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Illumination: Equity strategy and market outlook

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Global perspectives: Holding pattern

Analyst

Alastair George
+44 (0)20 3077 5700
institutional@edisongroup.com

- **Investors are taking a glass half-empty view of the recent dovish moves in US and eurozone monetary policy, which has necessarily been accompanied by meaningful downgrades to 2019 GDP forecasts.** Equity investors should prefer downbeat central banks running overly loose monetary policy, rather than hawkish institutions in denial about a slowdown in growth. However, easier financial conditions only act on the real economy with a lag. It is still too early to expect meaningful improvements in the incoming data.
- **Globally, risk assets have rebounded strongly since December and largely anticipated the moves from central banks.** This has therefore been a buy-the-rumour, sell-the-news environment where despite encouraging noises from US Fed Chair Powell and ECB President Draghi, markets have shrugged.
- **An inversion or flattening of the yield curve does not necessarily suggest an increased probability of a US recession.** While there is a correlation between the slope of the yield curve and US recessions in prior cycles, this time it is genuinely different as there is no growth/inflation trade-off constraining US monetary policy. Investors' quite realistic expectations of a continued front-line role for monetary policy in warding off any future downturn may be a confounding factor in interpreting any flattening of the yield curve.
- **Global earnings forecasts have declined over the past month, but only modestly.** It appears that the peak in downgrade activity was reached in January and recent downward revisions in 2019 GDP growth may already have been accounted for in corporate guidance. We also note that the recent Ifo Institute survey in Germany was ahead of market expectations, highlighting the mixed picture for incoming data.
- **The Brexit process remains difficult to predict.** We continue to believe that the UK will either leave the EU on the terms contained in the withdrawal agreement or there will be a substantive delay to any Brexit. While PM May has recently gained the support of a limited number of prominent Eurosceptics, it may be too late in the day to salvage her deal and in our view the risk of a long delay to Brexit has increased.
- **At this point we continue to believe equity markets are in a holding pattern, following the strong gains since December.** This holding pattern is likely to persist until investors gain more evidence for a stabilisation in economic growth, and we expect such evidence no earlier than mid-year. In the meantime, the corporate sector is likely to be encouraged by the relative stability in credit markets and lower financing costs now on offer, thus incentivising merger and acquisition activity.

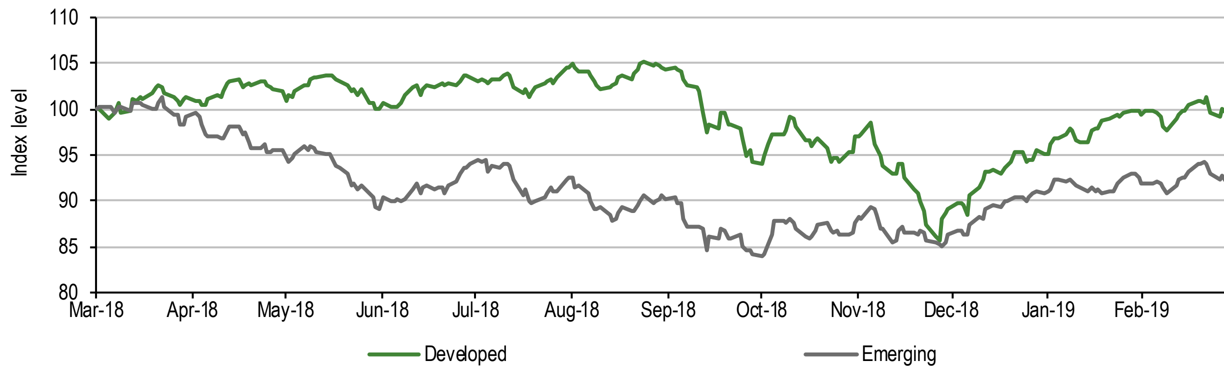
Holding pattern

Central banks deliver on prior market expectations

Global equity markets have remained near their year-to-date highs, but the rapid pace of progress evident earlier in the year has now given way to a glass half-empty view of the recent dovish moves by the US Federal Reserve and ECB. Easier monetary policy was in any case fully anticipated by investors. Such an active degree of monetary policymaking also validates our earlier views that the Fed and ECB would respond to the deteriorating growth outlook.

