Market Overview

The Fed Chair, Jerome Powell, was expected by many market commentators to be more pragmatic than his predecessors Janet Yellen and Ben Bernanke. Unlike an academic economist, Mr. Powell would brush aside short-term market gyrations and pay little attention to Wall Street's fear of market volatility. 2019 was anticipated to be the year when for the first time since 2008 the aggregate balance sheet of the world's major central banks would start shrinking. Mr. Powell was leading the way by delivering four rate hikes in his eleven-month tenure.

Enter the December 2018 sell-off. MSCI World lost over 13% in two weeks and the S&P 500 dropped almost 16% over the same period. Mr. Trump's "tariff wars" have also been adding fuel to the fire. One of China's retaliatory tariffs on the U.S. food and agriculture hit about $20.6 billion worth of US exports. A tough pill to swallow for some of Trump's core base states.

The US economy is still one of the key drivers of the global business cycle. This is due to the direct impact of US interest rates on the global economy via financial markets. In fact, except for the Global Financial Crisis the US has been propelling the global economy through most of the last 100 years.

If this positive impact of the US demand fades will there be another economy ready or willing to pick up the baton?

China is likely to see growth slow towards 6% with the US trade policy putting considerable strain on its economy. Also, trade tariffs are already trimming global growth through supply-chain disruption, higher uncertainty for businesses and higher import prices. The Eurozone has been one of the first victims of the US-China trade war. Germany's March manufacturing PMI index approached a recession like reading of 44.7 from a high of 63 recorded fourteen months ago.

However most major central banks have already spotted trouble on the horizon and started winding down the QT rhetoric therefore realizing that the window of opportunity for monetary policy normalization has closed. The Fed went from a hawkish "Quantitative Tightening (QT) on autopilot" in June 2018 to a more dovish and patient "wait and see" approach in March 2019. Chinese policymakers decided to step in as well. Yuan-denominated bank loans rose 40% year over year in January. According to the Wall Street Journal this was the fastest single-month growth since records began in 1992.

European policymakers are not sitting on their hands either. During its March meeting, the ECB proposed a new series of quarterly TLTROs (Targeted longer-term refinancing operations) after it had revised next year's Eurozone's growth projections from 1.7% to 1.1%. With the UK government hell bound on taking its withdrawal talks to the brink, the BOE has been signaling no interest rate hikes in the near term.

The uncertainty about further economic development therefore remains an issue, but it's a so-called "known unknown" which would imply markets have already started discounting global economic slowdown. Under this assumption the expansion of global trade could continue, albeit at a somewhat slower pace. In other words, we might be experiencing a small recession already and because most economic indicators are lagging, we will not be able to confirm it till after the fact. Since the beginning of the year most global markets have climbed their way back to 2018 highs and most developed government bond yields had retreated back to or below February 2018 levels, when Mr. Powell was appointed Chair of the Fed. Although there might not be a single economy to take over the burden of driving global demand, it looks like bond and equity markets are expecting most central banks to come to the rescue if needed.

