AND THE BEAT GOES ON… FOR NOW

- The macro deceleration that characterised 2018 and early 2019 has subsided – for now. The global economy is expanding at around its potential rate, supporting the case for equities and credit.
- Central banks are starting to follow through on their recent dovish rhetoric, adding additional support to growth-oriented assets while driving up bond valuations further.
- Geopolitical uncertainty, in particular the US-China trade war, is a good reason to remain vigilant and protect against periods of elevated market stress.

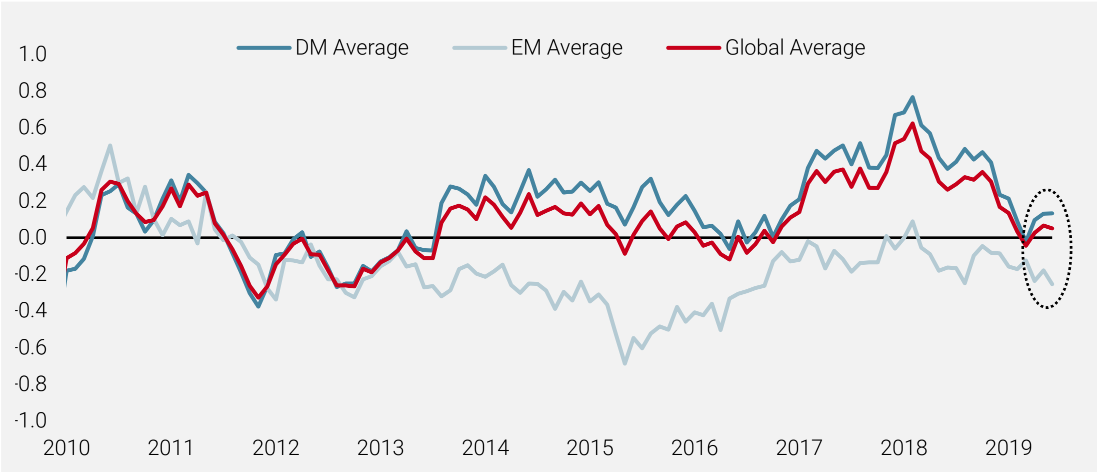
OVERVIEW

Risk is multidimensional and managing it effectively demands diversification of perspectives and metrics, as well as return sources. We believe there are three key drivers of risk for multi-asset investment portfolios: macroeconomic conditions, market sentiment, and asset valuation. Viewing global financial markets through this framework, we observe that some of the most concerning risks around macroeconomic slowdown have abated. Conditions have stabilised over the last few months and central banks have made it clear that they are ready to step in with their full suite of tools if needed. Nonetheless, geopolitical uncertainty, especially around US-China trade relations, are reminders that investors should remain alert and not be lulled into complacency in light of the recent market rally. Indeed, from a cross-asset valuation perspective, there are few obvious opportunities and traditional hedges like sovereign bonds are very expensive. Nonetheless, with few signs of imminent recession, muted inflation pressures, and accommodative monetary policy, the global expansion looks likely to continue, to the benefit of risky assets.

MACRO CONDITIONS ARE SHOWING SIGNS OF STABILISATION

One of our major themes of the last 12 to 18 months has been the slowdown in global economic growth. This perspective was based mainly on our proprietary set of economic indicators that assess in real-time the current risk of recession across more than 80% of the world's GDP. These "Growth Nowcasters" aggregate and analyse more than 600 economic data series across 21 economies in both the developed and emerging world. Chart 1 shows the evolution of the Growth Nowcasters at a global level, as well as broken down by developed and emerging markets (DM and EM, respectively). After peaking in early 2018, global growth saw a sustained downward trend, hitting the zero level in March of this year. This indicated that the global economy had decelerated significantly and was growing around its potential. A continuation of this trend would have been quite concerning, as it would suggest the economy was tipping toward recession. However, since that low point in March, the global economy has shown signs of stabilisation around this potential level, not further deterioration, as highlighted by the circle region. While it is still too early to say the economy has bounced back and will likely re-accelerate into 2019, we can say that the likelihood of a global recession is much less probable than it seemed just a few months back.

