

OCM Asset Management

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Market Update: 12th June 2019

Markets defy data as uncertainty prevails

Investor concerns over protectionism and global growth began to ease this week, with markets gaining on the avoidance of a fresh tariff war between the US and Mexico. As the week went on however, with existing trade concerns still remaining, stocks began to slip on indications that the June revival in risk appetite may have overshot. Risk appetite now appears to be dissipating again, with key risks and near-term uncertainty weighing on equity markets. Political tensions flared in Hong Kong today as demonstrators shut off roads across the city, and stocks declined across Asia as President Trump reiterated that the US-China trade deal won't complete unless China agrees to the terms of the original proposed trade deal. President Trump's latest comments on the US-China trade spat have brought uncertainty back to the surface in financial markets, testing interest rate expectations and corporate earnings forecasts.

Will the Fed cut rates?

Pressure on the Fed to cut rates has been increasing in recent weeks as the trade tensions with China have been increasing, with President Trump openly criticising the Fed for not cutting rates. Currently, the prospect of rate cuts is somewhat counterbalancing trade concerns in equity markets, however it should be noted that current market expectations leave significant room for disappointment, with three cuts expected before January next year. The market is currently expecting the Fed to cut in July, therefore we should have more clarity on the timing of cuts after next week's FOMC meeting, as the Fed will typically set expectations a month in advance. Given the recent reduction in the threat of US-Mexican trade tariffs, although we agree that the US economy is weakening, it still seems too soon to cut in our view, with any interest rate cut being viewed as an insurance cut given political pressures and trade uncertainty. All eyes will be on the Fed next week to drive market movements.

Irrational Market Movements

To put into context the irrationality of market movements this week, equities were boosted last week as President Trump's trade tiff with Mexico increased the probability of an interest rate cut (essentially because the US economy is weakening and further trade tensions would exacerbate this weakness). This week, Trump backed off on his threats to Mexico, and stocks rallied again. Essentially, sentiment led the market higher regardless of data or economic conditions. Regardless of the irrational intra-day movements, the macro and micro economic data continues to deteriorate, with weak durable goods orders, lower capital spending, declining retail earnings and a soft jobs number indicating considerable weakness in the US economy. Additionally, weaker global demand and political uncertainty is weighing down UK and European markets, while Chinese growth continues to decelerate, evidenced by weaker export data and declining consumer spending.

Corporate Earnings Expectations

As it stands, there has been no assurance that China will meet the US at the G-20 summit meeting later this month to discuss trade, with trade tensions continuing to fuel uncertainty and reduce corporate earnings expectations for 2019. With only a few weeks remaining in the second quarter of the year, trade tensions and slower global economic growth are expected to negatively impact companies with high international revenue exposure.

According to Factset data, S&P 500 companies with higher global revenue exposure are expected to outperform those with lower global revenue exposure in terms of earnings growth and revenue growth in Q2. The analysis produced an average estimated earnings decline for Q2 of -2.3% for the S&P 500 index. Within this figure, those with lower global exposure (less than 50% of revenue) are expected to grow earnings at 1.4%, while those with higher global exposure (over 50% of revenue), are estimated to experience a 9.3% **decline** in earnings in Q2. When we break this down on a company level, considering that US equity markets are typically driven by big tech and large industrial players which have higher global exposure, and given that equities are already trading at high valuations relative to earnings (the S&P 500 is currently trading at a price of 21x earnings versus an average of 15x earnings), this could dispel trouble for equity markets during the coming earnings season.

Overall

Given current market conditions, it is clear that risks within the global economy are now skewed heavily towards the downside, with irrational market movements reiterating our view that a defensive positioning remains the most sensible way to navigate this uncertain market. There is room for disappointment in market expectations for Fed cuts, with any temporary relief of a July cut potentially being overshadowed by economic decline and corporate earnings weakness as the Q2 earnings season begins. It is looking increasingly likely that the second half recovery which many companies expected earlier in the year will not materialise unless there is a significant increase in GDP growth. Given the continuing risks and uncertainty in the global economy, we fail to see a significant growth rebound in the coming months, and therefore reiterate our expectations for further equity market weakness in the near term.

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