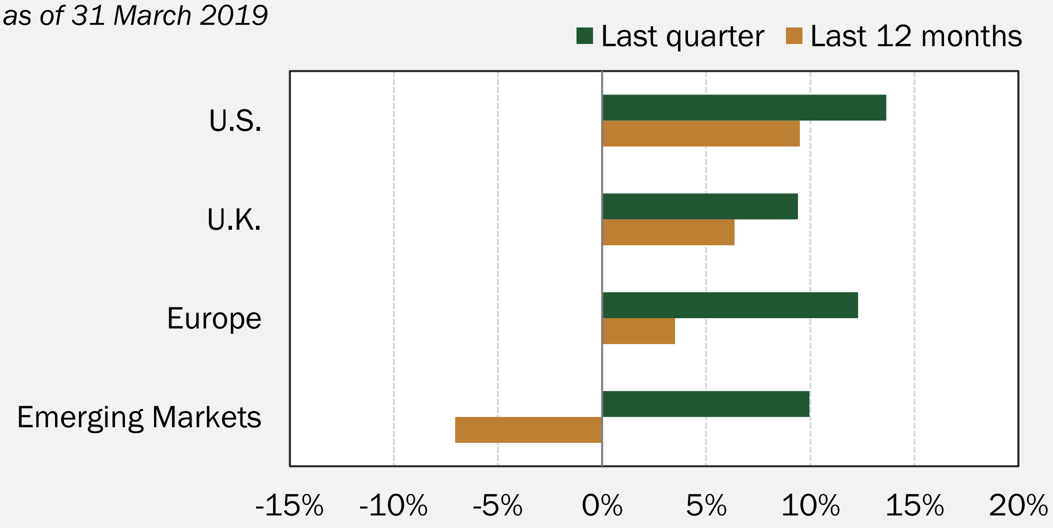
Asset Classes

Equities

Stocks rallied strongly for most of the first quarter, partially recouping heavy losses suffered by global equities in the waning weeks of 2018. Indeed, the Dow's drop of 15.5% was the worst December recorded since the Great Depression. Even so, by the end of March, US stocks had recovered 13.6%, UK stocks were up 9.4%, European equities had gained 12.3%, and the badly battered emerging markets had added 10.0%, year-to-date (see Figure 1). China, the worst performer among major stock markets in 2018, registered a staggering 29.3% gain through the end of March.

