For the markets, it’s slowdown versus recession

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| SummaryThis time last year, high long rates and the trade war kicked off what turned out to be a 20% correction for the S&P 500. The move took the market back to levels signalling that the fundamentals for 2019 were not as great as were once thought; as if by magic, analysts started pegging back their US earnings estimates for this year. Having started with a 10% gain, they are now looking at no change at best. The same goes for world GDP growth, once forecast at 3.2% and now estimated at 2.8% with more downward revisions on the way. The market was right about a slowdown, in other words, but failed to take account of interest rates. Bond yields have slumped to all-time lows, which has spurred equity prices higher even without higher profits. Having looked likely at one point, recession has been avoided. With equities some 20% better than their lows of last year, investors now seem to be in two minds where the S&P 500 can go from here. It is hard to say whether we are simply passing through a temporary deceleration in activity or verging on recession once again. The trade war is the main factor behind the uncertainty, and the failure to find a solution could worsen the outlook for activity. FedEx’s share price is a good proxy for sentiment on world trade, and it has halved. The IT sector is also a major casualty of the fallout with China. The outlook for world growth in 2020 is poorer than that for 2019 and includes projections of just 1.7% for the USA and 1% for Europe excluding any Brexit effect. US equities are just 2% off their record high and make no allowance for anything worse. Signals from companies are not very encouraging: consensus analysts are pencilling a 10% EPS gain next year, but the latest announcements point to 6% and our own top-down scenario assumes 8%.Recent data releases for the American economy are mixed. The good news includes an upturn in construction, buoyant consumer confidence and a tight labour market offering higher wages. But the trade war is driving manufacturing PMIs towards or below levels dividing expanding from contracting activity more or less worldwide.The US yield curve is still inverted, although somewhat less so since the Fed’s rate cut. Negative interest rates around the world raise questions about how central banks propose to react to any fresh downturn in activity. We believe the only weapon they have left is ‘helicopter money’, which has the advantage of putting money directly into consumers’ pockets. Investors are likely to be focused over the coming months on asset values and their portfolios’ capacity to generate cash flow. Our S&P 500 valuation model gives us a theoretical year-end objective of 2,897 points with a 30-year yield of 2.13%, compared with last week’s close at 2,962 points. The recent wave of IPOs highlights pressure on existing valuations, and the market is horribly exposed to new twists in the trade war and a no-deal Brexit. Optimists will be banking on agreement between Donald Trump and China ahead of the presidential election campaign and a reasonable Brexit solution. In the euro zone, negative interest rates have created a real estate bubble. Equity valuations are not as high as they are on Wall Street. We continue to recommend equity weights below investors’ benchmarks (in our case, 35% rather than 40%). We would also be buying the S&P 500 at 2,740 points, which would correspond to a ‘sharp slowdown’ economic scenario. Jacques Chahine |

## Interest rates to the rescue

This time last year, high long rates (3.2% on the 30-year) and the trade war kicked off what turned out to be a 20% correction for the S&P 500. The move took the market back to levels signalling that 2018 and 2019 would not see any repetition of 2017; as if by magic, analysts started pegging back their US earnings estimates for this year. Having started with a 10% gain, they are now looking at no change at best. The same goes for world GDP growth, once forecast at 3.2% and now estimated at around 2.8%.

Was last year’s correction warranted? If long rates had stayed where they were, most certainly. Central bankers rushed in to put out the fires, just as the markets had ordered them to. Long rates adjusted swiftly, but the Fed took its time getting to grips with the situation. While the markets proved pretty clairvoyant, the correction last year was exaggerated. It was big enough to imply recession at a time when activity was merely slowing.

The market hesitates



Right now, nobody can say whether we are weathering a temporary dip in growth or teetering on the verge of a recession after the longest period of growth ever recorded. Clairvoyant or not, the market could slump at any time upon some random event or negative economic indicator. Prices would slip first, ahead of a turndown in economic data and downward revisions to profits.

The strong rally in equity prices this year can be attributed exclusively to lower interest rates, as shown in the chart below. The US 10-year yield hit 1.48%, its lowest level since the worst of the 2008 crisis, while the 30-year (used to value equities) fell to an historic low at 1.98%.

