accelerates



Sources: Bloomberg Finance L.P. and UBP
* return figures represent 18-month forward annualized returns of the Hang Seng China Enterprise Index

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12 March 2019

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