Chart 1: Growth Nowcasters Across Regions

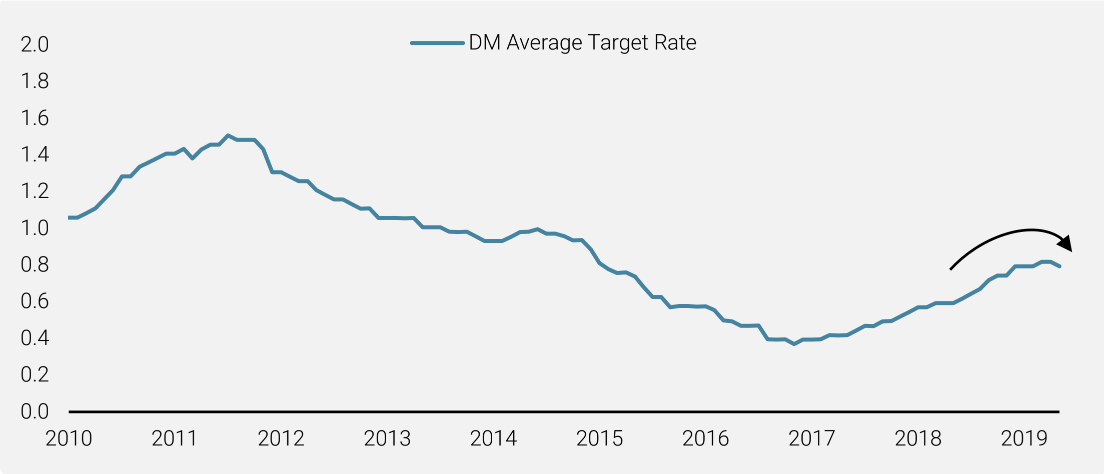


Source: Bloomberg, Unigestion (as of 28 June 2019).

Importantly, this chart highlights the divergent growth dynamic between DM and EM economies: while DM economies broadly saw a strong resurgence of growth starting in early 2017 that has now fallen back to potential, growth in the EM world has been stagnant at just under potential over the same period.

The developed world has central banks, led by the Federal Reserve (Fed) in the US, to thank for stemming the economic deceleration. After spending 2017 and 2018 tightening monetary policy, central banks pivoted in early 2019 to a more accommodative stance. As Chart 2 demonstrates, this shift in tone is now becoming evident in policy actions, with a levelling off and even a slight reduction in the average target rate across developed central banks. In mid-June, President of the European Central Bank (ECB) Mario Draghi made it clear that further interest rate cuts were available to policymakers if needed. This time last year, the ECB was talking about a possible rate hike toward the end of 2019. And following Draghi's comments, the Fed made clear at their June meeting that the US tightening cycle is over and they are ready to cut interest rates to support the economy.

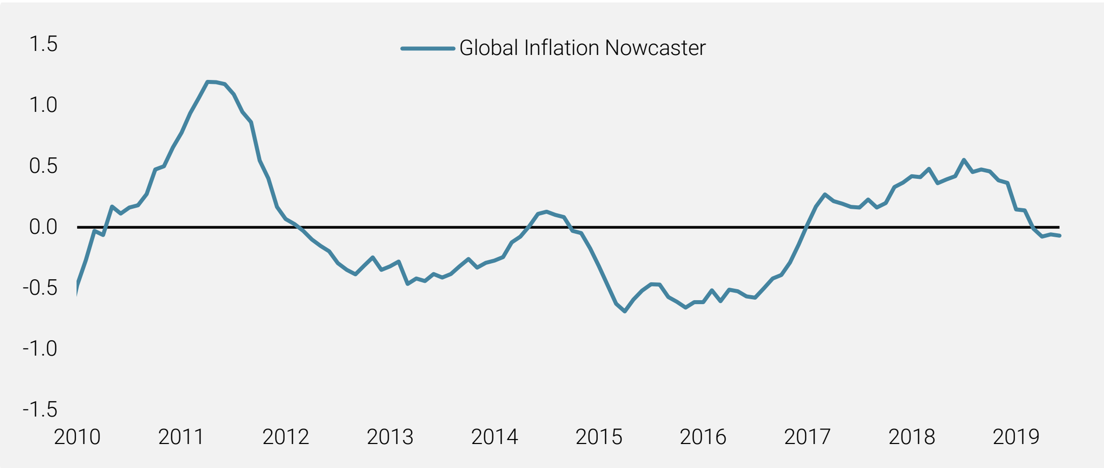
Chart 2: Developed Central Bank Target Rates Reflect a More Accommodative Policy Stance



Source: Bloomberg, Unigestion (as of 28 June 2019).

