Market review September 2019

The start of September saw a rather exceptional trend reversal. Cyclical stocks, which had hitherto been neglected, on account of an expected economic downturn caused by the trade war, experienced a sudden bullishness. A snowball effect then followed. In the space of a few days, cyclical and banking sectors bounced back with verve, albeit in the absence of any actual fundamental support.

Besides the trade war which is taking a heavy toll on the economic climate, uncertainty and destabilising factors are mounting up.

Market trends at end of September 2019

	Equities in Local Currencies							
End of September	MSCI World	S&P 500	EuroStoxx	CAC	Spain	Switzerland	UK	Hong Kong
Perf 1 Month	1.94%	1.72%	4.16%	3.60%	4.90%	1.85%	2.79%	1.43%
Perf 3 Month	0.08%	1.19%	2.76%	2.51%	0.50%	1.82%	-0.23%	-8.58%
Perf YTD	15.72%	18.74%	18.93%	20.02%	8.25%	19.56%	10.11%	0.95%

	Commodities				Currencies vs EUR			
End of September	WTI Oil	Brent Oil	Gold	Copper	USD	JPY	GBP	CHF
Perf 1 Month	-1.87%	0.58%	-3.15%	1.29%	0.76%	-0.92%	1.83%	0.07%
Perf 3 Month	-7.53%	-8.67%	4.46%	-4.47%	4.30%	-3.87%	0.95%	-2.02%
Perf YTD	19.07%	12.97%	14.81%	-4.02%	4.99%	6.54%	1.27%	3.45%

	Bloomberg Indices Bonds Total returns							
End of September	Global Aggregate	US Aggregate	Euro Aggregate	US 10 Year Treasury	German 10 Year Bund	Global Credit	Global High Yield	Emerging Sovereign $
Perf 1 Month	-1.02%	-0.53%	-0.53%	-1.12%	-1.97%	-0.79%	0.47%	0.04%
Perf 3 Month	0.71%	2.27%	2.86%	2.74%	5.87%	1.15%	-0.67%	1.28%
Perf YTD	6.32%	8.52%	8.42%	9.89%	17.18%	8.99%	8.76%	10.79%

Source: Bloomberg 30/09/19.

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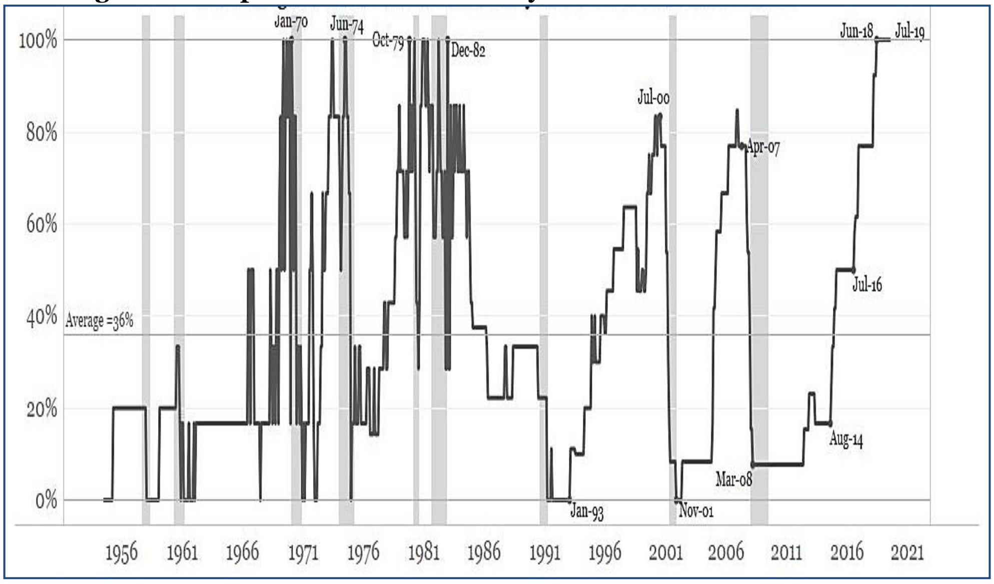
In Europe, Brexit looms large without any hint as to how things will pan out. Legislative elections will take place in Spain in early November. A new team will take charge at the head of the European Commission. In this context, the ECB has its work cut out. Not only must it continue to support the European economy, but it must also oversee the transition taking place at the head of its institution by way of the arrival of Ms Lagarde on November 1st. For the first time, we are hearing dissonant voices from several members of the Executive Board of the ECB and national central banks.

In the US, the trade war with China is beginning to leave its mark on economic statistics. The Fed has lowered its key interest rates but, just as with the ECB, there are now signs of dissent. The situation is punctuated by a new unexpected phenomenon: the requested impeachment of President Trump by the Democratic Party. Although it is difficult to speculate on the outcome of any such action, there can be no doubt that it will dominate political discourse in the run-up to the presidential election of November 2020. Markets hate uncertainty and when economic news take a turn for the worse, caution is called for.

