Investment Insights

Identifying Vulnerabilities

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Highlights

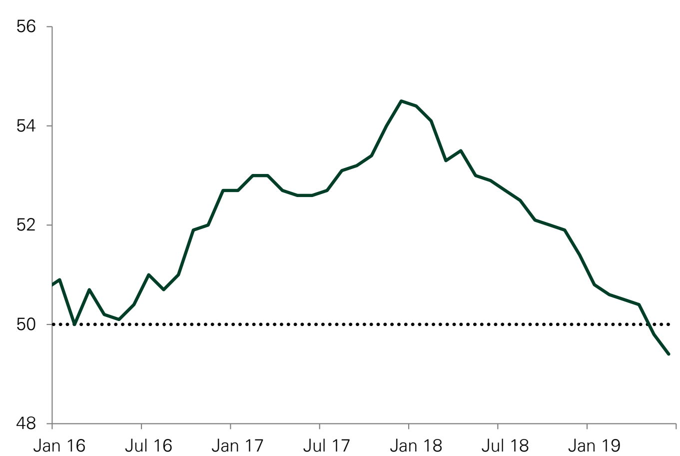
- Since our last allocation shift in late February, the S&P 500 has gained another 9% while the global equity index has risen almost 8%; for the U.S., the first half of 2019 was the strongest such period since 1997
- The additional equity gains have been supported by expectations for easier monetary policy, well-positioned consumers, and especially in the U.S., continued large share buybacks
- At this juncture, we believe investors may be discounting too much monetary easing unless the global economy is about to sharply decelerate — in such a scenario, we would expect corporate earnings to slow significantly
- Should global growth only slow modestly into 2020, investors are unlikely to get all they want from central banks — this too would impact rate-sensitive assets as well as expectations for corporate earnings
- Overall, we see a world with growing vulnerabilities compared with market supports — with limited expected upside from here, we want to take another incremental step to reduce equity exposure in favor of more defensive assets

The first half of 2019 felt a bit like a county fair carnival ride: fun at times but jerking around in different directions and leaving you feeling a bit nauseous.

Over the last six months, investors had to grapple with a dizzying barrage of risks and threats tied to tariffs — not just the central U.S.-China trade war, which pulled equities sharply lower during May, but tariff threats around the world, from Europe to Asia to Mexico (the latter for security rather than economic reasons). At the same time, the U.S.-China tech "cold war" intensified, with export controls and targeted company lists on both sides — making firms question and even start taking steps to redirect global supply chains. Worries also increased that tensions with Iran would further destabilize the Middle East and hurt oil supplies.

Perhaps not surprisingly, the persistent, uncertain backdrop for companies — especially those focused on manufacturing and global trade — took a toll. Business confidence fell, precipitously in some countries. As of June, the global manufacturing PMI survey had its second consecutive month below 50 (suggesting economic contraction; Exhibit 1). As we have noted in the past, these surveys are fairly reliable predictors of near-term business activity.

Exhibit 1: Global Markit Manufacturing PMI



As of June 30, 2019. A reading above (below) 50 indicates an expansion (contraction) in business activity.
Source: Bloomberg, Markit, JP Morgan

There is little to suggest global manufacturing will recover anytime soon, even with an eventual deal of some sort between the U.S. and China. Continued tariffs and potential new tariff threats should not be ruled out — indeed, as we noted in our latest [Quarterly Investment Perspective ("Politics and Portfolios")](), opinion polls suggest that U.S. President Trump may see tariff threats and trade wars as an effective campaign tool. Meanwhile, we expect that technology firms in particular will remain distracted by questions over global supply chains as well as regulatory threats into the 2020 election. We are seeing lower business confidence translate into slower capital expenditures, with a few tentative signs of spillover into hiring.

