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WEALTH MANAGEMENT

Market Insight

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Navigating between economic Fear and financial Greed

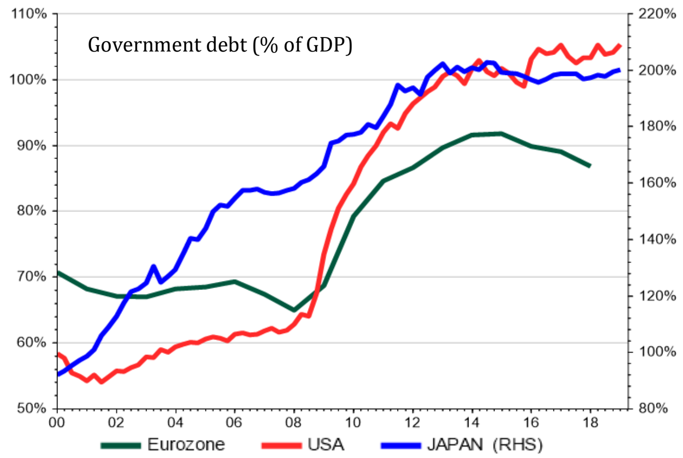
Financial markets have been back with a vengeance during the first quarter of the year, and yet, we have rarely seen so many doomsayers among the forecasters of the global economy. True, certain European countries are in - or close to - recession, but there is still a lot of economic momentum out there, especially in the US and Emerging markets. In our view, recession fears in the US are overblown, and that should provide some support to the rest of the world. With major central banks like the Fed or the ECB turning dovish, the major risk our there is that financial markets enter the "Greed zone". We are not there yet, but the strong pace of the rally year to date warrants some caution going forward.

US recession fears are overblown

Financial markets have been back with a vengeance during the first quarter of the year, and yet, we have rarely seen so many doomsayers among the forecasters of the global economy. Essentially, there are 3 types of Cassandra.

First, there are those who look at the world and see only imbalances. Everywhere. Take the government debt in the US for instance. An investment strategist we recently met in London told us: " The US public debt was 50% of Gross Domestic Product before the Great Recession of 2008. Today, it has doubled ... do you really think that a debt which exceeds the GDP is sustainable?". Things are not that simple and that the 100% bar is not fateful in itself. Take Italy for instance: the country has been living for decades with a much higher debt than its GDP. And in Japan, government debt has been exceeding 200% of GDP since 2011, as you can see form chart 1 ! The level of debt is only one parameter for judging its viability.

1. Government debt : High does not mean unsustainable



Source: Thomson Reuters Datastream

The fundamental condition for ensuring the latter is given by interest rates: as long as they remain below GDP growth in a sustainable manner, debt can be sustainable.

By expressing the debt service as a percentage of GDP, we have a simple, yet straightforward measure of debt sustainability: it is endangered when the ratio rises excessively, either because the interest burden increases or while debt takes the elevator, or, finally, because economic activity tumbles. In this respect, our indicators are crystal clear: we are far from the alert levels recorded just before the 2008 crisis, triggered by a household debt overhang. From the 100% of GDP recorded just before the crisis, it has dropped to 70% today. And the interest burden is today much lower than it was at the time, thanks to massively expansionary monetary policy by the Fed. So if you are to predict a recession in the US on the basis of the debt imbalances, the probability you can assign to it hardly exceeds 20%.

The second category of "recessionists" are the "quants": those who only swear by quantitative models, and often leave others with the need to understand what they are quantifying. From your database of economic and financial variables, you draw long-term averages and standard deviation of the observations from the mean. Statistically, you can then infer that if the last observation of any variable is 2 standard deviations above its mean, the probability of returning to the latter is 95%. At 3 standard deviations, the probability increases to 99%. You can imagine the damage that these quantitative models can do today if the variable in question is the US stock market index. But this analysis is only right if the series are stationary over time - that is, fluctuate around a stable average - and ... this condition is rarely verified. The fact is that the quantitative models used to measure financial risk did not see the 2008 crisis coming: we were 5 standard deviations from the mean!