Of course, a key reason that central banks can afford to make this shift is that inflation pressures have retreated significantly along with the growth deceleration. Chart 3 shows our global Inflation Nowcaster, which assesses the risk of inflation surprising to the upside or downside. In line with the stabilisation in the Growth Nowcaster, over the last couple of months our Inflation Nowcaster has stabilised around zero. This level indicates that inflationary and deflationary pressures are broadly offsetting each other, allowing central bankers to focus less on keeping prices stable and more on supporting the economic expansion.

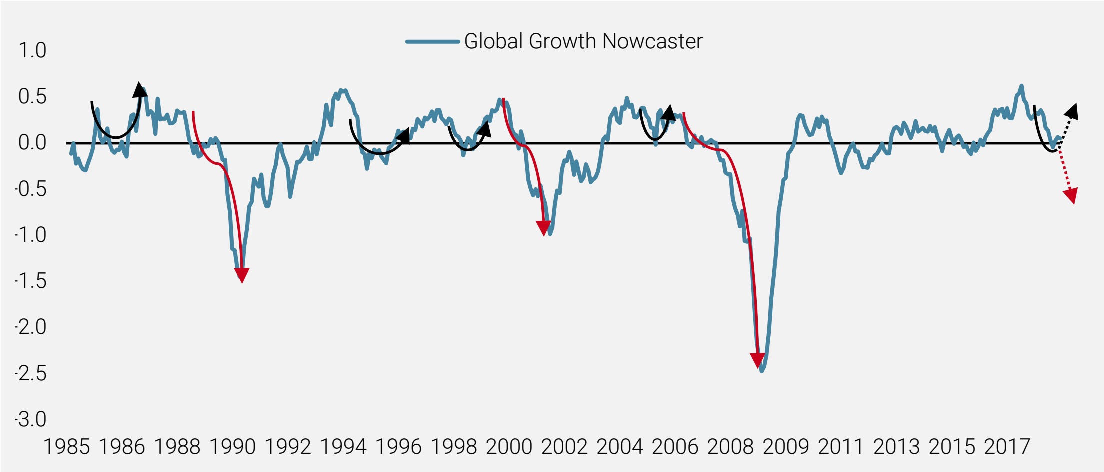
Chart 3: Developed Central Bank Target Rates Reflect a More Accommodative Policy Stance



Source: Bloomberg, Unigestion (as of 28 June 2019).

To be clear, the economy rarely stays at these potential levels for long. Looking over the last 35 years, we can see that in four cases ('97, '95, '99, '05) the economy re-accelerated after decelerating to potential, while in three cases ('90, '00, '07), it fell into recession (see Chart 4). Monitoring the evolution of the economy from here in real-time will be critical in assessing which trajectory we are likely to be on in the months and years ahead. However, this economic stabilisation and a synchronised turn toward accommodative monetary policy should provide macro support to risky assets in the near-term.

Chart 4: Historically, Growth at Potential is Not a Steady State for the Economy

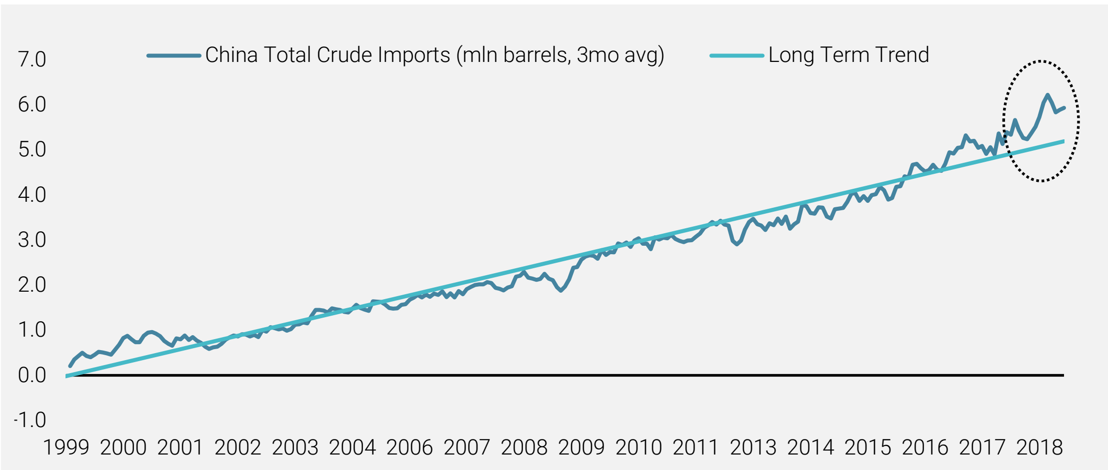


Source: Bloomberg, Unigestion (as of 28 June 2019).

