FIS GROUP

MARKET OUTLOOK Q2 2019

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Late Cycle Rally on Borrowed Time

Although global growth declined in Q1, as anticipated in our Q1 2019 Outlook, risk assets continued their December 2018 romp as a result of an apparent de-escalation of U.S.-Sino trade tensions and a decidedly dovish pivot by G10 Central banks (See Table One). Some US indices recorded the biggest quarterly gains since the global financial crisis, while others approached record highs. Emerging markets pulled even with developed markets; but most of the former's return was driven by a powerful relief rally in Chinese equities, sparked by the late 2018 suspension of escalating tariffs on Chinese imports. Indeed EM ex China underperformed developed markets by 3.5% on a U.S. dollar basis and 4.25% on a local currency basis. China's A-share market is dominated by momentum focused retail investors. This initial rally, further fueled by accommodative policy in both China and the U.S., basically fed on itself and climbed by a whopping 30.9% during the quarter.

We believe that global risk assets will perform well this year; but that we are in the midst of a late cycle topping process. We also continue to believe that performance leadership will shift from the U.S. to the RoW during the second half of the year. That said, global equity markets are increasingly living on borrowed time which will ultimately expire as profit margins become impaired by mounting wage increases, the FOMC resumes interest rate hikes in early 2020 to battle resurgent inflation pressures and China returns to its policy focus on structural reform and deleveraging sometime in 2020.

In our last Outlook, Après moi, le déluge - A Late Cycle Rally as Part of a Protracted Market Topping Process, we stated that the Q4 rout in global equity prices was overdone and created a window for global equities to experience a tactical rebound. We anticipated a late cycle market topping process with the following economic dynamics:

> *In 2019, global leading indicators herald a soft spot for the first half of 2019....Early in the year, inflation is likely to be subdued because of the lingering effects of a strong dollar and low oil prices. That said, we expect a build-up of capacity pressures as well as money velocity (the number of times each unit of money is turned over) as market participants reduce money balances and hold higher-yielding assets; leading inflation to surprise to the upside as the year progresses. Further rises in interest rates combined with a slowdown in global trade and Chinese growth remains a headwind for non-U.S. economies and earnings. However, these slowing growth trends in the rest of the world (RoW) which began in 2018 and are likely to bottom out in the second half of 2019, while U.S. growth is set to roll over. Emerging Markets will become more attractive when the U.S. dollar, which has traded sideways recently, softens, and Chinese reflation stems the decline in credit and industrial production.*

The most significant event not anticipated in the aforementioned report has been the dovish pivot by the Fed, which now

TABLE 1 | Annualized Return

Description		1Q 2019		2018 Calendar Year	
		USD	Local	USD	Local
MSCI AC World Index - Net Return	ACWI	12.18	12.28	-9.42	-7.69
MSCI AC World Index ex USA - Net Return	ACWI ex US	10.31	10.53	-14.20	-10.65
MSCI EAFE - Net Return	EAFE	9.98	10.59	-13.79	-10.99
S&P 500 - Total Return	U.S.	13.65		-4.38	
MSCI Canada - Net Return	Canada	15.37	12.85	-17.20	-9.74
MSCI Europe - Net Return	Euro Area	7.59	5.89	-14.86	-10.59
MSCI United Kingdom - Net Return	U.K.	11.89	9.36	-14.15	-8.82
MSCI Japan - Net Return	Japan	6.66	7.61	-12.88	-15.15
MSCI China - Net Return	China	17.69	17.86	-18.88	-18.71
MSCI China A - Net Return	China A	30.94	28.08	-30.32	-26.48
MSCI EMF (Emerging Markets) - Net Return	Emerging Markets	9.92	9.83	-14.57	-10.07
MSCI EMF Asia - Net Return	Emerging Asia	11.11	11.30	-15.45	-13.12
MSCI EMF Latin America - Net Return	EM Latin America	7.85	7.48	-6.57	3.78
MSCI EM ex China - Net Return	EM ex China	6.50	6.34	-12.42	-5.67
S&P GSCI Brent Crude Total Return	Brent Oil	30.68		-15.30	
	Trade-Weighted Dollar	-0.30		7.91	

Source: FIS Group Professional Estimates & FactSet

forecasts no rate increases in 2019 and only one hike in 2020. Thus far this year, both the ECB and the BOJ followed suit, pushing long term rates down globally, with 10-year bonds falling below 0% again in Germany and Japan. China also ramped up their monetary stimulus, with total social financing in January and February up 12% over the same months last year.

