THE DRIVE YOU DEMAND

INVESTING IN A TIME OF GEOPOLITICAL UNCERTAINTY

Spotlight

August 2019 | Global Investment Committee

UBP

UNION BANCAIRE PRIVÉE

Key points

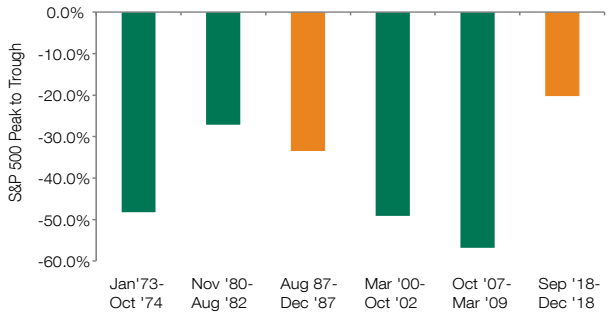
- *Unlike previous cycles, avoiding economic recession no longer ensures markets can avoid falling into bear market territory. Instead, investors must now pair traditional economic and valuation analysis with an assessment of financial conditions and the growing geopolitical conflict to account for a growing set of risks.*
- *The state of the economy remains very much central for investors even in this new geopolitical regime. Encouragingly, signs still suggest the US economy is in a slowdown rather than a recessionary phase.*
- *However, with US financial conditions having tightened throughout August, much like in 4Q18, the ongoing slowdown leaves the economy susceptible to looming external geopolitical shocks.*
- *With the US-China trade war and a hard Brexit emerging as such shocks, investors should look for US 10-year yields to continue their de-rating towards 0.8-1.2% should global fiscal policy not be forthcoming in the months ahead.*
- *Even if a US recession is avoided, the S&P 500 could fall by as much as 10-15% to reach valuation triggers seen in previous post-2008 mini-cycles. We believe that fiscal stimulus or, more effectively, fiscal-monetary coordination presents the most potent upside catalyst to risk-assets.*
- *Asymmetric exposure to equity risk is an anchor for portfolios while we increasingly focus on capital preservation in fixed income allocations given elevated valuations across both asset classes.*
- *Investors should increasingly incorporate a portfolio of 'risk-off' strategies to moderate an expected long-cycle rise in volatility. With tactical headwinds to gold emerging, investors can look to CHF and JPY to diversify their 'risk-off' allocations.*

'This time it's different'

Although the phrase 'this time it's different' is probably the most dangerous attitude among investors, 2018 did see something 'different' emerge with the first bear market (a decline of >20%) in the S&P 500 outside of a recession since the 1987 stock market crash (chart).

While US growth was undoubtedly slowing and the Federal Reserve tightening (both typical preludes to a recession-induced bear market), the combination of a dramatic tightening in US and global financial conditions combined with escalating geopolitical tensions (via US-China trade war) likely exaggerated the decline despite the absence of an actual recession.

A 2018 US bear market outside of a recession



US bear markets outside of a US recession in **orange**

Sources: Standard and Poor's, Bloomberg Finance L.P. and UBP

Indeed, with the 2011-12 decline in the midst of the eurozone crisis coming close to the 20% threshold, the post-Global Financial Crisis period nearly had two bear markets outside a recession within a decade after nearly 20 years. This suggests that the current global backdrop is in fact 'different' and investors should adjust their approaches accordingly.

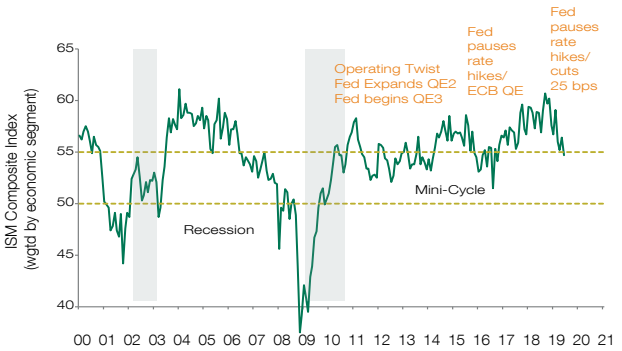
US growth – Still a slowdown not a recession ahead

Though near-bear markets are increasingly commonplace, history also tells us that an outright recession has always triggered a bear market. So, assessing recession risk remains a key risk management tool for investors even in this new regime.