However, central banks have offered relatively little that is new for markets. In addition, the relatively large cuts to growth forecasts by central banks appears to have spooked markets in recent weeks. We believe investors will ultimately 'look through' downbeat forecasts, which were a prerequisite to looser monetary policy. However, for markets to move higher we believe investors will require evidence of the positive impact of easier financial conditions on the real economy. Given the lags involved, we believe this evidence is unlikely to appear in the data at least until mid-2019.

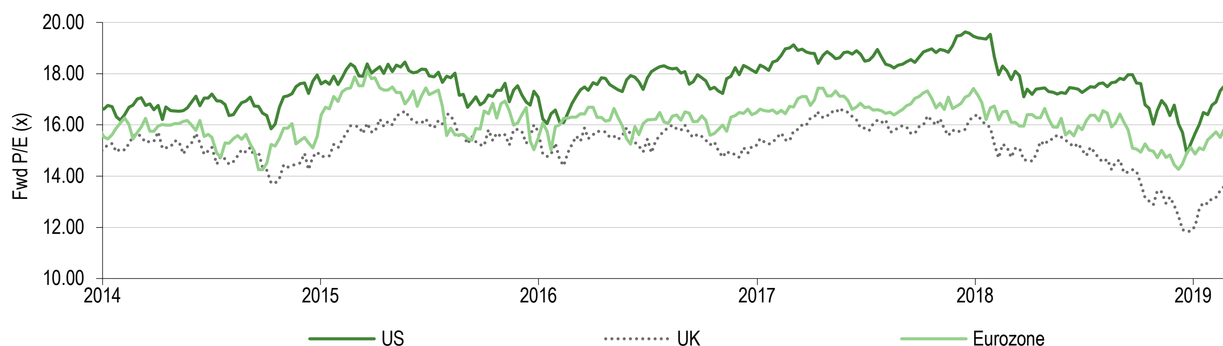
Exhibit 1: Global equity rally stalls during March 2019



Source: Refinitiv, Index in USD

Forward P/E valuation multiples in developed markets had approached the lows for this cycle at the end of 2018 Exhibit 2, but have now rebounded sharply in Q119 as markets recovered on the expectation of the monetary policy response. Similarly, credit market spreads have also contracted notably during Q119, including in the leveraged loan market, despite being highlighted as a potential risk factor by policymakers. Given higher valuations, the risk/reward balance for equities has therefore shifted towards wait-and-see. We maintain a neutral position on global equities and continue to expect markets to make at best limited gains pending evidence of an improvement in the growth outlook.