Figure 1: Equity Market Performance

Returns as of 31 March 2019



Source: S&P 500 (USD), FTSE All-Share (GBP), EURO STOXX 50 (EUR), and MSCI EM (USD) via Bloomberg

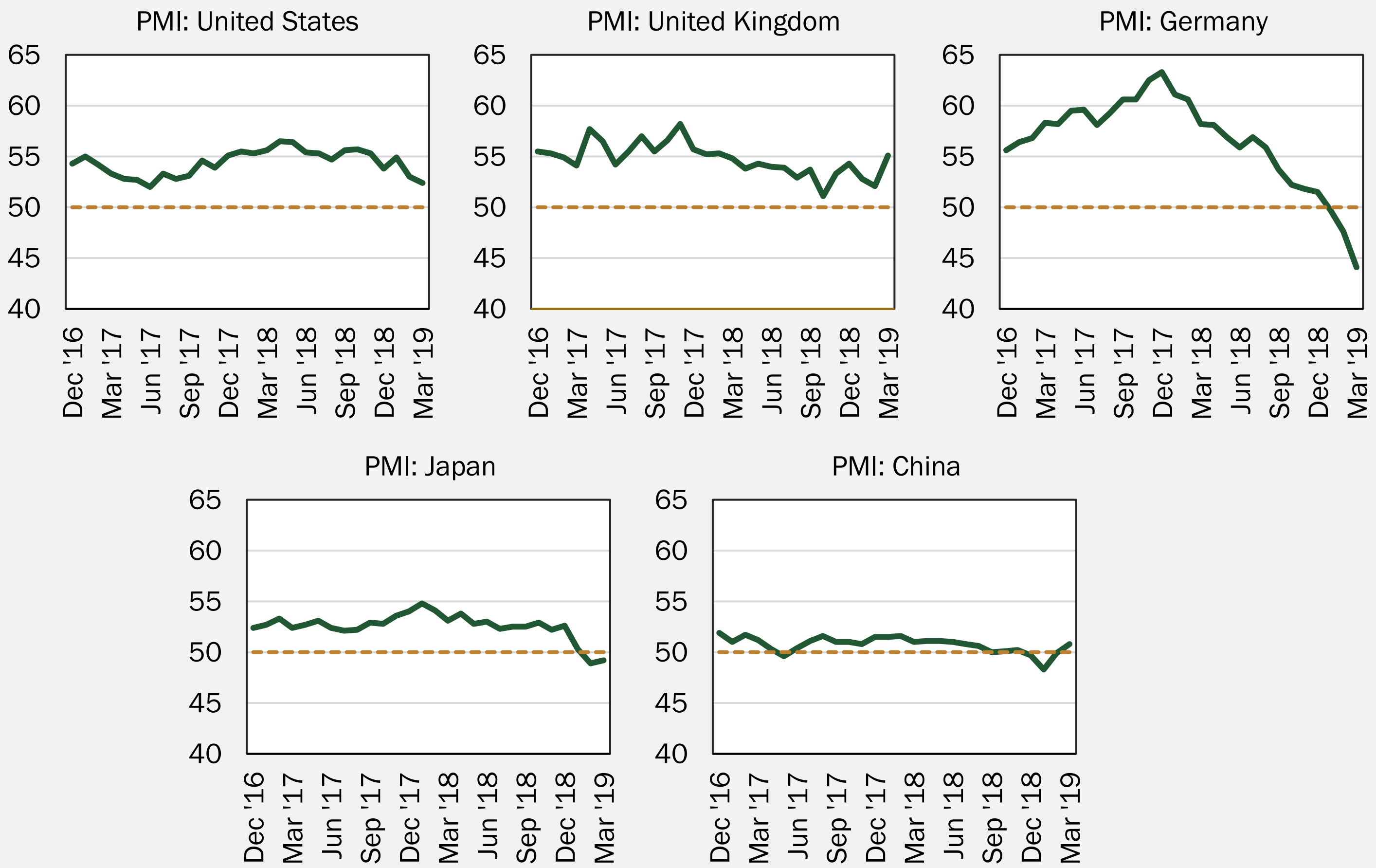
The world's central banks set the tone for a stock market comeback with hints at an investor-friendly rate environment, and the U.S. and China had returned to the bargaining table by the end of the quarter, rekindling hope that Trump's trade war might be nearing its end. Moreover, with low yields across the developed world, some analysts argued it's only a matter of time before investors herd back into stocks. Fairly good tailwinds, right? Perhaps.