GEOPOLITICAL TENSIONS CONTINUE TO WEIGH ON SENTIMENT

While the macro context is no longer a drag, fragile market sentiment is concerning and points us toward ensuring downside protection on our growth-oriented asset positions. The fragility is largely due to ongoing trade tensions between the US and its major trading partners, especially China. On the back of indications that a US-China trade deal was imminent, equity markets rallied strongly during the year with the S&P 500 hitting a new high of 2945 at the end of April. Alas, it seems that the more deeply entrenched differences were not fully addressed during the negotiations and these resurfaced to derail the agreement. These issues are at the core of the dispute: the role of state-owned enterprises (SOEs) in China's economy, enforcement mechanisms to ensure compliance, and insistence by both sides on a fair deal (in their eyes) and respect. Until these thorny issues are addressed, tensions will persist and continue to roil markets. Interestingly, despite clear signs of slowing demand and restrictions on US crude oil imports, China has been accelerating its total oil imports, suggesting they may be stockpiling reserves and preparing themselves for a protracted conflict (see Chart 5). Chinese President Xi Jinping's call for his country to prepare for a new "long march" further suggests that Chinese leaders do not see a resolution in the near term. The US is also sending a clear signal that they have other tools at their disposal in addition to tariffs, such as sanctions and export controls, and are willing to use trade to achieve other policy objectives (e.g., immigration).

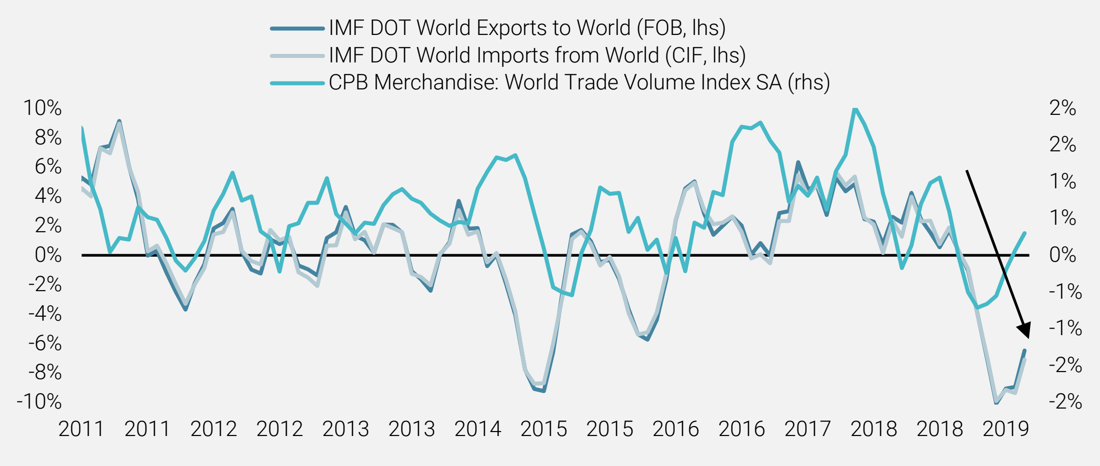
Chart 5: China Has Accelerated Crude Imports



Source: Bloomberg, Unigestion (as of 28 June 2019).

In the meantime, the impacts of the trade war are now evident in data. Until recently, soft data such as surveys and spending projections had shown the drag of trade tensions on sentiment. But over the last few months, hard data on world trade has sharply declined. Chart 6 shows the average three-month change for a few different measures of trade (import and export data from the IMF as well as trade volume data from the CBP), demonstrating the contraction in global trade over the last few months. This risk to external conditions is at the forefront many central bankers' minds, justifying to a degree their policy stance. On a positive note, the CPB data is showing early signs of trade expansion again.

