Market Update: 15th May 2019

Revisiting the Risks in a Changing Economic Landscape

When we compare current economic conditions to those back in December, we see just how much the economic landscape has changed. In the space of only 6 months, we have experienced a sell-off followed by a recovery in equity markets, a cooling and re-escalation of trade tensions between the US and China, a Fed pivot from further tightening to potential easing in interest rates, and a significant decline in global trade and corporate earnings growth. As we reflect on the changing economic conditions over this period, we consider what we expected to happen, what did happen, and where we should be positioned going forward.

Defensive Positioning

We went defensive in December as a result of four key risks:

> ***1. The economic data suggested that the global economy was slowing, with a reduction in global trade which would reduce corporate earnings and pull equity markets lower on a global scale.***
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> ***2. The risks of no Brexit were increasing, and the potential permanent strengthening in the pound which would follow a no Brexit or a soft-Brexit outcome would result in a structural and non-recoverable decline in asset values in globally allocated portfolios.***
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> ***3. US-China trade tensions were looking increasingly risky and a deal seemed far off.***
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> ***4. The US Federal Reserve appeared to be set on raising rates, ignoring the economic data suggesting weakness in the US economy.***

As a result of these risks, the decision was made to remove traditional long equity exposure from the portfolios, implement high cash levels and minimise currency risk in anticipation of a sell off in equity markets and potential appreciation of sterling. By doing this, we went into capital preservation mode, as we saw the risks in equity markets as significantly outweighing the potential return.

The Q1 Equity Rally

In the first quarter of the year, markets failed to confirm our thesis. While the economic data remained weak, a cooling of US-China trade tensions combined with a Fed pivot towards a more neutral rate stance boosted markets, resulting in a sentiment and momentum-driven rally in equity markets. In the absence of supportive economic data, the rally occurred on light volumes as key market participants remained on the side-lines. Throughout this period, as equity markets gained, global growth deteriorated, feeding our expectations for weaker corporate earnings and a subsequent sell off in markets. For this reason, our defensive positioning was maintained, as we opted to protect capital rather than invest in an unsustained and unsupported equity market rally.

Where We Are Now

While April was a relatively subdued month in markets as investors struggled to find direction amidst corporate earnings releases, volatility picked up this month as a result of an escalation of US-China trade tensions. As we examine the current economic backdrop and alter our thesis based on new developments, we are brought back to those four key risks back in December, and we consider where we are now:

1. ***The economic data suggested that the global economy was slowing, with a reduction in global trade which would reduce corporate earnings and pull equity markets lower on a global scale. This risk still remains.***

Economic conditions in the first quarter of the year were not quite as bad as first expected, however continued to display significant weakness, which was not supportive of a rally in equities. As it stands, there are significant risks in the Eurozone, which is at risk of recession as a result of weaker global demand and a decline in the key industrial sector. The US continues to show signs of slowing, with an escalation of trade tensions likely to speed up the deterioration of economic health. China is still losing momentum despite significant amounts of stimulus, as the stimulus fails to target the real problem areas in the domestic economy and external demand is reducing. When we look at the data, the global economy appears to be weakening and global growth is slowing, and this has not changed since December. Optimism and stimulus may have provided a brief boost in the near term in May, however when we look underneath the headline figures, weakness remains.

Despite not being as bad as first thought, corporate earnings are significantly weaker than in previous quarters. According to Factset data for Q1, the blended Q1 earnings decline for the S&P 500 is -0.5%. With 90% of the companies in the S&P 500 having reported so far, if -0.5% is the actual overall decline for the quarter, it will mark the first year-over-year decline in earnings for the index since Q2 2016. It should be noted that this does not take into account the recent escalation of trade tensions between the US and China, which indicates that further weakness could lie ahead for corporate earnings. With wages rising and sales growth coming under pressure from declining demand, corporate earnings are expected to feel the squeeze this quarter.

Originally, the expectation was that earnings would be poor in the first half of the year, before picking up moderately in the second half, however should the current trade concerns continue later into the year (which is likely given how far apart the two sides remain on key issues), this is unlikely to occur, which would lead to further prolonged weakness for corporates over the year. With this in mind, the outlook for equities is weaker, and further supports our expectation for a drop back in equity markets, which would need to realign to a lower growth environment. Even after recent market declines, it is our view that equities remain expensive relative to the outlook for corporates and global growth over 2019, suggesting that the equity markets have further to fall.

2. ***The risks of no Brexit were increasing, and the potential permanent strengthening in the pound which would follow a no Brexit or a soft-Brexit outcome would result in a structural and non-recoverable decline in asset values in globally allocated portfolios. This risk still remains.***

With the Brexit deadline now being delayed until 31st October, uncertainty and currency-related risks remain in this area. As the deadline has now been extended, we are now expecting a more gradual appreciation in sterling, with no-Brexit appearing more likely as cross-party talks have gone on. With little appetite for a no-deal Brexit and little progress being made on key issues, it appears more likely that the outcome will be a soft one, or no Brexit. With the risks remaining in this area, we minimise foreign currency exposure and carefully select UK asset exposure.

3. ***US-China trade tensions were looking increasingly risky and a deal seemed far off. This risk still remains.***

When we re-examined this risk towards the end of March following the cooling of trade tensions, we noted that markets appeared to have priced in all aspects of a positive deal, with room for disappointment should the talks drag on or should the agreement be altered. This was given the fact that China and US remained far apart on key issues, and we viewed it as being unlikely that Bejing would agree to all concessions detailed in the proposal.

In the first week of May, just as markets were expecting a deal, China reneged on its promises and made edits to the proposal which undermined months of talks, resulting in President Trump threatening to increase tariffs on $200 billion of Chinese goods from 10-25%. On Friday, after unsuccessful talks, the tariffs were hiked, and in response China pledged to retaliate with tariffs on $60 billion of US goods as of the 1st June. Talks are set to continue, however the two sides appear further apart than ever, and Trump and Xi have taken hard lines. It appears likely that these tensions will continue, and this will feed into global growth and corporate earnings expectations.

4. ***The US Federal Reserve appeared to be set on raising rates, ignoring the economic data suggesting weakness in the US economy. This risk has abated.***

Back in December, the expectation was that the Fed would continue to raise rates in 2019, with a number of hikes expected throughout the year. In Q1, as weaknesses in the US economy emerged, the Fed pivoted on this stance, instead opting for a neutral stance and thus 'pausing' its rate hiking plan. As trade tensions have re-emerged, there have been calls for the Fed to pivot again to rate cutting, however this seems to be far away given that inflation is picking up and the previous pivot only occurred in the last quarter. A rate cut would boost equity markets, however seems unlikely at this point.

Our Positioning

Based on an in-depth risk analysis, although a lot has happened since December, only one of the four key risks has abated. As a result, considering the prevailing economic data and excessive risks in equity markets, it is our view that the defensive position is warranted and should be maintained. The intensification of US-China trade tariffs could provide as a catalyst for the sell-off we have been expecting, giving investors reason to re-evaluate the risk-return trade off alongside current valuations and future expectations for equities. In the meantime, as we await further clarity and until the data begins to change, we remain confident in our current defensive positioning, and have further strengthened the core element of portfolios this week, reducing cash levels to stable assets with low correlation and consistent returns over the long term.