But for those inclined to view the glass as half-empty, the start of the year also admits a less promising perspective. First, about those trade negotiations. In late-March, the South China Morning Post reported that talks have bogged down into a term-by-term review of the draft agreement, with two hours spent arguing over a single word. At the same time, German manufacturing data released to close out the quarter suggested the basis for dovish talk out of the central banks—concerns of a slowing global economy—might be legitimate concerns, at that (see Figure 2).

And despite fears of a recession, stocks aren't exactly cheap. By the end of March, U.S. stocks' cyclically adjusted P/E (CAPE) ratio, regarded by many as an inverse indicator of future stock market performance, was flirting with levels not seen since the late-1990s dot-com bubble. On a relative basis, EM equities still trade at markedly lower valuations than their DM counterparts—MSCI EM boasted a forward P/E of 12.5 vs. 15.8 for the MSCI World Index—possibly offering one bright spot for those equity investors seeking to diversify into the long-term growth of developing economies.

Figure 2: Economic Expansion Running Out of Steam?

Since the end of 2018, Purchasing Managers' Index (PMI) readings out of the world's major markets indicate a weakening global economy, with Germany leading the way, prompting a more dovish tone on the part of the world's central banks.



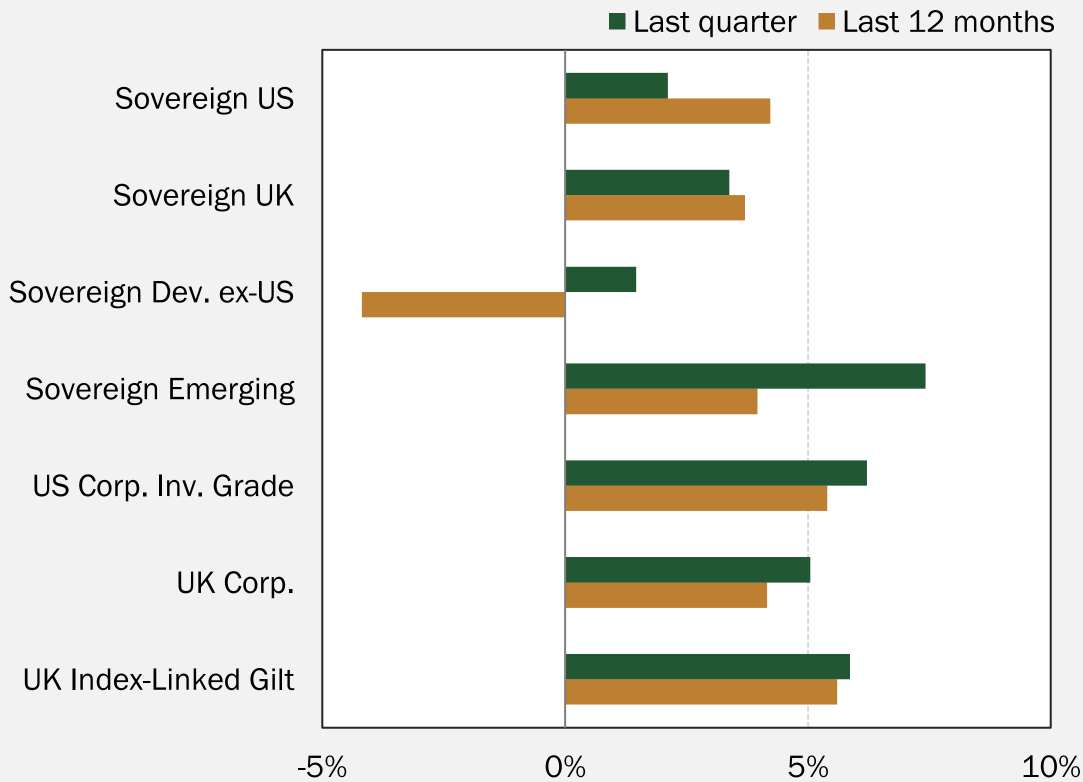
Source: Manufacturing PMI from Markit via Bloomberg