Chart 6: Global Trade Has Contracted since the Third Quarter of 2018

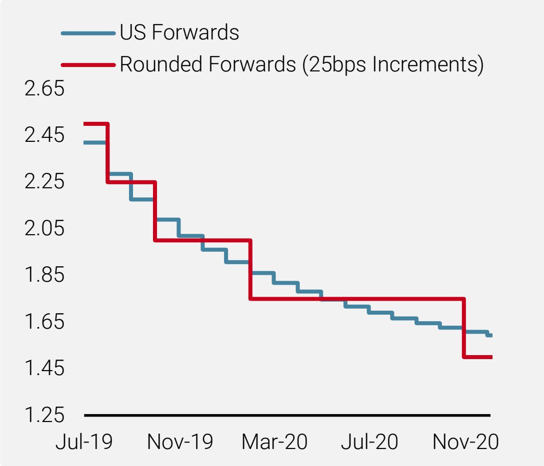


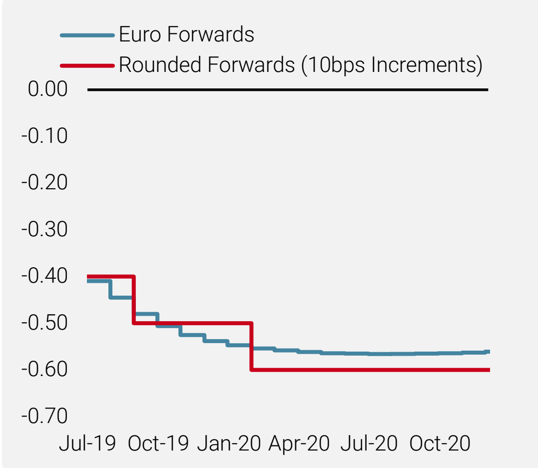
Source: Bloomberg, Unigestion (as of 28 June 2019).

While investors have been closely watching for any signals on US-China trade negotiations, other geopolitical risks have festered. In the UK, Boris Johnson has taken a commanding lead to replace Theresa May as Prime Minister. Johnson has made it clear that he aims to take the UK out of the European Union by October 31st, even if that means a 'no-deal' Brexit. While he may backtrack on that pledge and push back the deadline, the risk of a no-deal Brexit has risen significantly. In the Middle East, tensions between Iran and the US are boiling up as Iran threatens to breach the limit on the low-enriched uranium (used for nuclear power plants) it can stockpile under the 2015 deal. In response to this threat, as well as the attacks on oil tankers for which the US blames Iran, more US troops have been deployed to the region. While our core scenario for risky assets is supportive, sources of uncertainty such as these point us toward some cautiousness as we endeavour to provide smooth, consistent returns for our clients.

In additional to geopolitics, two key dimensions of risk to assess market sentiment are pricing and investor positioning. Regarding pricing, money markets have priced in significant cuts in target interest rates, as Chart 7 shows for the Fed and the ECB. In the US, three cuts are expected by early 2020 and four by the end of the year. In the Eurozone, markets are expecting a more cautious ECB to cut rates this fall and again in late 2019 or early 2020. With the Eurozone hovering just above recessionary levels and uncertainty on tariffs and trade restrictions hanging over the region, one to two cuts seems reasonable to us. On the other hand, the pricing of 75bps in cuts in just over six months in the US looks stretched. At this point, the macro data is simply not supportive of such an aggressive policy shift. Rather, the uncertainty generated by the trade war is pushing the Fed's hands to help smooth the economic impacts of this uncertainty. Thus, it seems to us that cuts from the Fed would be insurance cuts, which could be reversed if the uncertainty passes (the 1995 mid-cycle easing is the prototypical example). Until we see a significant deterioration in the US macro picture, it seems unlikely to us the Fed would pre-emptively cut rates to head off a potential recession. Indeed, if the Fed were to follow through with market expectations, we would be quite concerned about what sort of state the US economy would be in at that point.