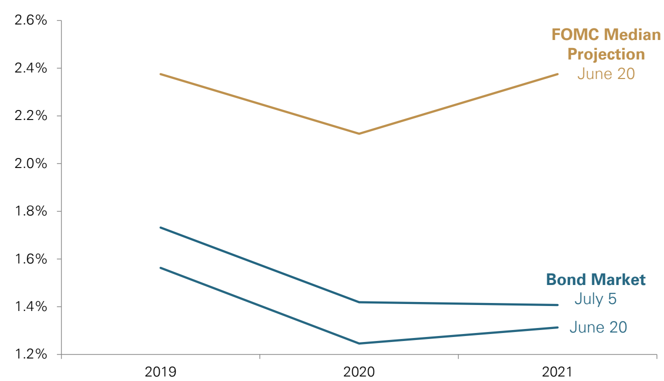
So far, investors have largely shrugged off both the sentiment and "hard" economic data, appearing to assume that central banks will save the day. Even an inverted U.S. yield curve, which late last year helped fuel investor worries and an equity sell-off, is now being largely ignored.

Investors understandably expect that easier monetary policy will provide a buffer, both for the economy and for cyclical assets such as equities. Lower interest rates ease debt-servicing burdens for leveraged companies and help consumers with bills.

Investors also have good reason to think that central banks will cut rates. First, central bankers seem increasingly inclined to focus on fighting low inflation or deflation, regardless of labor market or broader growth trends. Second, central bank staffing seems to be tilting more toward so-called doves. In Europe, Christine Lagarde (currently leading the International Monetary Fund) was nominated to replace Mario Draghi this fall as president of the European Central Bank (ECB). Lagarde is seen as someone who will be creative and aggressive with monetary policy if needed, and who appreciates the political sensitives within the European Monetary Union (EMU). Meanwhile in the U.S., President Trump has continued to nominate Federal Reserve board members who are widely understood as inclined to ease, in addition to regularly calling via Twitter and media interviews for the Fed to ease aggressively.

Still, we are skeptical that central bankers will act as much or more than is already priced in. Just looking at the U.S., interest-rate markets currently discount three 25-basis-point cuts before end-2019 and another two 25 bps cuts in 2020 (Exhibit 2). In modern history, the Fed has never eased this much outside of a recession. (In 1998, the last non-recessionary easing period, the Fed cut rates by 75 bps, half the amount discounted today, against a backdrop of the Asian financial and Russian ruble crises and the collapse of Long-Term Capital Management, which together helped pull down U.S. equities by some 20%.) Even if the Fed is focused on supporting inflation and embraces "insurance" cuts, is 150 bps of easing likely without a major change in the economic landscape?

Exhibit 2: Fed's Forward Policy Rate Versus the Market



As of July 5, 2019.
Source: Bloomberg

Putting together economic trends, central bank assumptions and market valuations, we conclude that equities are vulnerable. This is not to suggest markets cannot go up further. But we see the probabilities of further gains versus possible losses as increasingly asymmetric.

Even without recession, slower economic growth — our base case into 2020 — leaves financial markets more vulnerable to shocks. We have already mentioned a few of the "known unknown" catalysts out there: the Middle East, trade wars, China, and regulatory changes for key sectors. There are many more, including the U.S. federal debt ceiling (likely to become a real issue before early fall), Brexit (with a deadline now of Oct. 31), and fiscal policy that should turn from supportive to a slight drag on growth next year. There are always, of course, the additional things we cannot foresee that could suddenly change investor sentiment.

If we are correct, and equity markets are choppy or lower in the coming year, a slightly more defensive allocation — moving three percent of our equity allocation to fixed income — will help our performance versus strategic benchmarks. If we are wrong, and equities rise sharply from current record-high levels, we will give up some of our year-to-date relative outperformance but will still see even stronger absolute portfolio returns.

A final thought: After this allocation shift, we would not envisage another de-risking step without further, significant evidence of economic slowdown and/or market vulnerabilities. However the world evolves, we will continue to communicate frequently with you to explain our thinking and the logic behind our positioning. Our goal remains unchanged: to participate meaningfully in rising markets and to protect our clients' capital as much as possible in times of market distress.

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