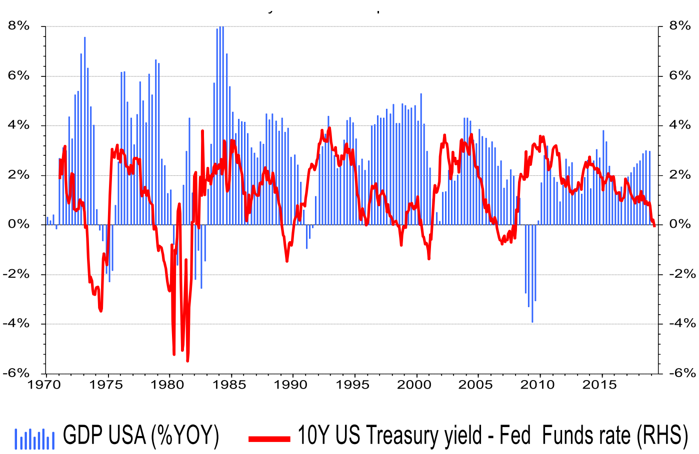
Anyhow, let us see what we get when using these types of models today. When comparing the current levels of the US stock market to either its historical mean, time trend, or previous peaks the conclusion is steadfastly clear: do not wait for May to sell and go away. And yet, if you compare the stock market levels to the earnings of the underlying companies, both historical and expected, the valuation measure brings a clear point home: we are not in expensive territory! So, if you are to use this kind of model to predict the next recession in the United States, you will have little more likelihood than with the "imbalance" version.

Last but not least, the third category of recession songwriters are the fans of the yield curve. The flattening, see the inversion of the yield curve has played a pivotal role in predicting recessions of the US economy. It is true that in the past, the phenomenon of inversion of the interest rate curve has always been followed by a recession. Not surprisingly, an inversion of the yield curve is evidence of a restrictive monetary policy that results in short-term interest rates rising above long-term interest rates.

As you can see from chart 2, an inversion of the yield curve (which occurs when the red line - measuring the difference between 10 Year Treasury yields and short term rates - becomes negative) was always followed by a recession (the blue bars of real GDP turning negative). But this was true until the 2008 crisis, but no longer since the central banks embarked in their "quantitative easing" (QE) policies! In this case, an inversion of the yield curve shows an expansive policy of the Central Bank, not the other way around. Why? When a central Bank injects liquidity through a QE program, it does so by purchasing bonds, which result in lower long-term yields. These may then fall below short-term interest rates, triggering an inversion of the yield curve, but ... it would be utterly wrong to draw the conclusion that the recession is near. A study of the Fed shows that bond yields are 150 points below where they would be had the US central Bank not carried out its QE program. Thus, the "true" 10 year Treasury yield today is closer to 4% ! At that level, we certainly do not experience an inversion of the yield curve !

So... US bond yields today are artificially low, because of past lax monetary policy. It would be wrong to infer from the close to currently inverted yield curve that a recession is looming in the US.

2. Inversion of the yield curve : this time is different ?



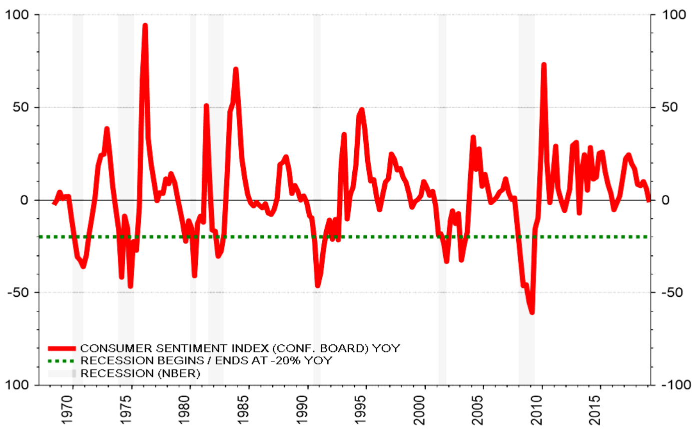
Source: Thomson Reuters Datastream / Macroguide

Rather than looking at these various indicators to predict the next recession of the US economy, we have developed a number of proprietary leading indicators of economic activity based on hard data closely connected to the business cycles.

One of these indicators is shown in chart 3. The indicator uses Consumer confidence as main component to predict the future path of the US Economy, knowing that close to 70% of it relies on US households spending. As you can see from the chart, a drop below the -20 line has been the recession trigger of all recessions in the US since 1970. Of equal, if not greater importance to financial markets, the crossing over this "recession threshold" from more depressed levels has always marked the end of all recessions, depicted by the grey vertical bars in the chart.

