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Market Update: 17th July 2019

Sentiment driven markets against a poor global economic backdrop – The story so far

The first half of 2019 has been counterintuitive to say the least, as global bond markets have gained 5% year to date due to rising global economic weakness and investor sentiment has driven equity markets reaching record highs in June following weakness in May. Valuations are now extremely stretched based on underlying fundamental company values. Although global stock markets have been relatively optimistic in the first half of the year, macroeconomic and political conditions continue to present challenges to equity markets going into the second half of the year, amid growing concerns of an earnings recession, as 77% of companies released negative forward guidance on Q2 corporate earnings. As poor economic data starts to feed through into financial markets, weaker equity performance is on the horizon. Brexit uncertainty, monetary policy stimulus across the globe and trade tensions have been core themes throughout the waning economic backdrop in the first half of the year and will continue to feed into the remainder of 2019 as the global growth slowdown remains.

Central Banks

Although the December sell-off in equity markets brought optimism with equities rallying in the beginning of 2019 and the credit market rallying in Q2, the concerns surrounding the escalation in the trade war between the US and China, and the prominent slowdown in global growth has led to central banks taking a more dovish stance on monetary policy. Much of the rally in the first half of the year has been sentiment driven as the Fed reacted to market weakness and sluggish global growth with a dovish turn on monetary policy stimulus, as a result markets have priced in a potential rate cut of 25bps at the July meeting, with the expectation of a further rate cut in the second half of 2019. Growing concerns regarding weakening global growth has weighed in on the Fed's economic outlook and confirms our thesis a market drop back is on the horizon in the near term.

The dovish stance by the Fed has led to investors becoming more cautious as bond markets have been supported by investors flight to safety into safe haven assets amid weakening economic data. Following the extremely dovish signal over rate hikes in 2019, the yield on the US 10-year treasury note dipped below the yield on the 3-month paper towards the end of Q1. A yield curve inversion is a reliable recession indicator, which occurred twice during the first half of the year, reiterating our view a market correction is increasingly likely in the near term.

The European Central Bank (ECB) also followed suit supporting quantitative easing and a more dovish monetary policy. The ECB kept deposit rates steady at -0.4% and confirmed it would not raise rates at least until the end of 2019. As global headwinds fed into the European economy, weakness in external demand impacted the domestic economy amid declining new orders and lower business sentiment. Although Banks initially drew support for the TLTRO's stimulus programme to support lending, ongoing low interest rates may continue to erode net interest margins, therefore the benefits of the stimulus will be short-lived.

Downside pressures have continued to weigh in on consumer sentiment as geopolitical tensions exacerbated in the first half of 2019, tempering expectations a further dovish shift towards stimulus from the ECB will occur in the near term. It is clear economic uncertainty and global headwinds will continue to drive for monetary stimulus, with a more dovish approach to monetary policy from the ECB reiterating the severity of economic weakness and the increasing risks for a market downturn in the near term.

Sino-American Trade War

Escalating trade tensions between the US and China have negatively impacted global trade and economic growth in the first half of 2019, as the IMF placed downward revisions on the global growth outlook for 2019 and 2020 forecasted at 3.3% and 3.6% respectively. The time lag in agreeing a suitable trade agreement, caused a drag in global growth, as many economies suffered from poor business sentiment in Q1 and Q2. Against a backdrop of poor economic data and political uncertainty, the Trump administration's willingness to actively use trade barriers as a tool of broader foreign policy remains a key risk, despite the agreement to a second temporary truce between the US and China as negotiations resume.

As political tensions heightened in Q2, US increased tariffs on $200 billion of Chinese goods imports from 10% to 25%, resulting in retaliation from China, raising their tariffs on $60 billion of US goods imports from an existing 5-10% range to a maximum of 25%, which caused a sharp pullback in equities of circa 5% in May. Although both countries agreed to ceasefire on further trade tariffs and resumed talks at the G20 meeting in June, President Donald Trump and Chinese President Xi Jinping are far from agreeing a trade deal. Existing tariffs have pressured profits and corporate earnings and will continue to drag on the global economy until a resolution is met. The ongoing trade negotiations will continue to weigh in on investor sentiment with major US companies fearing the effects of tariffs on their profits, further substantiating our view that a market correction is likely to happen in the near term.