The curve that saved equities in 2019



The fall in interest rates offset steep downward revisions to earnings



## Tangible effects of the trade war

The continuing trade war and contracting international trade flows will have dented what had been dramatic profits growth among the big American multinationals. The high-profile IT sector has suffered already from the situation in China, and many others face higher prices from the goods they import from China via new tariffs. One leading company – FedEx – is a good indicator of world trade; the halving of its share price reflects the impact of the trade war on long-distance freight, its main business.

A slump in FedEx profits and share price



IT sector profits will be down overall in 2019, with analysts revising their estimates down for this year and next, but its equities are up 29%. The microprocessing giant Micron Technologies, which has serious interests in China, has seen sales plummet from $32 billion to $20 billion this year and worse is expected in 2020. The Chinese appear to have succeeded in stealing manufacturing knowhow via headhunted individuals and are going for autonomy in this area. We agree with Mr Trump that China cannot be allowed to get away with this, especially as European firms are also victims.

Another trade war casualty



Fortunately, domestic economies are still rolling along and consumption is holding up well in the USA and in Asia, which remain important engines of growth. But growth is clearly slower than in 2018, and the outlook looks darker by the day. A year ago, economists were predicting a 3.2% increase in world GDP in 2019; they are now estimating 2.8% with an eye to further downward revisions. Forecasts for US growth this year have dropped from 2.5% to 2.3% in the wake of weaker data from the consumption and investment sectors. The consensus view for world growth next year is just 2.7%, and again downward revisions are the order of the day. US GDP is expected to rise only 1.7%, while both the euro zone and the UK are at around 1% on the basis that a no-deal Brexit will not happen.

Wall Street is a mere 2% off its highs, indicating that it is not pricing in worsening economic activity. Companies are very cautious on their own prospects for 2020, however, and our examination of 42 US firms that have already published Q3 results is revealing. This sample includes strong performers such as Nike, Adobe and Oracle as well as names that are not doing so well, such as Micron and FedEx. As usual, they reported better results than analysts were led to expect in Q3 but revised guidance for Q4 down. More significantly, they have played down 2020 as well. Excluding Micron, which as we have seen will post significantly lower profits, EPS growth for this sample is at 6.3% for next year, and consensus analysts are still at 10.1% for the S&P 500 as a whole. Our own 8% top-down figure also looks generous.

Growth to slow further in 2020, especially in the USA



Continuous downward revisions for 2020



## Mixed macroeconomic indicators

The latest US indicators include some positive data, notably a rebound in construction following a sharp drop in the mortgage rate. Housing starts have risen to an annualised 1.425 million units, their highest level since the financial crisis, although this is still some way short of the 2.2 million recorded during the subprime era. Regular rebuilding is typical of the US housing sector. New home sales are also up sharply, and the companies involved have outperformed the index by 30% over the past year. New car sales are holding up well, unemployment is at its lows and although job creation has slowed it remains positive. Consumer confidence tends to fluctuate from month to month but is stable on trend at a post-crisis high. Inflation has slipped below 2% amid lower oil prices; this masks an acceleration in the ex-food and energy index. Hourly wage growth has climbed above the 3% mark, ensuring modest purchasing power gains. Household consumption growth eased from a relatively high level in 2018 to virtually zero this August, prompting economists to reduce their Q3 GDP estimates.

Real estate a beneficiary of lower mortgage rates



One of the most relevant statistics in recent months has been the PMI series, which started on a downward track at the same time as last year’s market correction. The US PMI numbers are only just above the 50 level that separates expansion from contraction. The trade war has hit manufacturing first and foremost, which explains Germany’s difficulties. The country has briefly dipped into recession already and its outlook is not good.

The trade war has hampered manufacturing…



… which is contracting in the euro zone



## A slightly less inverted yield curve

We have already observed that in equity market terms, 2019 was saved by a slump in long-term interest rates to historic lows. The US yield curve shown below illustrates the difference between where we were this time last year and where we are now: the curve was upwardly sloped then, so much so that it triggered the sharpest market correction since the crisis. It is inverted now, although less so than it was before the Fed cut its rates by a quarter of a point last month and before long rates ticked up slightly. The Fed says that it is watching the economy carefully, suggesting that signs of slower growth – in US employment numbers on Friday, for example – would sting it into further action. It follows that such data releases could help the market somewhat.