So the key takeaway here is: at the current reading of 0 of our indicator, the recession risk for the US economy is low.

3. No recession risk in the US



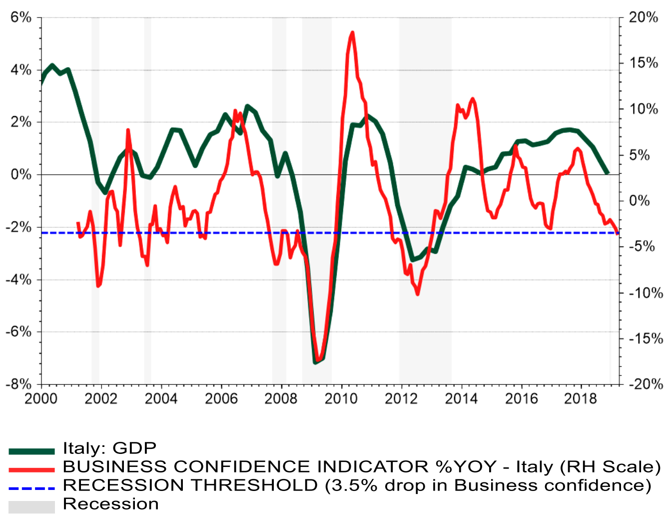
Source: Thomson Reuters Datastream / Macroguide

Less rosy economic picture outside the US

Using the same kind of indicators described above, we come to a less optimistic conclusion regarding economic activity in both Europe and Japan.

Indeed, some European countries such as Italy could already be in recession. If you stick to the definition of a recession by the National Bureau of Economic Research as being 2 consecutive falls in quarterly GDP, then Italy is in recession today, as shown by the grey vertical bars in chart 4. We actually believe this definition to be misleading for it measures the falls on a quarter-to-quarter basis and these may just signal a slowdown of economic activity rather than a full-fledged recession. We prefer to use year-on-year growth. On that basis, Italy is just on the brink of recession, but not there yet. Still, our leading indicator based on business confidence does signal a recession to come.

4. Italy in recession ?



Source: Thomson Reuters Datastream

Our leading indicators also warrant caution for some other major European countries like Germany, France and... the UK.

Outside Europe, Japan is approaching the recession cliffs as well. In China and the other BRIC countries, growth will be slower this year, but it will remain stronger than in developed economies.

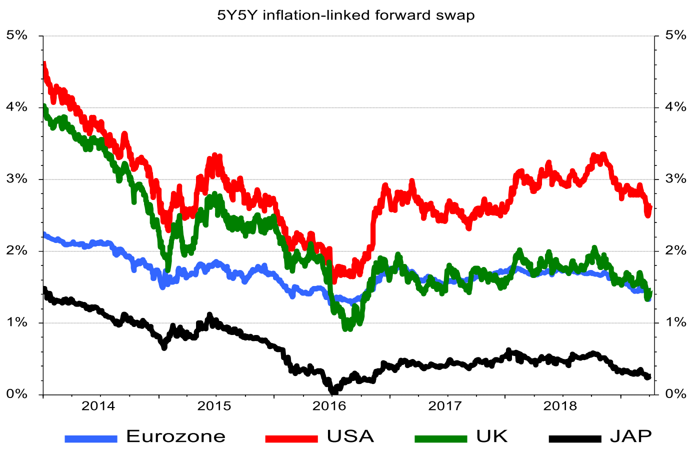
Two doves make a summer ?

We saw a major turnaround at the Fed and the ECB last month: the hawks have turned into doves and have relegated the rate increases planned for this year to a more distant future. What's more, the US central bank announced that it will begin to slow down the decline in the size of its balance sheet as early as May, and stop it in September. In question, the slower than expected slowdown in economic activity. A few days later, the European Central Bank was going to make similar decisions.

On reflection, the central banks play a relatively easy part: at the first signs of weakness in the economy, they just have to open a little more liquidity tap, and, presto, the economy recovers. The only central bank that is hindered in this action is the Swiss National Bank. Already below their floor, it would be difficult to reduce interest rates further in Switzerland to respond to the slowdown in growth that looms. And a rate hike is certainly not on the agenda as long as overheating is not a threat and, above all, the franc maintains its current overvaluation vis-à-vis the euro.