In this context, UBP's Recession Watch Framework served us well. In 2018, it signalled slowdown rather than outright recession leaving us only to wait for markets to better price or, as was the case in December, 2018, overprice this prospect.

With recessionary fears once again surfacing, the UBP Recession Watch framework continues to show a firm consumer/employment market offsetting a weak manufacturing sector as seen for much of the year. This suggests a slowdown rather than recession on the horizon.

A US Mini-Cycle* slowdown and not yet a recession



*For more details, please see 'Navigating the Coming 'Mini-Cycle' in the US economy (May, 2018)

Sources: Institute of Supply Management, Bloomberg Finance L.P. and UBP

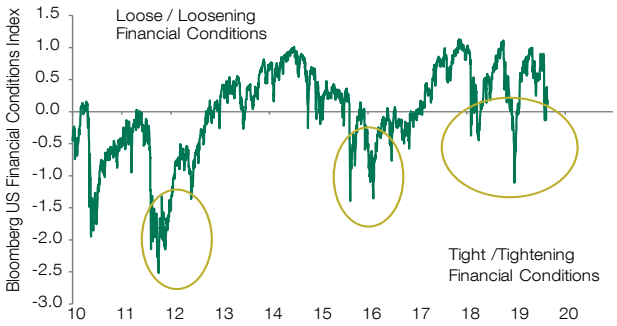
Indeed, while the US economy is slowing, investors should recall that it is doing so from a starting point of one of the strongest expansions in the past 20 years (Chart). Looking at the Institute for Supply Management manufacturing and non-manufacturing indices, in combination, they suggest a mini-cycle* slowdown rather than an outright recession consistent with our 'Recession Watch' framework.

Fragile Financial Conditions leave the economy at risk

Admittedly, the slowing US economy sits on an unstable foundation as financial conditions have pivoted from loosening and easier conditions earlier in the year to ones that are now more neutral.

Indeed, the backdrop appears worrisomely similar to October, 2018. Recall, how the initial October sell-off was triggered by elevated valuations, a hawkish Federal Reserve and escalating trade tensions between the US and China. Financial conditions tightened from loose to neutral during October and into November, 2018. They were then aggravated by the final rate hike in the Fed tightening cycle in December, 2018 leaving them tighter than during the energy bust of 2015-16 (chart).

Tightening US financial conditions = rising risks



Sources: Bloomberg Finance L.P. and UBP

Current conditions appear to mimic the 4th quarter, 2018 episode. Elevated valuations (see below), Federal Reserve policy which markets viewed as not easy enough plus rising tensions between the two largest economies in the world have triggered the initial tightening in conditions in the spring from a previously loose backdrop, similar to the October, 2018 tightening in financial conditions.

The autumn months present markets with renewed risk that the Federal Reserve will once again disappoint markets with 'only' a 25 bps rate cut in their September meeting and/or the EU-UK will fail to find an agreement and the UK will exit the EU via a hard Brexit.