A small step towards yield curve normalisation



The Fed has also altered course on qualitative easing. It had been reducing the size of its balance sheet since 2018 but went back to buying securities in September.

## Helicopter money to follow lower interest rates?

Equity market trends will depend far less on interest rates from here on than they did last year. That is because it would be difficult to drop long rates any further, although 30-year Germany in negative territory gives pause for thought! As we have argued for some time now, the major problem with such depressed rates is that they do nothing for the economy. All they do is inflate the values of assets such as equities, real estate and gold; no benefit accrues to consumers. We believe that as and when the next crisis comes upon us the only resort will be helicopter money. Germany may take a step in that direction soon, as it will be looking to stimulate growth from a position of budgetary surplus.

## Wall Street valuations on the high side

Over the coming months, investors’ attention is likely to focus on asset valuations and their capacity to generate cash flow. Our model for the S&P 500 gives us a theoretical end-year objective of 2,897 points with a 30-year at 2.13%, compared with 2,951 points and 2.1% last month. The slightly lower objective reflects slippage in profits growth and the uptick in long rates. Our 8-year CAGR is unchanged at 2.1%, a figure that incorporates a high probability of a recession-induced drop in profits at some point during the period. We have assumed EPS growth rates of 8% in 2020 and 6.3% in 2021. Consensus analysts are sticking with double-digit growth, as if we were still in the ‘good old days’. If there is a recession, we would expect the market to drop to between 2,545 and 2,706 points.

US equities look toppish



Tight valuations are also evident in the way several IPOs have flopped recently. WeWork is a good example: this is a company that was valued at $45 billion during its latest funding round but struggled to find buyers at $15 billion. Similarly, Uber was floated at $41 and is now trading at $30, its competitor Lyft has corrected from $81 to $40 and Peloton dropped 11% on the day it was floated. The market is unforgiving when companies do not live up to expectations. FactSet was trading at 27x 2020, in line with other growth stocks, but corrected 20% from its highs when 2020 earnings estimates were revised to no change on 2019, and despite share buybacks. Many innovative firms are reaching maturity or face serious competition. Netflix is challenging Amazon, Disney, Hulu and Apple, for instance. Inflated costs and fierce competition can be a toxic mix. Apple’s market is already saturated, although the company is hoping to do more in services. Competition authorities are onto GAFAM, whose aggressive tax ‘optimisation’ is being called into question around the world. What all this means is that the markets will struggle to appreciate on the back of PER in the same way as they have done in the past. It follows that equities are likely to continue trading sideways for the time being, unless slower economic growth makes a bigger dent in profits.

PERs will struggle to move higher…



… especially if there is no earnings growth



Coming Q3 profits announcements will not contain positive surprises. Earnings will be 4% down overall on last year, reflecting difficulties in IT, real estate and basic materials; given the usual game of issuing pessimistic guidance, the drop may look worse than that to start with. The average drop in profits over the past four quarter will be 0.3%. We have already seen that companies that have already published Q3 figures are predicting just 6% growth next year, far short of the 10% consensus figure.

## A worsening picture on risks

The markets face a number of political and macroeconomic risks that could affect performance. We would highlight four in particular:

1) A worsening trade conflict with China
2) A bigger deceleration in economic activity
3) A no-deal Brexit
3) A crisis in the Middle East that blocks oil supplies

Optimists might bet on better trade relations with China, if only for reasons related to US elections. The current deceleration in world growth stems in good part from weaker international trade flows, and if threatened and planned tariff increases take effect we will all suffer, including American consumers and companies. Share prices would correct further, thereby damaging Mr Trump’s re-election prospects. The president views Wall Street as the barometer of his success, and this is raising hopes of a pause in hostilities. Depending on the solution, uncertainty would remain over companies that are supposed to relocate production from China, for example. And Mr Trump is still keen to take on Europe, particularly Airbus and the auto sector. Unless he calms down, Germany will take the worst of it and could slide into recession.