Fixed Income

Mounting signs of a slowdown in global growth through the first three months of the year saw investors falling over themselves in a flight to quality, flattening the world's yield curves under their feet in the process (see Figure 4 on next page). By the end of March, the US curve had finally inverted, German and Japanese yields were competing to see which could go more negative and yields on Australian and New Zealand bonds had reached record lows. Meanwhile, uncertainty associated with the March 29th defeat in Parliament of yet another Brexit deal from British Prime Minister Theresa May sent U.K. bond prices up, with 10-year gilts yielding just under 1% as of the quarter's end.

Figure 3: Fixed Income Market Performance

Returns as of 31 March 2019

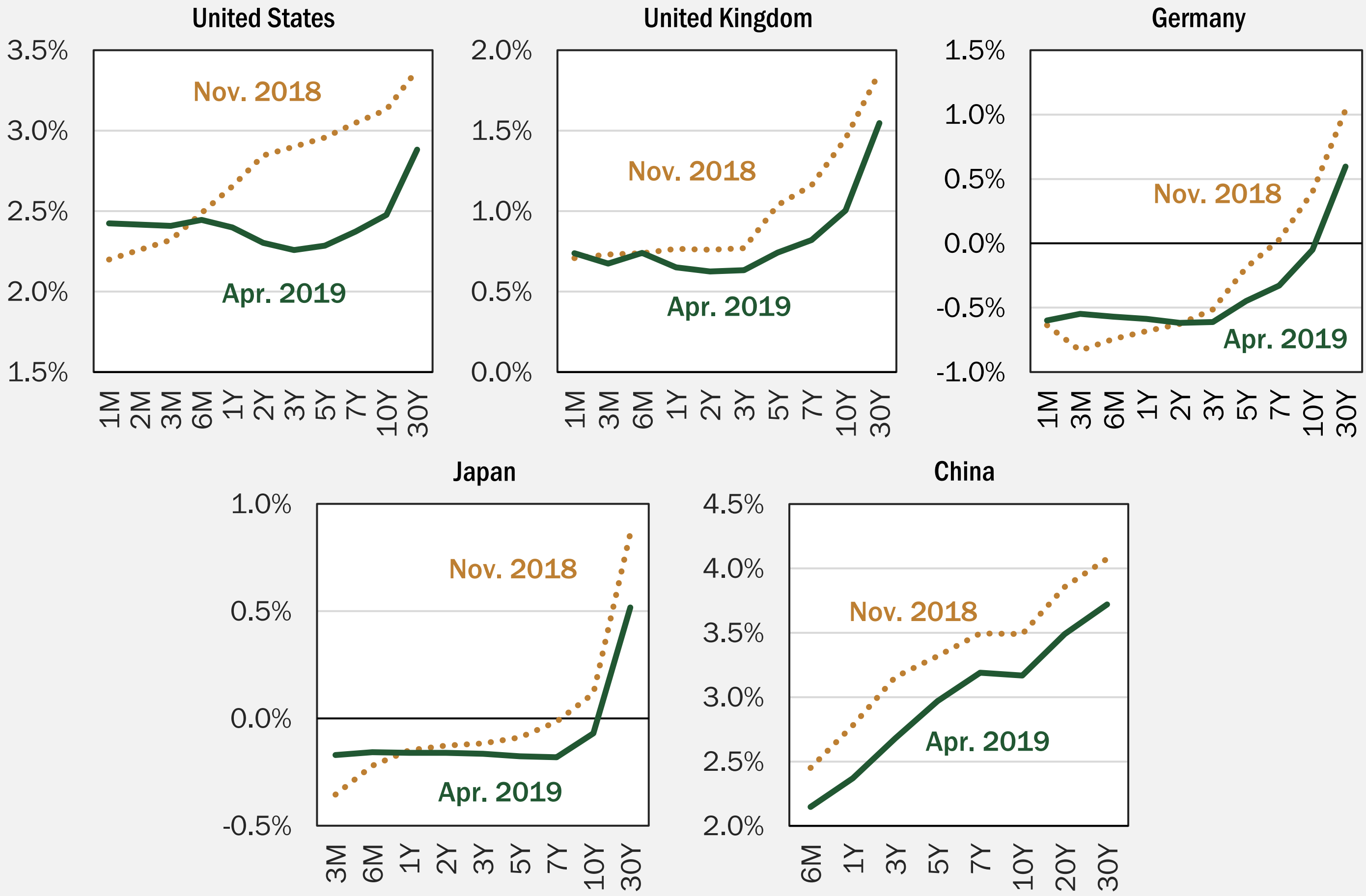


Source: Bloomberg, expressed in USD except for UK Index-Linked Gilt and UK Corporate in GBP

Elsewhere, in corporate credit markets, there's growing concern that elevated late-cycle indebtedness, spurred on by years of rock-bottom rates and firms' balance sheet restructuring, has placed borrowers at significant risk of the effects a coming downturn could have on corporate earnings. Nevertheless, based on numbers from Bank of America Merrill Lynch, those fears haven't put much of a dent in bond investors' appetite for investment-grade corporate debt, with high-grade U.S. bond funds and ETFs bringing in an average of US $846 million per day during the month of March. That willingness to purchase debt could, of course, vanish in short order if the economic picture further dims, with ongoing U.S.-China trade talks one potential catalyst for a sudden change in sentiment.

Figure 4: Under Signs of a Slowdown, Yield Curves Flatten

In November 2018, central bank balance sheets were shrinking, and rates expected to continue climbing. By early April 2019, concerns of slowing global growth brought with them renewed monetary easing and flatter yield curves, as seen below.