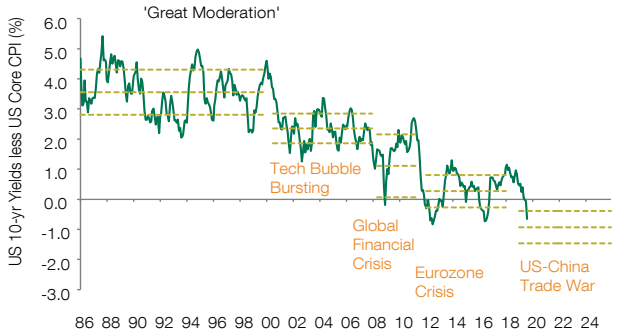
Moreover, whereas the US and China retreated in the 4th quarter of 2018 by restarting trade negotiations, the persistent weakening in the Chinese yuan since the August 1 tariffs were announced combined with ongoing tit-for-tat retaliation suggest that the trade battle between the two global superpowers is in the process of morphing into a broader conflict in the coming years, as outlined in our recent report *The End of the US-China Trade War*.

As a result, against a backdrop of neutral/tightening US and eurozone financial conditions combined with central banks which appear reluctant (US) or unable (ECB) to loosen conditions proactively both economies and markets appear at risk as was the case in 4Q18.

Look for US Treasury Yields to decline to 0.8-1.2%

Since the bursting of the US tech bubble in 2001, demand shocks to the US economy have been met with de-ratings of inflation-adjusted 10-year US Treasury yields. Indeed, the bursting of the tech bubble, the Global Financial Crisis, and the Eurozone Sovereign Crisis each resulted in de-ratings of 80 to 110 bps.

Trade war shock to continue a US Treasury de-rating



Sources: Federal Reserve Bank of St. Louis and UBP

With the US-China trade war augmented by the prospect of a hard UK exit from the European Union serving as shocks to the US economy, investors can expect a similar de-rating of US Treasury yields if monetary policy continues to carry the bulk of the policy burden for the US economy. If correct, investors can expect US 10-yr yields to fall to 0.8% to 1.2% and to see negative inflation adjusted risk-free yields out to 10 years on the US yield curve.

US Equities still not pricing a slowdown

As seen in late-2018, valuations which overprice the prospect of US recession can present an opportunity for investors.

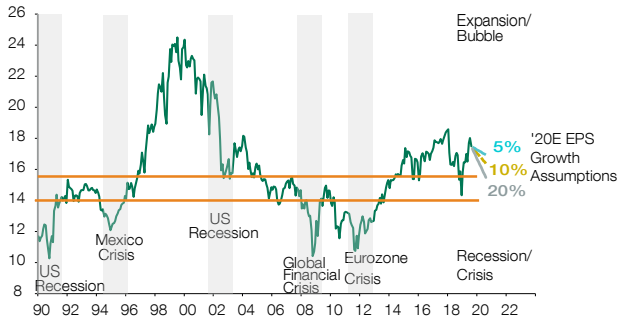
Indeed, US equities admittedly appear cheap relative to 10-year government yields with the spread between the S&P 500 earnings yield approaching levels seen during a similar recession scare in early-2016.

However, investors should be cautious before relying too much on this relative valuation approach. Experience from both the eurozone and Japan suggests that as risk-free bond yields approach 1%, the relative value proposition deteriorates as earnings yields rise (and their converse, price-earnings ratios fall) relative to the decline in yields.

Instead, taking an absolute valuation approach, with 2019 earnings growth for the S&P 500 settling at between 0-2%, even should 2020 earnings come in at the optimistic 10-12% currently forecast by the consensus, US equities would sit just

below 16.5x forward earnings despite having fallen 5-6% from their July highs. Unfortunately, this is still well short of the 15.5x forward earnings valuation that price a similar slowdown/growth scare as seen in both 2015-16 during the energy bust and in 4Q18 (chart).

US Equities: Still not pricing a slowdown



Sources: Thomson Financial and UBP

To reach comparable valuation triggers and assuming recession risk remains at bay and optimistic earnings expectations are achieved, the S&P 500 would likely need to decline a further 5-10%. If earnings cannot rebound meaningfully from the 0-2% likely in 2019, we estimate a 10-15% decline in the S&P 500 would better capture the economic slowdown in progress.