It would certainly be less easy for hawks to turn into doves if they were faced with stagflation, this dramatic combination of recession and inflation, or even hyperinflation, like the one in Venezuela. In developed countries, inflation is far from a threat, allowing central banks to adjust the monetary regime to business cycles as they see fit. This is shown in Chart 5, which evidences that there are indeed no signs of inflation expectations.

5. Lack of inflation opens the door to fresh monetary stimulus



Source: Thomson Reuters Datastream / Macroguide

For financial markets, this new monetary move is good news, especially in the United States, where the danger of recession is low. With the danger of a rising rate of interest moving away, we will relive a new episode of the series "Tina" ("There Is No Alternative"), this real fairy tale worthy of "Goldilocks" (where economic growth is" not too hot, not too cold, just right ") where you buy stocks only because bonds are outrageously expensive. This is a logical but dangerous strategy. We are not there yet, but the rapid pace of financial markets turnaround year to date does warrant some caution ahead.

Michel Girardin, *Senior Economic Advisor*

Money-market and fixed-income

There are more and more signs of economic slowdown. While growth remains strong in the US, driven by robust domestic demand, the economy is worsening in most other parts of the world. Within the euro zone, the main economies – Germany, Italy and France – are close to slipping into recession, as is the United Kingdom, which is bogged down in a Brexit process with an uncertain outcome. In Asia, Japan is nearing the danger zone, while China seems to be stabilizing, thanks to fiscal stimulus. Central banks are trying to counter this shaky environment by retreating back into dovish monetary policies, with the Fed doing an about-face in indefinitely postponing its rate hikes and in halting its balance sheet run-off process. This unequivocal message triggered a simultaneous collapse in yields in March from about 2.71% to 2.40% in the case of the 10-year US Sovereign paper and from 0.19% to -0.07% for the 10-year German Bund. The yield curve is gradually inverting in the US, while German yields slipped into negative territory for the first time since 2016. Throughout the first quarter, we got a boost from narrower spreads in both investment grade (20% of our balanced portfolio) and high yield (11% of our balanced portfolio), which resulted in a significant increase in returns in our bond allocation. Convertibles (10%) also made a positive contribution to returns. However, we did not try to lengthen the portfolio's duration, and it stayed at about 3.2 years.

Equities

Dovish monetary policies are driving equities up even against a backdrop of economic slowdown. Another contributing factor is the lull in political tensions pointing to a possible trade agreement between the US and China. US and European markets gained 13% and 12%, respectively in the first quarter, thus retracing, respectively, 80% and 100% of their fourth quarter 2018 losses. Risk appetite is indeed back, and market momentum does not appear to be ready to stop in April. In our balanced portfolio, we continue to overweight Europe (17%) and Japan (4%) and to underweight the US (15%). The Asia-Pacific region, ex-Japan and emerging markets make up 7% of the allocation, split mainly between China, Korea, Brazil, Australia and India. The main sector weightings are techs, financial services, consumer cyclicals, healthcare, and manufacturing. Our strategic equity exposure remains neutral at 45%. However, markets have moved up so much and so fast so far this year, that we are raising our tactical hedges, thus lowering our net equity exposure to 37% in our balanced portfolio.

Currencies

There were few changes in movements in the US dollar, which has been strong on the year so far. We are holding onto a long 13% USD position and 2% yuan exposure in our balanced portfolio.

Alternative

The alternative allocation made a neutral contribution in the first quarter of 2019. Global macro (20%), multi-strategy (13.5%) and event-driven (6%) strategies managed gains, while equity-market neutral (45%) declined slightly.

Outlook

The downturn in economic fundamentals that we have been witnessing so far this year has come with a steep re-rating in financial assets. While inflation fears have given way to recession fears, bond spreads and equity valuation multiples are once again at their historical averages. Investors are hoping for a temporary slowdown, followed by a subsequent recovery. The challenge for the financial markets is now to judge to what degree monetary and fiscal policies, which are now playing off each other to good effect, will manage to stem the economic slowdown that has begun, or even reverse it and push back the end of the cycle. Some signs of stabilization are showing up, particularly in global manufacturing and service indicators. We remain cautious on equities for the moment, even if that entails capturing only a portion of the gains, while continuing to actively manage our bond allocation and our decorrelated alternative allocation.

Armand du Pontavice, *CIO*

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