We expect that global growth will bottom in the second half of 2019 and that the current benign policy environment will support risk assets this year. The most significant risks to its continuance are:

1. **Fed resumption of interest rate hikes.** The FOMC's dovish pivot is consistent with weak data on both the inflation and growth front. Early this year, high profile data prints such as CPI inflation and GDP growth were subdued by the combined impact of the FOMC's interest rate increases in 2018 and the U.S. Government shutdown earlier this year. Moreover, the subdued inflation readings were likely due to the lagged effects of a stronger dollar (which lowers the prices of imports) as well as sharply lower oil prices last year; both of which will soon fade. The price of oil has rebounded 30% from its recent lows and we expect the dollar will soon come under modest pressure. Q2 and Q3 data on the other hand will be flattered by the first quarter's low base effects. Add to this the latent pressures from tight employment markets and rising wages, and there is a good chance that the market will once again be pricing hikes again (with the possibility that the Fed follows up with an actual hike).

   For most of the post GFC period, interest rate markets have been skeptical of the FOMC's forecasts. Consistent with this trend, the OIS curve is pricing in a 75% probability of a cut this year and rates at 1.9% at the end of 2020. Moreover, the market's repricing (from an expectation of almost four 25bps hikes in 2019 to more than one 25bps cut in two months) was significant in both its magnitude and speed (see CHART 1).

CHART 1 | Fed Hikes/Cuts Priced in Over Next 12 Months
BPs

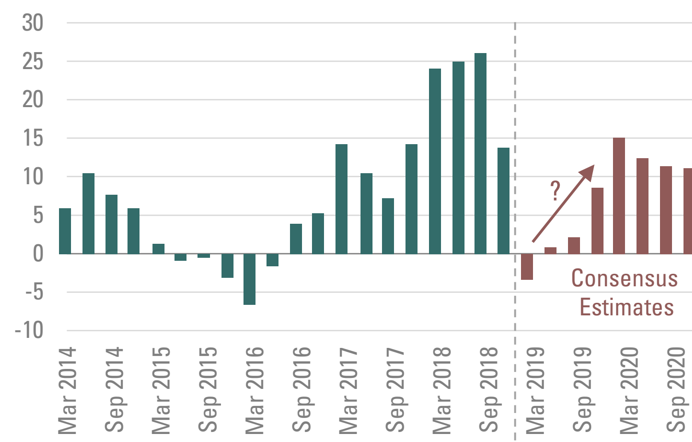
Source: Variant Perception

Our key take-away from March's FOMC meeting, is that the Fed is focusing on re-anchoring inflation expectations, which should push nominal yields higher. We believe that the market's expectation of 42 and 56 bps of rate cuts over the next 12 and 24 months respectively reflects an unwarranted level of pessimism. It would take a significant further weakening of economic data to make the Fed's stance turn even more dovish than it has already forecasted and for nominal yields to fall even further. The key risk therefore is that the market this time has become too sanguine about the discount rate underlying risk asset prices.

2. **Earnings.** The risk arising from earnings is two-fold. Over the short term, current valuations would be threatened if the anticipated recovery in negative earnings growth in Q2 underwhelms expectations. Over the next year or so, elevated EBITD margins will ultimately be threatened by rising wages.

   Thus far this year, the rally in global markets has looked beyond earnings downgrades. For example, year over year consensus estimates for S&P 500 companies point to negative earnings growth for the first quarter; but a quick recovery thereafter (see CHART 2).