Brexit-related Uncertainty

Brexit uncertainty has been a driver in the performance of equity markets over the first half of 2019, although UK equities have gained through international equity exposure, as a relatively weak sterling allowed UK stocks exploit overseas profits, low consumer confidence and poor PMI data has been a result of Brexit uncertainty increasing downside risks of the near term UK economic outlook. As previous attempts to pass a deal through the house of commons failed, an extension to the Brexit deadline until October 31st 2019 fuelled hopes that a disorderly Brexit may be avoided, however as former Prime Minister Theresa May resigned on the 7th of June 2019, this has now opened the possibility of a no-deal Brexit under a new Prime Minster, worsening the economic outlook for the remainder of the year

The Bank of England (BoE) have been less dovish than the Fed and ECB, following the MPC meeting in June, as interest rate remained unchanged at 0.75%, until the Brexit outcome is known. As retail sales for June came in at the weakest level since the financial crisis, the absence of monetary policy stimulus from the BoE leaves the UK economy vulnerable to further downside shocks and weakness in the sterling. It is our expectation that the UK economy will continue to weaken while further clarity is provided on the Brexit strategy, and with the possibility of a no-deal Brexit increasing, there is plenty of room for disappointment in our view.

Q3 Outlook

Within the third quarter, our focus remains on Q2 corporate earnings, monetary policy stimulus and weakening economic data, as this will start to feed through into financial markets and investor sentiment, providing a catalyst for a drop back in equity markets. All eyes will be on Q3 for markets to start to see the wider negative impacts of weakness in the global economy. Global crosscurrents and low inflation are apparent as the global economic slowdown continues, which will become more prominent in this quarter.

Weaker Q2 corporate earnings threatens the extended economic expansion, as investors will be watching company releases closely to ascertain expected performance for the rest of the year. With estimated earnings decline of -3.0%, it is our view that an earnings recession is increasingly likely to occur, causing a drag on market sentiment. As earnings season approaches, the volume of downward forecast revisions observed in recent weeks provides an insight into corporate profitability, with signs of the recovery first expected in the second half of the year diminished. It remains our view that given the weakness in the economic data (which continues to feed through into economic indicators) and the continued weakness in the outlook for 2019, equity valuations are inflated and will decline in the near term.

Monetary policy stimulus will also be a key focus, as further dovish manoeuvres expected from the Fed which reiterates our view of a persisting weakening US economy. Better than expected jobs data in the US was displayed with an increase of 224,000 jobs added to the US economy in June, beating market expectations of 160,000. US retail sales also improved by 0.4% from a month earlier in June, as a result abating expectations for an aggressive cut or any potential rate cut in the near term, however should Q2 earnings come through as negative as expected, this could give the Fed reason enough to cut as soon as July. We will continue to monitor US data in the run up to the July meeting, which will further indicate the direction of financial markets and more so view of central banks, shaping equity performance for the coming months.

Portfolio Positioning

Overall, risks remain tilted towards the downside, and with risk off sentiment spreading across bond markets, equity investors will be forced to consider dampening economic data and trade concerns in the coming weeks. As the first half of the year was heavily sentiment driven against a backdrop of political uncertainty and economic weakness, it is our view weak economic data will take centre stage in the second half of 2019 and investors will price in the worsening economic backdrop. Optimism in equity markets will be short-lived as softness in the global economy continues and lower than expected corporate earnings data begins to feed into the US economy. With no signs of a near term recovery and with the end of the cycle approaching, it remains our view that given the weakness in economic data, weak corporate earnings expectations and stretched valuations, monetary stimulus will have little impact on economic growth in the near term.

Given the economic data and current market conditions, we remain defensively positioned for a decline in equity markets and will act accordingly when economic conditions change. We continually monitor the economic data and analyse trends in markets, and at the moment, the data is only confirming our thesis and reinforcing the need for defensive positioning and caution in financial markets.

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