In China too, the situation is getting tense. Growth remains sluggish and events in Hong Kong bring to mind the sad memories of Tienanmen Square 30 years ago. Symbolism is appropriate during this, the 70th anniversary of the establishment of the People's Republic of China.

For the past few months, indicators have foreshadowed a future economic recession. Although the performance of stock markets since the start of the year has admittedly given us reason to cheer in this context, it compels to exercise the greatest possible caution. The economy is slowing down, as are corporate profits. Interest rates are again on a downward trajectory.

Percentage of developed countries whose key interest rates are lower than US rates



Source: Bank for International Settlements, Bianco Research.

For several months now, we have referred to the yield curve inversion in the US as a precursor for a recession. Since the 2008 credit crunch, Western and Japanese central banks have implemented an ultra-accommodating rate cut and asset repurchase monetary policy. If the Fed, in the US, is also committed to a rate cut, these rates remain at very high levels in relation to other developed economies. This rate differential merely reasserts the appeal of the dollar in a context of negative rates. But in a globalised economy, the US cannot disassociate itself from the global context. The graph below confirms that this rate environment very often precedes an economic recession.

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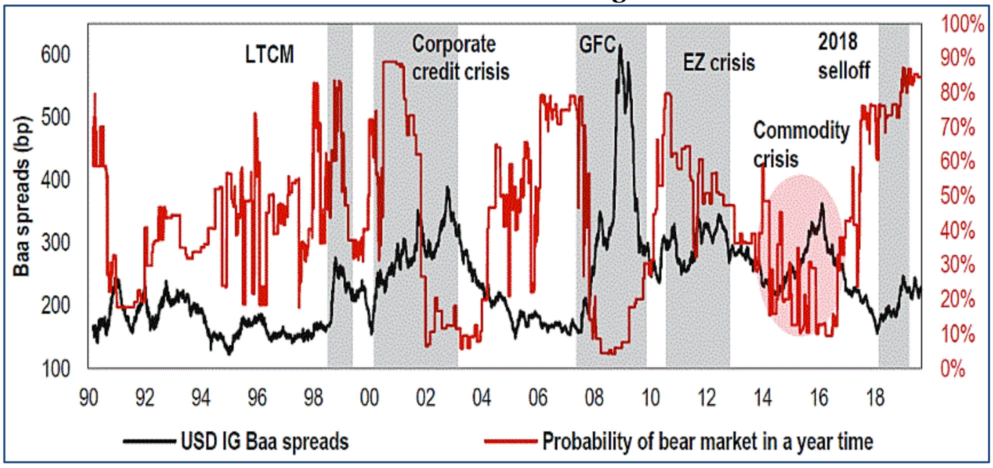
HSBC recession forecasting model

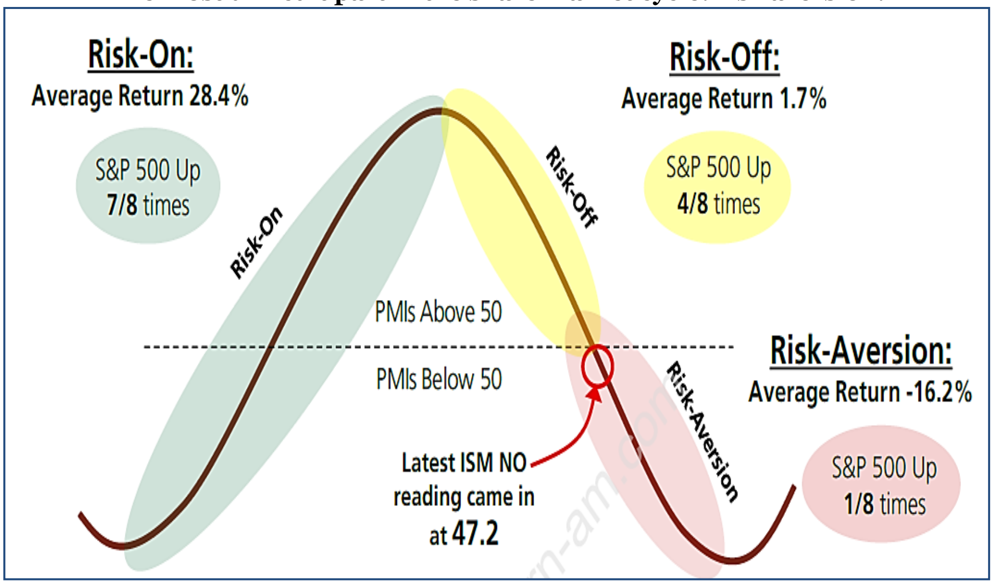


Note: USD IG spreads, Pink shaded area highlights credit bear market from the commodity crisis, which the model failed to predict.
Source: HSBC calculations, St Louis Fed.