CHART 2 | S&P 500 Earnings Growth
%YoY, EPS



Source: Morgan Stanley Equity Research

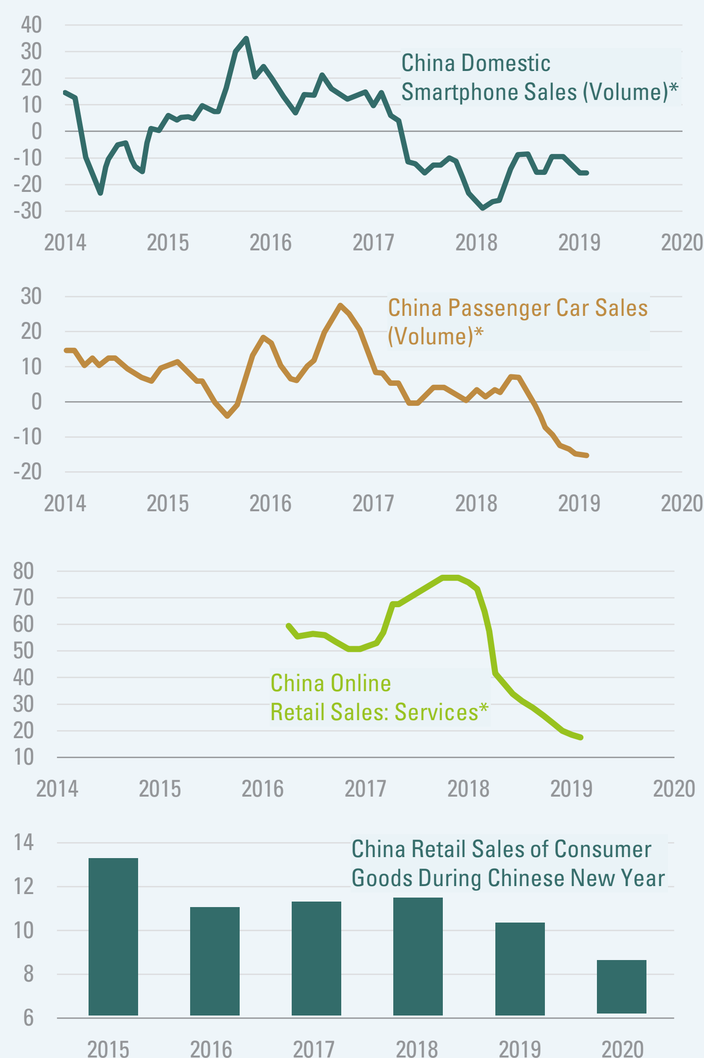
At 31.7%, EBITD margins for U.S. equities are elevated. In fact, if profit margins were to normalize to their historical average, the Shiller P/E would climb to 40.3 from 29.9 today (levels last seen in at the dot com bubble peak). Over time, the combination of an economy at full employment and the Fed goosing economic growth points to rising wages. Since the pass-through from wages to prices is below 100%, unless productivity rises more than labor costs, profitability will suffer and current P/E ratios will become unsustainable.

3. **China.** In the short term, the risk to global equities is that China's reflation efforts underwhelm expectations and that U.S-Sino tensions escalate. Our base case for 2019 is that China will minimally morph from a headwind into becoming a neutral to mildly positive tailwind for global growth. As we discussed in the Q1 report, we expect the policy uncertainty from the U.S.-Sino trade imbroglio to diminish because both sides need an apparent "win", even if it does not substantively address their underlying strategic fissures. At a minimum, the U.S. will halt the escalation of tariffs on Chinese imports in exchange for Chinese commitments to purchase U.S. industrial products and manage its currency relative to the U.S. dollar, as well as measures that open up the Chinese market to U.S. companies (such as removing the requirement for Chinese partners as well as forced technology transfers). We do not, however, expect the potential tensions underlying the "strategic rivalry" between the world's first and second largest economies to be resolved by these talks.

   Premier Li-Keqiang's recent emphasis on stability and preserving employment by easing both fiscal and monetary policies support our base case thesis. But it is important to note that the impact of these policies is yet to be seen in hard data, such as consumer and business spending (see CHART 3).

   The jury is still out on whether China is injecting liquidity on anything like the same scale as it did in 2016. Even if it is, historically it has taken six to 12 months before the effect showed through via a rebound in global trade, commodity prices, and other China-related indicators. The first green shoots of a bottoming are emerging: Chinese fixed-asset investment and the Caixin Manufacturing PMI beat expectations last month, the German ZEW Expectations Indicator has started to recover, and the diffusion index of the Global Leading Economic Indicator (which often leads the LEI itself by a few months) has picked up. The challenge is that the continued clampdown on shadow banking and China's bifurcated credit system means that despite attempts to ease liquidity conditions for small private businesses, the money is just not flowing to where it needs to go. Corporate lending rates for A-rated corporates remains exceedingly high, way above the benchmark rate, while non-bank financial institution balance sheets (a proxy for shadow finance) are continuing to contract. While the authorities are once again boosting infrastructure spending by allowing local governments to issue more special bonds, the mainland's real estate completions, particularly in coastal cities, have been underwhelming.

   Over the long to intermediate term however, we believe that it is unlikely that Chinese policy makers have abandoned their efforts to push debt loads lower and reform the economy. Since 2008, China has created USD 26 trillion worth of yuan; making the Chinese money supply larger than the U.S's and Europe's together. Consequently, China's incremental output-to capital continues to trend lower and State-Owned-Enterprises (the primary recipients of credit creation over the last 10 years) now generate lower ROAs than their cost of capital. Therefore, we don't anticipate a repeat in either the magnitude or duration of prior reflation efforts in 2009 and 2015. Sometime in 2020, we expect Chinese policy makers to return to structural reform and debt reduction policies, giving the Communist Party sufficient policy room and credibility in time for the July 2021 one-hundredth birthday of the Communist Party. Given the impact of China's policy shift from stimulus back to tightening on global (particularly X-US) growth in 2018, this next pivot could well be the catalyst for the next global recession.



