THE DRIVE YOU DEMAND

LOOK FOR GLOBAL GROWTH CONCERNS TO FADE

Spotlight

Global Investment Committee

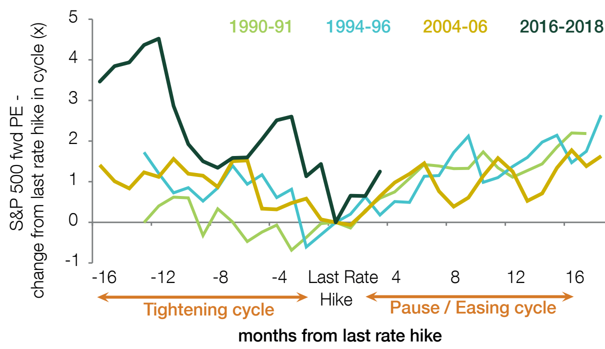
Key points

- *P/E expansion in US equities is approaching its limit in terms of its ability to be the primary equity return driver looking ahead.*
- *Signs of a reduction in current worries about recession or in the downside risks to today's modest earnings expectations are needed as a catalyst to support the next sustainable leg of equity market returns. We remain constructive on both fronts though further evidence may only emerge gradually throughout the 2nd quarter.*
- *The inversion of the US yield curve has rightly raised concerns about an imminent recession. However, in six of the seven inversion episodes since the mid-1980s, US equity investors saw returns of +12-26% one year after inversion.*
- *Even as investors await signs that recession and earnings concerns are set to fade, historically attractive risk-return prospects in both investment grade and emerging market debt are available.*
- *Should negative global economic momentum continue to stabilise and inflect moving into the summer as expected, opportunities exist in China, Japan and export-oriented Europe.*

P/E expansion reaching historical extremes

The 15% year-to-date rise in US equities has been driven primarily by a rise in PE multiples as earnings expectations have been steadily downgraded throughout the first quarter. This rise is unsurprising, since going back to 1990, a pause in a Federal Reserve rate hiking cycle has tended to trigger such multiple expansion (as highlighted in our Spotlight, *Key Questions from the Road*, March 2019).

Chart 1. US P/E expansion approaching previous peaks



Sources: Bloomberg Finance L.P. and UBP

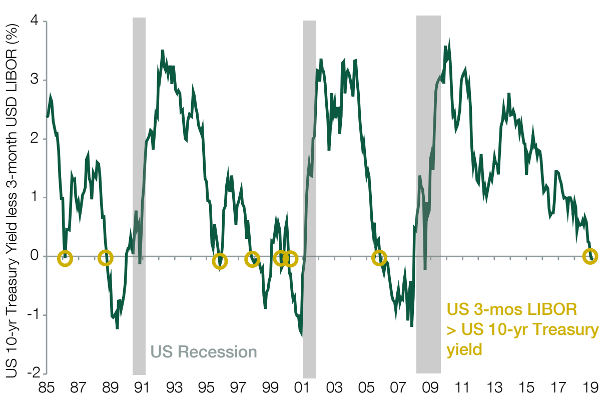
However, the expansion from end-December is now nearing the upper end of the P/E expansion seen in the three previous pauses in Fed rate hikes (Chart 1). As a result, investors will have to rely on earnings growth and, in particular, upside surprises to earnings growth to drive the next leg of the market rally.

US Yield Curve Inversion…a sign of a recession ahead?

Rising concerns about a US recession present a meaningful hurdle to such upside surprises (or at least an end to the year-to-date downgrades) to future earnings expectations.

In particular, the collapse of US 10-year Treasury yields below 3-month LIBOR rates has increased concerns among investors. Indeed, historically such an 'inversion' has preceded previous US recessions. However, since the mid-1980s, we have seen seven such inversions in contrast to only three US recessions over the period.

Chart 2. Historical 'Inversions' in US yields



Sources: Federal Reserve Bank of St. Louis, NBER and UBP

Typically, shallow inversions have coincided with slowdowns in the US economy (and usually more meaningful slowdowns globally as in 1995 and 1998). However, deeper inversions – as in 1988, 1999-2000, and 2005 – have preceded outright US recessions (Chart 2).

Perhaps as importantly for investors, during those seven inversions, while bond market performance has varied, US equity market performance has been relatively consistent, with investors realising positive returns 12 months after the first date of inversion in six of the seven episodes averaging 14% (Table 1). This suggests that investors should not aim to be early in anticipating a more meaningful slowdown.