Chart 7: Market Pricing Aggressive Easing Cycle, Especially in the US

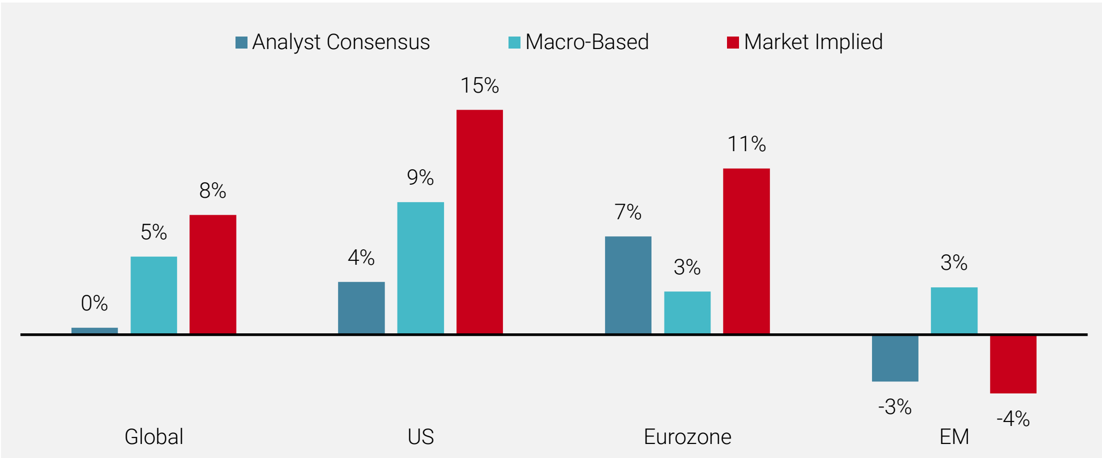




Source: Bloomberg, Unigestion (as of 28 June 2019).

Equity markets, which have been buoyed by the central bank pivot, are pricing in significant earnings growth for the developed world, as shown in Chart 8. These expectations are at odds with the analyst consensus and our macro-based estimate, both of which see broadly muted earnings growth (mid-single digits). Interestingly, there is closer agreement between analysts, our estimates, and market pricing for EM equities, which are expected to see stable to slightly negative earnings growth over the next year. This suggests that if there were a resurgence of growth in the emerging world, driven possibly by further easing measures in China, a more accommodative Fed, or a trade deal, EM equities would strongly benefit as markets readjust their expectations to earnings expansion.

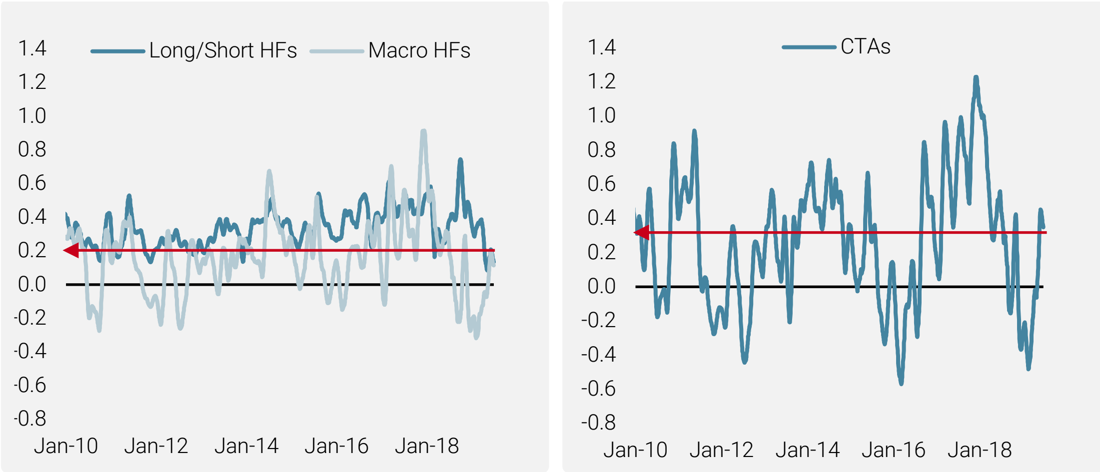
Chart 8: Divergent Pricing in Developed Equity Markets but Agreement on EM



Source: Bloomberg, Unigestion (as of 28 June 2019).

A supportive sentiment factor is investor positioning, which remains relatively light despite a strong market rally. Chart 9 examines the implied beta to equities for a few key investor types as a proxy for their positioning. From this, we can see that Equity Long/Short Hedge Funds (HF) are at the lower end of their exposure to equities since 2010, while Macro HFs are relatively neutral. Commodity Trading Advisors (CTAs), which generally employ systematic trend-following strategies, have been active in increasing their equity exposure since the beginning of the year as markets rallied, but they remain far from overly-exposed at this point and seem to have room for additional buying if markets rise further.