*Shown as a 3-month moving average
Source: BCA Research

For Q2 2019, we maintain our neutral position to **U.S equities**. because of the market transitioning process discussed above (please see TABLE 2 on PAGE 5 for a summary of our global country positioning). **Europe** has been particularly hampered by its banking sector, which has been undermined by relatively

flat yield curves, prolonged economic stagnation and the re-emergence of political risks. Additionally, German autos and their concomitant industrial supply chains could be particularly vulnerable to potential Section 301 tariffs from the Trump Administration. However, Europe is most poised to benefit from Chinese reflation so we are pairing our overweight to Switzerland to tactically overweight Italy and Spain, whose banks are best positioned to gain some breathing room from the ECB's third TLTRO program and are trading at deep discounts. Despite the expected increase in the VAT, we have a neutral weight to **Japan** because of a more attractive earnings profile and which would also benefit from Chinese reflation.

As shown in TABLE 2, we are neutral to **Emerging Markets**. Within emerging Asia, we remain neutral to China, but have added A-shares as relative overweight within China as we tactically ride the wave of onshore momentum. We have moved Korea to overweight, following short-term underperformance in the market, but in line with our long-term positive view on the market as well as an expectation for some near-term catalysts coming from Chinese consumer spending. We have also resumed our strategic overweight to India (from neutral in Q1) after a brief period of underperformance vis a vis EM. While India's strategic growth story remains intact, Modi's ability to leverage the recent dust-up with Pakistan to solidify the BJP's standing in the upcoming parliamentary elections diminishes the policy uncertainty which had been overhanging Indian equities. We have pared back our overweight to Thailand, whose financial profile is less exposed to U.S. dollar liquidity and also trimmed further our long-time overweight to Russia. As noted in our Q1 Outlook, Russia's macro-prudential profile and valuation remains attractive (though somewhat diminished relative to 2018) and we believe that its current account and earnings will be further boosted by increasing oil prices. However, slipping poll numbers for Putin forecasts more geopolitical adventurism from the Kremlin sometime in the next 12-18 months and so we have moved the market to neutral in our tactical ACWIxUS portfolios and a slight overweight in our tactical EM portfolio.

With respect to Latam, we are neutral to both **Mexico and Brazil** and exited our Q1 overweight in Colombia after a +14% excess return.

Although there are few signs of improvement in global trade and manufacturing, we have implemented a more balanced allocation between **defensive sectors and Cyclical Consumer Discretionary** and other Late Cycle sectors. We continue our overweight to **Energy** and **Industrials**. Our perspective on oil prices was discussed previously. The industrial positions are largely thematic; made up of European Defense companies (a play on increased geopolitical uncertainty) and Chinese Environmentally focused companies (please See TABLE 3 on PAGE 6 for our sector and style positioning).

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TABLE 2 | Global / Country Positioning