Exhibit 2: One-year forward P/E multiples have rebounded during Q119

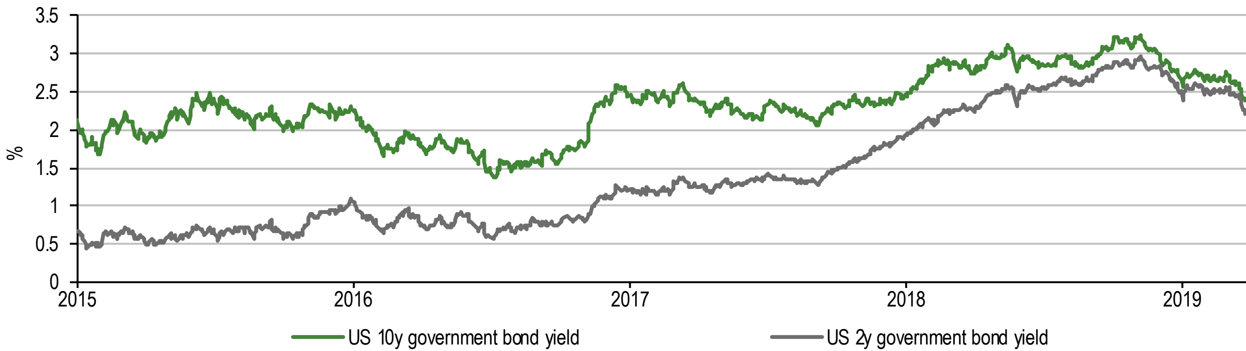


Source: Refinitiv, Edison calculations, unweighted average

Declining government bond yields spook equity investors

Recent declines in US government bond yields and the resulting flattening of the US yield curve, Exhibit 3, have led to a flood of articles discussing the likelihood of a US recession over the next 12-18 months. This is understandable, first given the relatively strong correlation between yield curve inversions and US recessions in the past and second, the extraordinary length of the current US economic expansion. However, we believe recent correlation-focused commentary misses a key point in terms of causation. There are in our view good reasons to believe that the signal from the yield curve at present is a false positive.

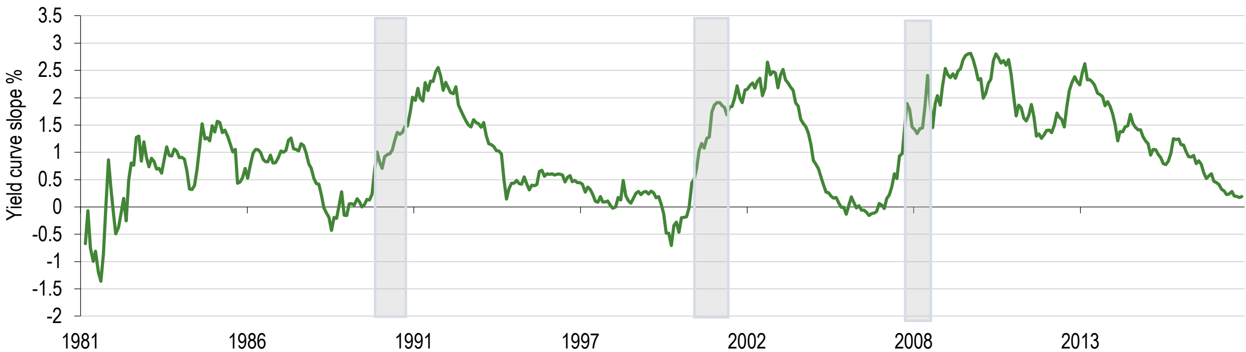
Exhibit 3: US yield curve has flattened even as two-year rates peaked in October 2018



Source: Refinitiv.

A yield curve inversion is where short-term interest rates are higher than longer-term rates. This situation can occur for a number of real-world reasons, even if it may appear illogical in simplified economic models which “assume away” the economic cycle. In prior US economic cycles, the yield curve inverted as the US Fed increased short-term interest rates with the intention of slowing the economy in order to ease inflationary pressure, Exhibit 4.

Exhibit 4: US yield curve slope and US recessionary periods



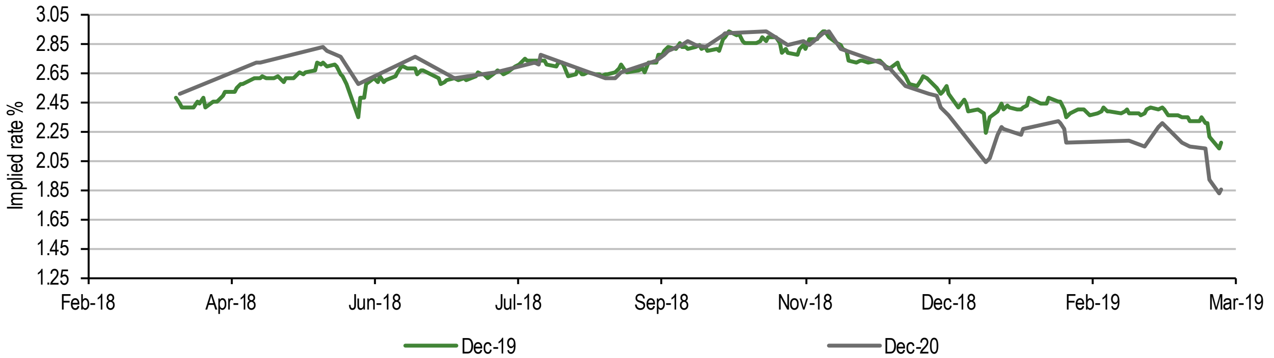
Source: Refinitiv, US National Bureau of Economic Research