Chart 9: Implied Equity Betas Suggest Positioning is Light

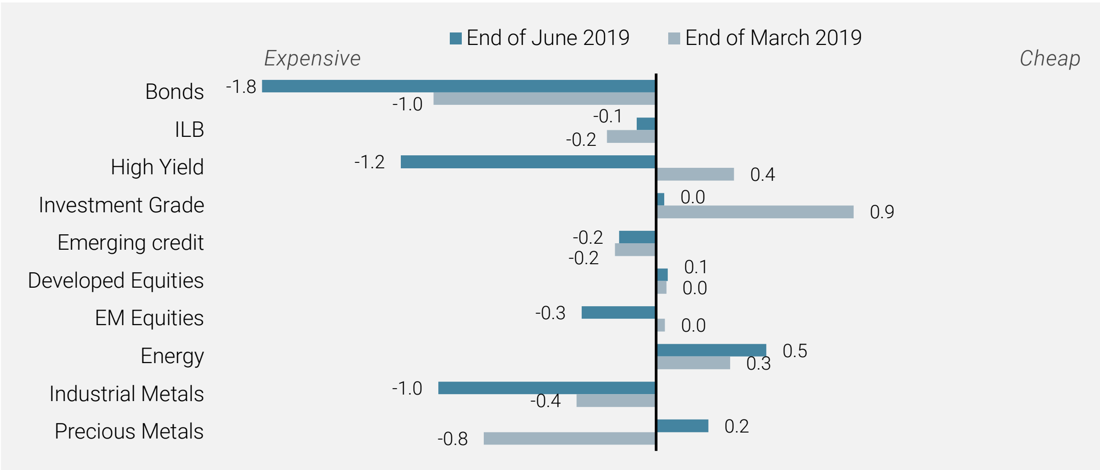


Source: Bloomberg, Unigestion (as of 28 June 2019).

VALUATIONS PRESENT FEW OBVIOUS OPPORTUNITIES

Finally, investment portfolios are exposed to valuation risk: "expensive" assets should underperform "cheap" assets, all else being equal. Our preferred measure to assess valuation across assets is carry, i.e., the return an asset holder receives if prices evolve in line with market expectations. By examining carry across assets, both with respect to each other and to their own histories, we can see that valuations right now are quite mixed, as shown in Chart 10. Bonds have continued to get even more expensive as yield curves flatten, while high yield credit and industrial metals are also looking rich. Most other growth-oriented assets, such as global equities, investment grade and EM credit, and energy commodities have fairly neutral valuations by this metric.

Chart 10: Unigestion CAS's Cross-Asset Valuation Indicator



Source: Bloomberg, Unigestion (as of 28 June 2019)

Looking closer at global equities via standard valuation measures, we see that, at the aggregate level, neither DM nor EM equities are particularly over-valued (Chart 11). Though some metrics are high, such as forward-looking Enterprise Value (EV) to Earnings Before Interest/Taxes/Depreciation/Amortisation (EBITDA), on average the metrics show these markets to be hovering a tad above their long-term levels. The case of the S&P 500 is more concerning, as nearly all valuation metrics are significantly elevated. Whether you consider the underlying assets, earnings, dividends, or cash flows you get for the price you pay for US stocks, you are getting much less today than you would have historically. On the other end of the spectrum, stocks in Japan's TOPIX index are cheap by any measure we monitor, reflecting uncertainty around the planned consumption tax, trade tensions with the US, pressure on firms' top-line due to the global economic slowdown, and tight labour markets squeezing margins.

Chart 11: Unigestion CAS's Cross-Asset Valuation Indicator

	DM Equities	S&P 500	Euro Stoxx	TOPIX	EM Equities
EV/Sales (LTM)	74	85	74	5	76
EV/EBITDA (LTM)	81	93	91	2	82
EV/EBITDA (NTM)	96	88	97	8	97
Price/Book (Index)	55	84	54	17	55
Price/Book (NTM)	83	97	73	31	54
NTM P/E	66	73	80	15	73
CAPE	63	79	61	20	54
P/Dividend (LTM)	27	57	47	5	18
P/Dividend (NTM)	56	67	63	10	27
Price/FCF (NTM)	58	96	54	32	19
Average	66	82	69	15	55