The policy of low, or even negative, rates distorts the reflection prism. The credit spreads remain at modest levels. However, more complex indicators including multiple economic variables which have been put to the test over time, all point to the same thing: increased likelihood of a future recession.

Our risk aversion is growing. It is extremely rare to see a positive outcome in the current configuration. That is also the reason why we are currently reducing our equity allocation.

The most difficult part in the share market cycle: risk aversion.



Source: FactSet, UBS

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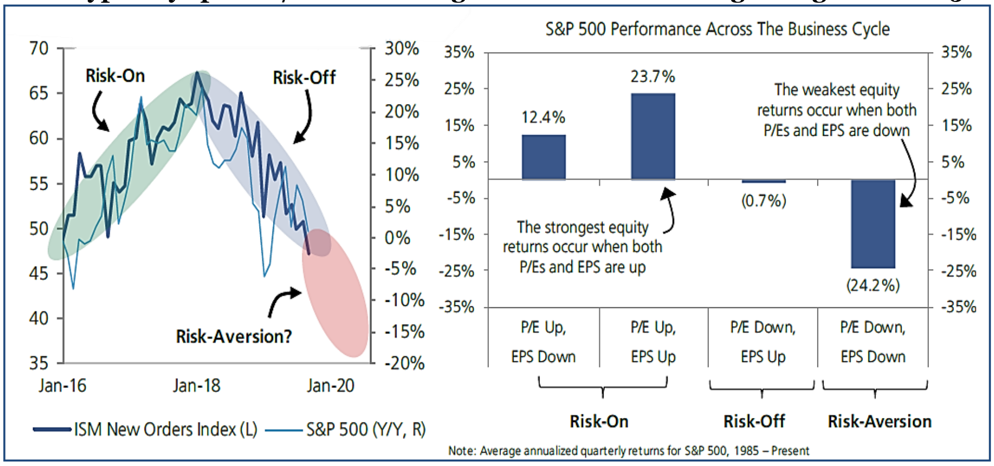
Government bonds no longer offer an attractive yield. Investment-grade bonds are in the same boat. Investors are now therefore reverting to the equity market. The phase we are entering is becoming complicated. Admittedly, low rates may serve to explain higher valuations for shares (the lower discount rate increases the present value of future profits) just as for real estate!
The problem we face is, however, more complex, but it is not a new one. In a phase of falling profits and risk aversion, we are seeing compressed valuations. An investor is reluctant to overpay for an asset with eroding profits.

Risk-Aversion typically spells P/E and earnings contraction resulting in negative S&P 500 returns

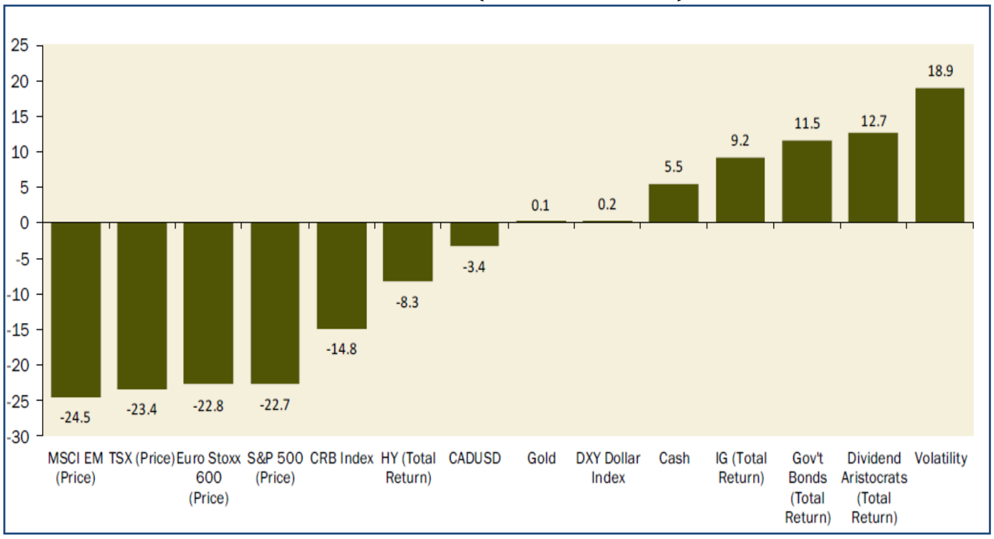


Source: Factset, UBS.

Although a recession is not imminent, we remain circumspect. Stock market growth since the start of the year is making us consider various options to secure potential gains. It is worth bearing in mind the historic performance of various asset classes in a context of potential deceleration.

As Mark Twain once said, “History does not repeat itself, but it often rhymes.” Past performance is no indication of future performance although it does give a number of signs.

Median return (annualised as a %)



Note: Returns calculated from six months prior to recession to three months before it ends
Source: Bloomberg, Gluskin Sheff.

Our gold allocation and dividend strategies are part of this tactical repositioning thinking.

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