It should not be a surprise therefore, assuming monetary policy has any effectiveness, that following a period of tighter monetary policy the data show the US economy slowed. This is the growth/inflation trade-off which was the monetary policy constraint of previous expansions and is in our view largely responsible for the observed correlation between yield curve slope and future economic activity. However, this historical growth/inflation trade-off is qualitatively different from the challenges facing monetary policymakers today.

In fact, central banks on both sides of the Atlantic have eased policy considerably during Q119, both in terms of actual steps taken and forward guidance, in order to promote growth and to avoid a shortfall in inflation. The flatness of the yield curve is, in our view, therefore more a result of perceptions of downside risks to inflation, the expectation of the continued primacy of monetary

policy in countering any further weakness in growth and the impact of the effective lower bound in interest rates. While a US recession can never be ruled out, we believe only a slowing of growth in 2019 should be the base case for equity investors. As a signal for a US recession, the flatness of the yield curve is currently being over-emphasised, in our view.

Exhibit 5: US Fed pushes market interest rate expectations to new lows in March 2019



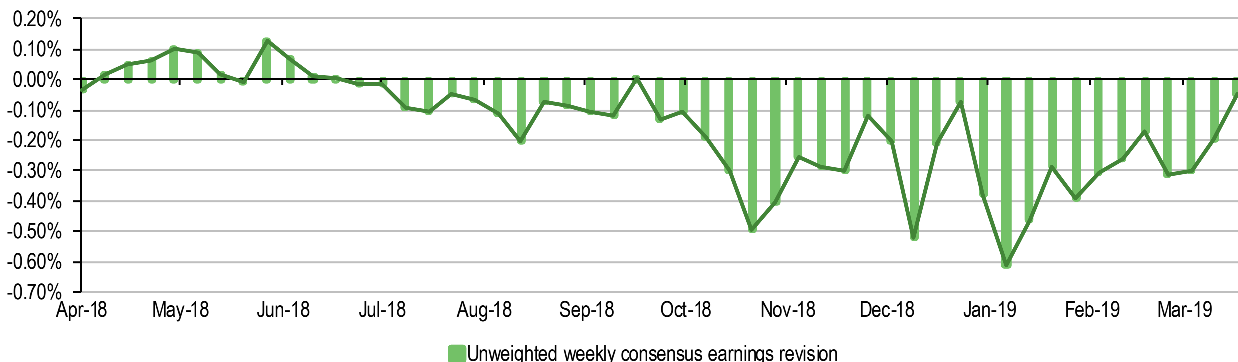
Source: Refinitiv

Recent cuts to central banks' GDP growth forecasts have necessarily been dramatic – but this is a necessary step in facilitating the easing in policy. Given the choice, equity investors should prefer downbeat central banks running overly loose monetary policy, rather than hawkish institutions in denial about a slowdown in growth.

Furthermore, rather than interpreting the muted equity market reaction to the recent changes in monetary policy as a sign that investors are spooked by these downbeat GDP forecasts, we believe that during Q1 investors had already re-appraised the outlook for monetary policy in 2019 and beyond. Interest rate expectations have been falling even as equity markets rose significantly from the December trough. In fact, central banks have largely just confirmed markets' prior expectations – a case perhaps of buy the rumour, sell the news.

Furthermore, in terms of global earnings revisions, downgrades have moderated significantly since Q418, suggesting the corporate sector as a whole has accounted for the slower growth expected during 2019, Exhibit 6. Finally, we also note that commodity and industrial metals prices are relatively stable at present and are not flagging any near-term shortfall in demand.