Region / Countries	-		N		+	
Developed Markets			●			We remain neutral to developed market equities. Valuations outside of the US remain reasonable, but earnings growth is also expected to be modest. Within developed markets, we remain biased towards defensive markets in Switzerland and selected themes such as European defense at the expense of financials and consumer discretionary.
United States			●			Neutral. The US economy remains strong, but is no longer strengthening. After a healthy market rebound in Q1, most of 2019's returns are likely baked in, but this may be equally true for other global markets as well and so we remain neutral. Our positioning within the US remains in more defensive sectors and high quality value stocks.
Core Europe			●			Neutral, with an underweight outside of Switzerland. While valuations are tame, we believe economic and geopolitical headwinds will keep EPS growth modest. Within Europe we have taken a conservative posture with regards to sector, country and factor exposure. We remain heavily overweight Switzerland and our long-time theme in European defense stocks.
Japan			●			Neutral. Japanese valuations continue to trade at discounts to other developed countries and their own history, but a pending tax hike should keep the upside limited. We remain biased towards stocks with rising ROEs and improving governance with a slight overweight to Japanese banks as a call option on liberalization in M&A or changes in monetary policy.
U.K.			●			Neutral. High levels of uncertainty surrounding Brexit have led to cheap valuations and poor investor sentiment. We have taken a neutral posture because any positive surprise on Brexit negotiations could lead to a significant rally in UK equities.
Australia				●		Tactical Overweight. Despite serious concerns from the property market, our tactical models point to high confidence near-term outperformance based on a high degree of valuation dispersion among Australian stocks. Additionally, Australia typically benefits from Chinese reflationary policies.
Canada			●			Neutral. Our tactical models also point to tactical outperformance in Canadian equities, but at a lower confidence than Australia and without clear signals for offsetting underweights elsewhere in DM, we remain neutral.
Emerging Markets			●			EM continues to look modestly more attractive than Europe and Japan for 2019, but with a muddled view versus the U.S., so we remain neutral. Our large country overweights in Korea and India are funded by underweights in many of the smaller EM markets and by trimming our previous overweight positions in Thailand and Russia.
Emerging Markets Asia						
China			●			Neutral. We took a position in the A-share market mid-quarter on an intra-China basis (selling down broad Chinese beta), on expectations that this retail driven market will continue the momentum rally. Within China we also remain exposed to investments in environmental improvements (waste, water treatment, etc.).
Korea				●		Overweight. Korea is a long-term strategic overweight. We have taken an overweight position based on our strategic view and the potential catalyst of improved sentiment regarding Chinese consumer spending in the near-term.
India				●		Overweight. Our long-term positive view on India coincides with an expectation for a tactical rebound after a slow start to the year as well as positive sentiment following an expected win for Modi in the May elections.
Emerging Markets Europe						
Russia			●			Neutral. After holding our Russia overweight for nearly 2 years, we close the trade after a healthy +23% excess return. Valuations remain low, but less compelling on a relative basis, no longer compensating for geopolitical risks.
Emerging Markets Africa						
South Africa			●			Neutral. South Africa's economy remains stalled by a lack of investment and business confidence. At the same time, the market has slumped to a near decade low in P/B while market titan Naspers appears to finally be working to realize part of its massive holding company discount.
Emerging Markets Latin America						
Brazil			●			Neutral. We trimmed the market in early March after the market rally fully priced in optimism surrounding pension reform. Looking ahead, it seems clear that the much needed pension reform is the fulcrum for the market's next six months of performance and that the reform is likely to merely kick Brazil's fiscal can down the road, though if it can do so for as many as 10 years, that could be very bullish for the market.
Mexico			●			The Mexican market is at a 10-year valuation low based on both P/B and P/E, while the peso is among the cheapest currencies in the world based on Real Effective Exchange Rates. Our neutral position, balances the enhanced policy uncertainty surrounding President Obrador ("AMLO").

TABLE 3 | Sector Positioning

Sector / Style / Capitalization	-		N		+	
Early Cyclicals Consumer Discretionary, Financials		Developed Emerging Markets				We are underweight to early cyclicals as a whole, mainly from Financials, which face headwinds from flattening yield curves globally. We pared back our overweight to Japanese financials to a more neutral position but maintain our underweight financials within Europe due to continued geopolitical risk clouding the credit expansion cycle of the banking sector. We also maintained our underweight to financials in EM due to the credit focused reform agenda in China.
Late Cyclicals Energy, Industrials, Materials, Technology, Communication Services				Developed Emerging Markets		We are overweight to late cyclicals as a whole as we believe that the Fed is still below a neutral interest rate level, which has historically supported returns of these sectors globally. We have maintained tactical overweights to energy and industrials throughout Developed and Emerging markets. Energy companies have been beaten down by investors pricing in heightened bankruptcy risk across the sector, but that harsh sentiment has begun to soften as oil prices have come out of a bear market. Our industrial positions are largely thematic; made up of European Defense companies and Chinese Environmentally focused companies.
Counter Cyclicals Consumer Staples, Health Care, Utilities			Emerging Markets	Developed		We are overweight to counter cyclicals within DM with a greater focus on country ETF positions in EM. With markets pricing in zero rate increases for the US this year, this group will benefit from any earnings hiccups in developed markets. Our positioning is in the defensive sectors without clear interest rate sensitivities, staples and healthcare.
Large vs. Small Cap			Developed Emerging Markets			Neutral. We are neutral to US small cap stocks due to historically high valuations, despite recent pullbacks. Within Europe, small caps received a big bump during the first quarter, but based on diminished growth expectations and increasing uncertainty we take a more moderate stance on returns going forward.
Value vs. Growth			Developed Emerging Markets			Neutral. Modest overweight to value within the US, where higher Inflation expectations will likely lead to the end of the growth market sooner than it will in other developed markets.

● Developed ● Emerging Markets