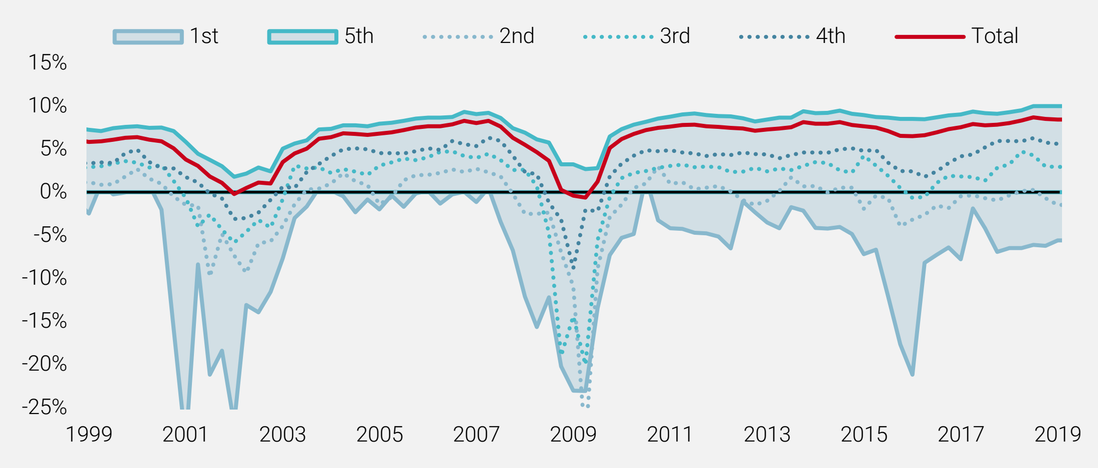
Reading note: NTM denotes next twelve months, while LTM denotes last twelve months. CAPE is the cyclically adjusted P/E ratio. Source: Bloomberg, Unigestion (as of 28 June 2019)

One justification for the high valuations of US firms is their strong profitability, especially after margins recovered in 2010 and then re-accelerated in 2016 to new highs. If we dig underneath the surface however, we see that there is strong dispersion between small, mid, and large-cap stocks. Chart 12 depicts the range of profit margins for firms in the Russell 3000 aggregated by market cap quintile (1st quintile are the smallest firms, 5th quintile are the largest firms), along with the total aggregate profit margin. Historically, it is not surprising to see the aggregate total close to the largest firms. However, what is interesting is how the spread, i.e., the range of margins between the smallest and largest firms, has grown since 2010 (shaded region of the chart). Typically, this band has remained narrow (around 10%) outside of recessions, when the spread widens significantly as small firms come under pressure and see their margins turn negative while large firms are able to ride out the storm. However, in the post-financial crisis recovery, the spread has widened. Indeed, 60% of firms currently have margins of 5% or below. Looking at balance sheets raises additional causes for concern:

- Net debt is around 5x EBITDA for the 80% of small and medium-sized firms versus around 1x for the largest 20% of firms;
- Interest coverage ratios at the aggregate level look quite healthy at around 8, but for the bottom 80% of firms, the ratio is around 3.6 while top 20% have a ratio around 10.

While we do not see this divergent corporate picture as an imminent risk since growth remains strong and monetary policy is easing, we are worried that when the cycle turns, this hidden dispersion will surface and reinforce the sell-off.

Chart 12: The Spread of Profit Margins across US Firms Has Expanded Since 2010



Source: Bloomberg, Unigestion (as of 28 June 2019)

WE ARE CONSTRUCTIVE BUT ATTENTIVE TO LATENT RISKS

For most of this year, we have maintained a cautious stance for a few key reasons: the pace and breadth of the macro deceleration, our doubts around the likelihood of a US-China trade deal, and the closing of the valuation gap that helped drive up markets at the beginning of the year. Taking a look where we are today, we believe the case for risky assets, or broad beta, is strong: the global economy is expanding in aggregate at around potential with little risk of an inflation overshoot and central banks ready to step in if (or even before) needed. Akin to the 'goldilocks' period of 2017 (though importantly at lower growth levels), the context should benefit equities, credit, and sovereign nominal bonds. Nonetheless, the skies are not completely clear and geopolitical uncertainty remains a primary source of risk. Market pricing and valuations are also not compelling, especially in bonds, the hedging asset of choice for most investors. Thus we continue to protect against an equity sell-off via options and make use of alternative return sources like low volatility equities and defensive FX strategies.

CONTACT US

| unigestion.com

General Information	info@unigestion.com
Clients	clients@unigestion.com
Press	pressrelations@unigestion.com

IMPORTANT INFORMATION

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