Table 1. Asset Class performance following 'inversion'

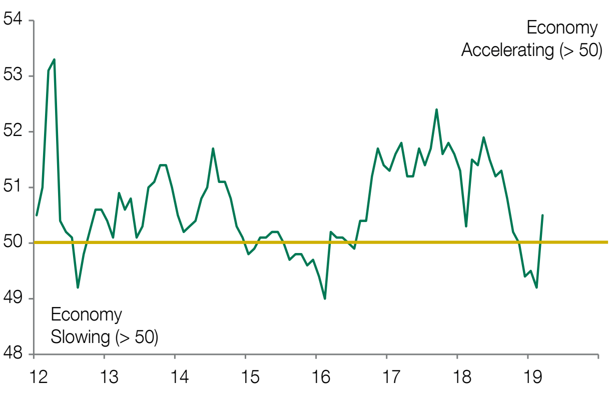
First Date of Inversion*	Chg in UST 10-yr yield (bps)	Chg in Baa Spread (bps)	Chg in S&P 500
Mar-86	19.3	(108.3)	22.1%
Nov-88	(122.8)	55.8	26.4%
Nov-95	30.3	(19.3)	25.1%
Nov-97	(116.0)	108.0	21.8%
Sep-99	15.4	(0.4)	12.0%
Mar-00	(89.0)	45.0	(22.6%)
Dec-05	20.7	(10.7)	13.6%
Average	(34.6)	10.0	14.1%

Orange: represents a US recession within 24 months of 1st invession
Sources: Federal Reserve Bank of St. Louis, NBER, Bloomberg Finance L.P. and UBP
* 3-month LIBOR greater than US 10-year Treasury yields

Economic ‘green shoots’ starting to appear…

Encouragingly, data beyond the concerns of US yield curve inversion suggest stability may be returning to the global economy. In particular, recent China Manufacturing PMI data (Chart 3) suggest stabilisation may be emerging in the Chinese economy following a slowing trajectory since mid-2018.

Chart 3. Stability in China should bring stability in Europe



Sources: China Federation of Logistics and Purchasing, Bloomberg Finance L.P. and UBP

With slowing exports to China contributing meaningfully to the weakness seen in European economies year-to-date, recent Chinese reports provide a glimmer of hope that weak growth on the continent and in Germany in particular can stabilise in the months ahead.

In the US, similar encouraging signs have emerged recently which, if confirmed by a broader range of data, can characterise the slowdown in late-2018/early-2019 as being only transitory. In particular, the weekly US jobless claims figures suggest that claims by the unemployed, having been rising since late-2018 have now fallen back to levels last seen in summer, 2018.

On the manufacturing front, with sharp declines in the Institute of Supply Management index suggesting a deceleration in manufacturing activity in late-2018, the March rebound suggests that stability is re-emerging in the manufacturing sector.

While recent data have been encouraging, admittedly in aggregate, economic figures remain mixed with downside surprises still common in both the US, Europe and Japan. More specifically, the US consumer, as reflected in the key US retail sales data has been hesitant to spend in recent months, with a weak Christmas season followed by disappointing figures again in January-February, 2019. We are hopeful that a firm job market as evidenced by jobless claims and non-farm payrolls may bolster overall retail sales momentum moving ahead.

Opportunities in IG / EM debt and China-linked demand

As investors await signs that recession and earnings concerns are set to fade, risk-return prospects remain attractive in both investment grade and emerging market debt.

So, despite the sharp fall in risk-free USD and EUR government yields, the premium earned (“spreads”) by investors from investment grade bonds remains near historical averages. We expect the dovish tilt by the US Federal Reserve and the announcement of the eurozone’s third Targeted Long-Term Refinancing Operation (TLTRO) to spur a hunt for yield and keep downward pressure on yields looking ahead.

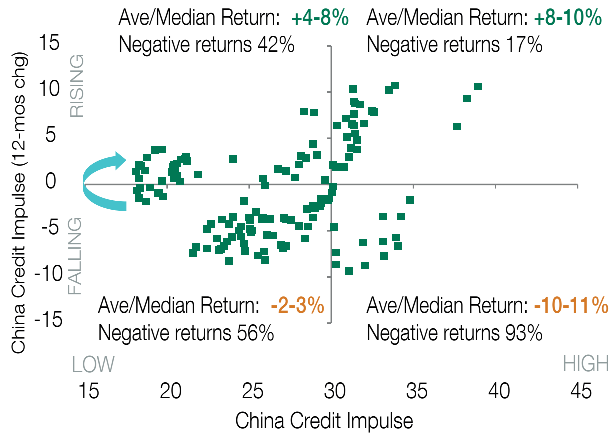
With USD high yield bonds having seen spreads tighten more meaningfully than their USD investment grade counterparts, short duration emerging market debt is an increasingly attractive opportunity for USD investors supported by more dovish US and EM central banks and the prospect of firmer growth among key economies.

In the EUR high yield space, however, spreads remain reasonable attractive especially against the near zero percent yields seen in 10-year German bunds. In contrast, we feel that EUR-hedged emerging market debt is comparatively less attractive than EUR high yield bonds given the high hedging costs that remain in place undermining total returns to EUR investors.

With initial signs of a firming manufacturing sector in China, investors should now be focused on whether this translates into an ongoing loosening of credit conditions within China.

Having seen the first sign of loosening in January, 2019, further credit expansion and the maturity of the economic cycle should continue to provide higher conviction opportunities in China.

Chart 4. China equity risk-reward improves as credit momentum accelerates



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

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10 April 2019

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