Macro-economic Press Release – 7th January 2020

Soft landing drives broadening of equity bull market

After a long period of consolidation and doubts in 2018 and 2019, the equity markets have ended up topping their previous highs hit in January 2018. The escalating tit-for-tat on border duties between the US and China now seems to have come to a halt, while the no-deal Brexit scenario has been warded off. This scale-back in political tension is admittedly relative, and other pressures may emerge, but we have every reason to think that we are now over the worst of the angst. Investor doubts have abounded and fears of recession have sometimes reared their ugly head, for example during the summer of 2019 when the trade war looked set to scale worrying heights.

Soft landing scenario is taking shape

After two slowing years with downgrades to growth, a soft landing scenario for the world economy is now taking shape. Investors are becoming more discriminating, as they make a clear distinction between the manufacturing sector – which has been very hard hit – and the services segment, which is larger and more resilient. Realization is also dawning that the manufacturing slowdown was not only – and probably not even primarily – driven by trade tension, but rather other totally unrelated setbacks have played a crucial role in the sector's slowdown. Take for example the automotive sector, which was hit by a double whammy of the end to subsidies in China and the transition to new environmental standards around the world. Recent indicators show that these disruptive effects are fading very gradually, and a moderate rebound in 2020 is developing as a likely scenario. Another example of a cycle turnaround is the semiconductor industry, which should be buoyed by the roll-out of 5G for the mobile phone industry, among other factors.

So the lengthy macro-financial cycle that kicked off in 2009 should be able to march on, despite its record length and regardless of signs of maturity that will continue to unnerve observers. Economists surveyed by Bloomberg estimate the likelihood of a recession in the US over the next 12 months at 33%, with their justifications ranging from eroding US corporate margins to very low unemployment, as well as the inverted yield curve last summer. With the manufacturing industry's current stabilization, and major macroeconomic imbalances few and far between, we feel that moderate growth is poised to persist, especially as meager inflation is spurring central banks to extend the cycle. Their intervention is still more effective than is sometimes thought, and its impact can be seen in the robust activity for sectors most exposed to interest rates. However, attention is now also turning towards fiscal policy, which will be moderately expansionary in 2020. In this more "Keynesian" world – with a preference for support over growth – recession is now a less likely scenario, at least in the short term. However, countries must now tackle the challenge of reconciling ecological imperatives with economic growth, especially in Europe, and this could take the shape of a green "new deal" stimulus program for public investment, as the sector has so far played second fiddle in the phase of growth.

Ongoing moderate nominal growth would curtail resteepening of yield curves

The focus for investor anxiety is shifting to the risk of rising interest rates, as always when the economic outlook improves. The central banks have already announced that they have no intention of hiking short-term rates, even if inflation gradually normalizes, but long-term rates could rise, and this makes for a feasible scenario for 2020, although it is running into resistance. Growth and inflation projections are still curbed by the structural slowdown trend in China, the normalization of US growth after the 2018 tax cuts and continued very sparse support from fiscal policy in Europe, on top of lingering trade tension. So, we think that even if interest rates rise slightly, they will have to stay very low for a long time to come in order to keep world growth alive.

Collapse in interest rates has spread to large growth stocks…

These doubts are useful for the equity market at this stage, as they safeguard the impressive balance between moderate growth and very low long-term rates. However, the question is whether this upbeat scenario is not actually already priced in – or even excessively priced in – after stock-markets worldwide took a sharp surge in 2019. The median P/E (price to earnings multiple) for world equities has admittedly climbed considerably since its low in December 2018, but it is still sticking close to its past average: this is both reassuring and thought-provoking, as other assets have surged even more over the past several years, buoyed by plummeting interest rates. Take for example real estate in cities, where rental yields have fallen severely, and unlisted investments, such as private equity and private debt. The equity markets most definitely offer good value by comparison.

However, one section of the equity market has been swept up in this general trend towards rising asset prices i.e. large growth stocks. The MSCI World Growth, which includes stocks in developed markets, carries P/E of more than 22x, which is its highest since early 2002. This is a far cry from the 30-40x witnessed during the asset bubble in 1999/2000, but this is still a significant rise nonetheless. One of the key challenges for 2020 will be whether these stocks can sustain their valuations, especially if interest rates take a dramatic upswing. However, this is not our scenario at this stage.

…but the environment should help markets and stocks forsaken in 2018/19 make up their lag again

However, one thing is sure. The rest of the market – including cyclicals and financials, as well as small-caps – has definitely not followed this trend, and this is exactly where change may lie in our view, as worries ease on world growth and the valuation gap has now become very attractive. The most reasonably priced markets include Japan, which harbors a great deal of discounted manufacturing stocks and thereby offers several opportunities. The UK market also provides openings, as investment in the market is appealing once more – despite ongoing risks – after investment managers have steered clear of the country over the past more than three years. We would also mention emerging assets, particularly currencies, which have only gained very slightly so far from renewed optimism propelled by the dollar's strength. Lastly, European small-caps have built up an attractive liquidity-related risk premium vs. large-caps again over the past 18 months, while profit growth momentum is still relatively buoyant.

Dwindling anxiety on the cycle, but a raft of structural questions on asset allocation

If our economic stabilization scenario is borne out, investors may take the time to step back and think about the decade that lies ahead. The much-touted and broadly analyzed energy transition theme is set to be a major macro and microeconomic challenge. This area admittedly harbors opportunities, but it also involves risks, which will broadly hinge on the pace and profile of political impetus garnered to address this issue. Lastly, interest rates will probably increase ever so slightly, but they will remain extremely low and require a drastically different approach to managing investment, which should benefit the equity markets.

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