Upside Risks? Fiscal + Monetary Stimulus

With the US Federal Reserve apparently reluctant to provide aggressive stimulus to the economy, upside risks to this cautious outlook sit with the prospect of fiscal stimulus, not only in the United States, but potentially first in Europe.

The incoming European Council President Usula Von der Leyen will need to lead a campaign for pan-European fiscal support. However, this comes against an increasingly public debate in Germany about the prospect of an admittedly modest €50 billion fiscal stimulus and calls for government to loosen the taps also growing in Austria and Italy. In combination, they suggest that discussions are at least beginning to develop policy options in the face of a slowing continental economy and ahead of a visible prospective demand shock (Brexit) in the months to come.

Indeed, even in the US, US President Donald Trump has floated some admittedly modest fiscal policy options including a capital gains or payroll tax cut to boost the economy. On a medium-term horizon, with campaigning for US presidential elections set to ramp up moving into 2020, both Democrats and Republicans appear keen on accelerating fiscal spending in the 2021 presidential term.

Should such stimulus come in coordination with renewed monetary easing from central banks, a more potent upside catalyst would present itself for equities and other risky assets. Currently, this appears a high political hurdle to overcome both in the US and eurozone.

Managing Risk amidst Geopolitical Uncertainty

Facing richly valued markets, weakening growth backdrops around the world, reactive rather than proactive policymakers and a complex geopolitical landscape, managing risk has been a key focus over the past year.

Indeed, investors have been facing what we expect is a long-cycle pick-up in volatility. In 2018, this began with a rebound in equity volatility from historic lows. In 2019, this has expanded to fixed income markets and precious metals with, we suspect, other asset classes yet to come.

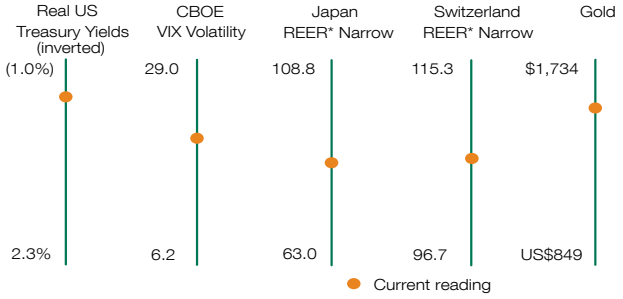
As a result, for fixed income investors, we are increasingly taking a capital preservation bias given the low absolute level of yields around the world.

While credit spreads fail to price the macro backdrop outlined earlier, we expect that central banks, given their limited policy toolkits, will shift their focus towards seeking to avoid systemic credit events in their respective economies. Indeed, Japan and to a lesser extent China are already pursuing similar objectives. Therefore, though volatility should pick up in the fixed income space, we expect hold-to-maturity, active credit selection approaches will remain attractive.

In equities, 'asymmetric' exposure – participating in upside returns in equity markets, while containing exposure to substantial equity declines – to equity risk remains an anchor to our positioning. The temporary decline in equity volatility in June-July allowed us to make a tactical addition to the capital protected equity exposure in portfolios. Similarly, we took the opportunity to augment our asymmetric long-short hedge fund exposure in China, allowing for a more attractive risk-reward backdrop for investors in the face of a continuation of geopolitical stress.

Beyond this, we also believe that investors should incorporate a portfolio of 'risk-off' strategies to moderate this expected long-cycle rise in volatility. Gold has been the anchor of our 'risk-off' approach in 2019. However, with the move towards US$1,550/oz. investors should begin looking to diversify their risk-off allocations. In particular, we see opportunities in both the Japanese yen and Swiss franc, which remain comparatively undervalued versus gold, US and German government bonds, as well as equity volatility.

A portfolio approach to 'risk-off' assets



Source: Bank of International Settlements, Chicago Board Options Exchange, Bloomberg and UBP; scales represent 10-year ranges OF -2/+2 standard deviations;* Bank of International Settlements Real Effective Exchange Rate

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