Exhibit 6: Pace of downgrades to 2019 consensus profits forecasts has diminished



Source: Refinitiv, Edison calculations, global average including emerging markets

We have also highlighted the prospect of a moderating of the strong gains shown in global equity markets this year due to the lags between easier monetary policy and the ultimate improvement in the economic data. Last week, poor purchasing manager's survey readings in Germany and the US combined with the Fed's GDP forecast cuts to create something of a buying panic in 10-year government bonds. Yet for Germany at least, the Ifo Institute index released this week came in

above expectations. We expect this trend of mixed incoming data to continue until at least the end of Q219.

We would certainly concur with investors' and central banks' conclusions that earlier developed market GDP growth forecasts for 2019 were somewhat optimistic, based on a fading US fiscal stimulus and the lagged effects of tighter US monetary policy, combined with global trade uncertainties which affected exporters such as Germany.

The outlook is not however binary and a period of slower growth does not necessarily presage a recession. We would not over-emphasise the slope of the yield curve as a predictor of recession at present, as the flattening is a result of policymakers easing policy to support growth, rather than tightening policy to cool the economy.

Brexit: Still limited probability of no-deal but delay risk now material

Political developments in the UK have been challenging to follow in recent weeks. The biggest surprise perhaps has been the resilience of the UK PM May, who until the very last moment clung onto power despite a massive erosion of her political authority, following the loss of a number of key Parliamentary votes. However, aside from the political noise the key point remains that an accidental no-deal outcome, which investors would have good reason to fear, remains very unlikely.

The most market-friendly outcome is perhaps ratification of Prime Minister May's Withdrawal Agreement, which would provide a smooth path to exiting the EU and provide immediate certainty to markets. This also represents perhaps the "hardest" Brexit possible under the current composition of Parliament. A failure to agree on this deal would involve a much longer delay to Brexit, in effect resetting the clock and opening up scenarios such as a second referendum or general election.

We can see some signs that Eurosceptic Conservative MPs are softening their opposition to PM May's deal following her indications that she will resign if it is passed in Parliament but it is now rather late in the day to marshal support from the DUP and other rebels. At the time of writing, the DUP has now announced that it will not support the deal which makes a delay to Brexit much more likely. While reports indicate that the UK government is planning a third meaningful vote this week despite the Speaker's procedural objections, it far from clear that a Parliamentary majority can be obtained to ratify the deal.

The indicative votes held in Parliament this week merely highlighted that the chamber is split on every possible way forward with no Parliamentary majority in favour of any single option. In the event of a delay to Brexit, we would expect the Brexit risk premium for UK equities and sterling to remain in place until there is a clearer political path forward. Separately from the immediate issue of Brexit, in this scenario a general election would also risk raising fears amongst investors of a left-leaning Labour government.

Conclusion

The waning of momentum in global equity markets during the past month, even as central banks signal significantly easier monetary policy ahead, is a demonstration of an efficient market discounting mechanism. The good news on monetary policy was already in the price. Growth fears are now the primary economic driver of market returns in the short term and we believe likely the incoming data will be at best mixed until the end of Q219.

The flattening of the US yield curve, which has been a reliable but far from perfect predictor of US recessions in the past, should not be over-emphasised at this stage, in our view. In prior cycles, the inversion has been driven by undesirably high inflation which is not the case at present. In time, we believe the recent policy easing on both sides of the Atlantic will become evident in the economic data.

In terms of political developments, the timing of a US/China trade deal appears to have been pushed back while the UK's Brexit process now appears to be heading for a long delay. For Brexit, we still believe the risk of a no-deal Brexit is low and all of the other Brexit possibilities are relatively favourable to markets, except perhaps a general election which results in a left-leaning Labour government. Until the uncertainty is resolved, we expect a Brexit risk premium to remain in place for UK assets.

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Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1,185 Avenue of the Americas
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 12, Office 1205, 95 Pitt Street,
Sydney NSW 2000
Australia

Frankfurt +49 (0)69 78 8076960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1,185 Avenue of the Americas,
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 12, Office 1205, 95 Pitt St,
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