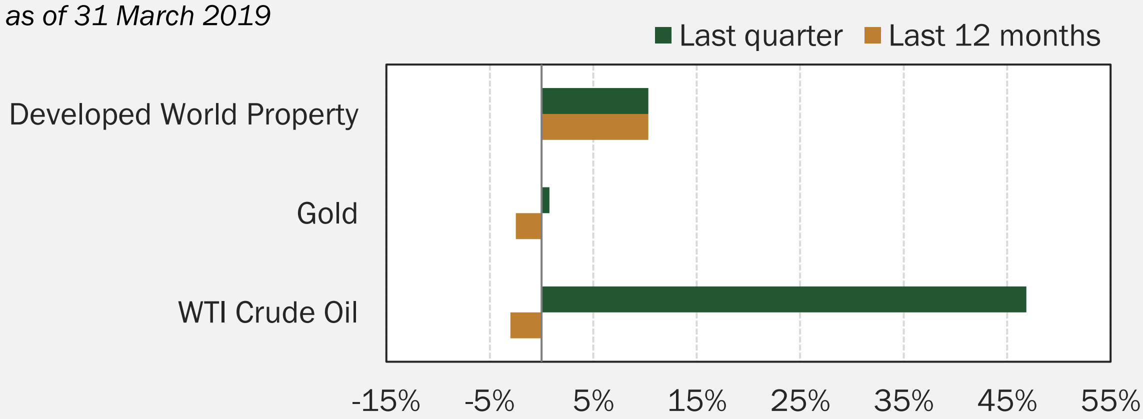
Source: Bloomberg

Alternatives

Real estate investors fared well in a quarter characterized by falling rates, with developed world property advancing by 10% through the end of March. Climbing bond prices boost real estate investments by simultaneously stimulating sales in a rate-sensitive industry, while driving yield-hungry investors into an asset class that historically offers fixed-income-like performance at somewhat higher levels of return. After a year of tightening, valuations were relatively low when central banks turned dovish, contributing to REITs' rally. In the commodities space, oil prices posted an impressive 46% gain in the first quarter, fueled by U.S. sanctions against Iran and Venezuela and OPEC supply cuts. Despite rising geopolitical uncertainty and declining yields, Gold gave back some early gains in 2019 to finish March ahead by just under 1% (see Figure 6).

Figure 5: Alternatives Performance

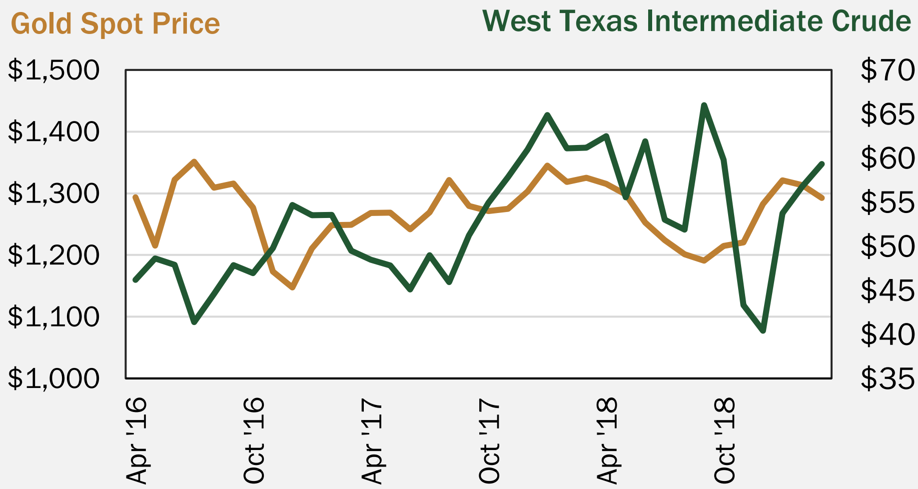
Returns as of 31 March 2019



Source: iShares Int'l Dev. Real Estate ETF (GBP), WTI Crude (USD), Gold Spot (USD) via Bloomberg

Figure 6: The Last Three Years of Gold and Oil Prices

Prices in US Dollars



Source: Bloomberg

Looking Ahead

As we start the second quarter, it is tempting to make predictions about what to expect for the remainder of the year. After the S&P 500 had its strongest quarter since 2009, it's enticing to expect the trend to continue. In the world of investing, accurate predictions are notoriously difficult. The unexpected occurs, and as history shows again and again, it occurs more often than probability suggests. Exactly how that manifests we can't say for sure, but we do think the likelihood for an increase in volatility in the financial markets is higher.

While historically the stock market remains one of the best leading indicators of the economy, it's important to note, in terms of the market's movement relative to economic data, it isn't whether the economic outlook is positive or negative, but whether economic expectations already priced into the market are met or exceeded.

There's reason to believe positive sentiment and momentum in equities could continue. Despite fears of a disruptive Brexit and escalating U.S.-China trade war, we interpret recent market strength to show a higher probability of a tranquil resolution of these issues.

In the coming quarters, it will be important to pay close attention to the actions and commentary from major Central Banks. If economic momentum is stabilizing and if monetary and fiscal efforts continue to remain accommodative, we should be able to see it in next quarter's data.

Key Economic Releases and Events for Q2 2019

UNITED KINGDOM

Bank of England Official Bank Rate release: 2nd May & 20th June

Brexit: The UK is expected to be given an extension until 20th June

EUROZONE

ECB Monetary Policy Meeting: 6th June

European Elections: 23rd-26th May

UNITED STATES

FOMC Rate Decision: 1st May, 19th June

FOMC meeting minutes: 22nd May

CHINA

GDP YoY%: 17th April

Caixin China PMI Composite: 6th May

BoP Current Account Balance: 10th May

Closing Comments

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