A no-deal Brexit would be extremely serious and would put many firms in difficulty on both sides of the Channel. Trade flows would contract in sectors such as French agriculture. A Theresa May-type deal would be a lesser evil.

The standoff over Iran could end with a more flexible American position, and that may be in the pipeline. We should not exclude the resumption of talks and less stringent sanctions.

Mr Trump’s diplomacy has created disorder worldwide and slowed economic growth. He may be cheering the rich via higher equity values, but poorer Americans have even less social security protection than before. His recent involvement with Ukraine says a great deal about his ethics.

## No excesses among European equities

Negative interest rates have created a real estate bubble in the euro zone. They have not done anything to help European firms, however, which taken together have not posted earnings growth for years. The consensus estimate for 2019 is a 3.7% increase in EPS, but that could dwindle further. Dividends are worth 3.8%, however, compared with an average 30-year yield of 0.4%, and this gives us the required 3% risk premium all on its own. Recent developments in Germany highlight the banking sector’s fragility. Our theoretical objective for year-end suggests upside of 3%, but the market is completely dependent on Wall Street.

We continue to recommend weighting equities at below benchmark levels (35% rather than 40% in our case). Last month we left a buy order at 2,740 points on the S&P 500, which corresponds to a sharp slowdown scenario. That order is still in place.

A degree of upside for eurozone equities



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| ConclusionsThis time last year, high long rates and the trade war kicked off what turned out to be a 20% correction for the S&P 500. The move took the market back to levels signalling that the fundamentals for 2019 were not as great as were once thought; as if by magic, analysts started pegging back their US earnings estimates for this year. Having started with a 10% gain, they are now looking at no change at best. The same goes for world GDP growth, once forecast at 3.2% and now estimated at 2.8% with more downward revisions on the way. The market was right about a slowdown, in other words, but failed to take account of interest rates. Bond yields have slumped to all-time lows, which has spurred equity prices higher even without higher profits. Having looked likely at one point, recession has been avoided. With equities some 20% better than their lows of last year, investors now seem to be in two minds where the S&P 500 can go from here. It is hard to say whether we are simply passing through a temporary deceleration in activity or verging on recession once again. The trade war is the main factor behind the uncertainty, and the failure to find a solution could worsen the outlook for activity. FedEx’s share price is a good proxy for sentiment on world trade, and it has halved. The IT sector is also a major casualty of the fallout with China. The outlook for world growth in 2020 is poorer than that for 2019 and includes projections of just 1.7% for the USA and 1% for Europe excluding any Brexit effect. US equities are just 2% off their record high and make no allowance for anything worse. Signals from companies are not very encouraging: consensus analysts are pencilling a 10% EPS gain next year, but the latest announcements point to 6% and our own top-down scenario assumes 8%.Recent data releases for the American economy are mixed. The good news includes an upturn in construction, buoyant consumer confidence and a tight labour market offering higher wages. But the trade war is driving manufacturing PMIs towards or below levels dividing expanding from contracting activity more or less worldwide.The US yield curve is still inverted, although somewhat less so since the Fed’s rate cut. Negative interest rates around the world raise questions about how central banks propose to react to any fresh downturn in activity. We believe the only weapon they have left is ‘helicopter money’, which has the advantage of putting money directly into consumers’ pockets. Investors are likely to be focused over the coming months on asset values and their portfolios’ capacity to generate cash flow. Our S&P 500 valuation model gives us a theoretical year-end objective of 2,897 points with a 30-year yield of 2.13%, compared with last week’s close at 2,962 points. The recent wave of IPOs highlights pressure on existing valuations, and the market is horribly exposed to new twists in the trade war and a no-deal Brexit. Optimists will be banking on agreement between Donald Trump and China ahead of the presidential election campaign and a reasonable Brexit solution. In the euro zone, negative interest rates have created a real estate bubble. Equity valuations are not as high as they are on Wall Street. We continue to recommend equity weights below investors’ benchmarks (in our case, 35% rather than 40%). We would also be buying the S&P 500 at 2,740 points, which would correspond to a ‘sharp slowdown’ economic scenario.  Jacques Chahine |

Main ratios for markets and sectors as of 27/9/2019 (in local currency)



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