Weekly Strategy

Multi Asset Navigator

UNIGESTION

18 March 2019

Can't Stop Red Hot Chili Peppers, 2002

It has been a week since the ECB revised GDP and CPI forecasts sharply lower and it is one week before the next Fed meeting where we expect a downgrade in both economic forecasts and dot projections. Yet risky assets have continued to rise, reaching a new high for the year. Markets believe that central bankers will save the world once again, increasing the gap between market pricing and fundamentals. But we think differently. Our conviction is that central banks "can't stop" the deceleration trend in the global economy and asset prices will need to adjust to reflect higher recession risk.

WHAT'S NEXT?

Lost in translation

Since the beginning of the year, growth-oriented assets have recovered sharply. Global equities are up 12% on a year-to-date basis and US high yield spreads tightened by 115 basis points (bps) from 450bps to 345bps. The current rally is one of the strongest in history because both the hit ratio, which compares the number of positive days versus negative ones, and the asymmetry ratio, which compares average positive performance to average negatives ones, have significantly improved compared to historical averages. To illustrate, the S&P500 index has delivered a hit ratio of 63% in 2019 vs 53% on average since 1999. The average daily gain has been 0.7% vs -0.5% when the index was down on the day, reflecting a positive asymmetry, which is unusual over a long period.

Does this rally reflect a great expansion in the global economy? Clearly not. The OECD, IMF, ECB and most central banks globally have downgraded their economic forecasts for this year. As an illustration, the ECB expects 1.1% GDP growth in the Eurozone economy in 2019, the lowest rate since the European recession of 2011/2012. Our proprietary, global Growth Nowcaster, which aims to track changes in the economic cycle in real time, shows that 60% of the data that we monitor is deteriorating. This number reaches 70% for our European Nowcaster.

Is the rally fueled by higher earnings expectations? Not anymore. Data from Bloomberg shows a large downward revision in earnings growth estimates. Expectations are 2% growth for developed equities, flat for emerging ones, between 4% to 6% for US and European ones and negative growth for UK and Japanese ones. It remains for the famous "central bank put" to justify current valuations in growth-oriented assets. As a reminder of "bad news for the economy is good news for financial assets", the shift in central bank stance globally has been the main trigger in the asset recovery seen over the last months. However, we tend to be "lost in translation" because the famous mantra usually works when risk premia are large and assets depressed, not when the economic cycle is ageing and valuations are stretched. As a result, we believe that we are entering into a regime change and that bad economic news will be negative for financial assets.

Liquidity injections create a market bubble

10 years after the bottom of the financial market, the performance of risky assets has been outstanding in total return terms: 413% in cumulated terms for the S&P500 index (17% annualised), 194% for the US High Yield Basket (11% annualised) and 175% for the MSCI Emerging Market index (10.5% annualised). Over the same period, the global economy grew at 6.3% on average in real terms according to the OECD. As a result, the market capitalisation to GDP ratio jumped, touching a new record high this year. Between 2009 and 2019, the ratio increased from 76% to 112% for the world economy and from 78% to 165% for the US. The gap between financial assets and fundamentals has since increased and broken the tech bubble level, seen in 2000. That is the consequence of large central bank balance sheet expansion, which has triggered higher growth in broad money than GDP growth. The Broad Money to GDP ratio computed by the World Bank is now at 120%, up from 105% in 2008 and 99% in 2000. Clearly, generalised QE has helped to smooth the negative economic effects of the deleveraging process after 2008. But it has also fueled the rising divergence between asset prices and the real economy. Moreover, in our view, the most negative effect of the increasing correlation between central bank actions and risky asset returns is its impact on economic and financial volatility. A recent study from BIS shows that QE and forward guidance helps to lower the volatility of market reactions to news in the United States. This relationship is key when risk aversion is high as in recessionary periods, but we doubt that it promotes accurate risk assessments in today's more stable economic and market conditions.

Historically, central banks cannot stop the decelerating trend

The assumption made by investors to justify current pricing is that central banks will have sufficient ammunition for avoiding economic recession and a market crash. What is history telling us? Since 1990, there were three recessions in the US as dated by NBER. However, we include 1997/1998 in our analysis because the Fed eased its monetary policy during this period. For these four macroeconomic shock periods, the US equity market reached its highest level 3 to 6 months before recession, as dated by NBER, and 1 to 4 months before the Fed cut its rates. In all episodes, the rate cut failed to stop a market decline and to avoid recession. What are the implications for the current situation? Firstly, markets can be wrong by pricing in high growth premia and reversing very quickly. Secondly, the Fed does not need a large market crash to remove tightening. Thirdly, when the economic situation turns bad, bad is bad for asset returns. Finally, in every episode, the real 2-year US rate, a key indicator, reached a high ahead of the broader market high and the Fed's first cut. In the current cycle, this indicator reached its highest level in November 2018.

Listen to: "Can't Stop" by Red Hot Chili Peppers

IMPORTANT INFORMATION

Past performance is no guide to the future, the value of investments can **fall** as well as rise, there is **no guarantee** that your initial investment will be returned. This document has been prepared for your information only and **must not** be distributed, published, reproduced or disclosed by recipients to any other person. This is a promotional statement of our investment philosophy and services **only in relation** to the subject matter of this presentation. It constitutes **neither** investment advice nor recommendation. This document represents **no** offer, solicitation or suggestion of suitability to subscribe in the investment vehicles it refers to.

Please contact your professional adviser/consultant **before** making an investment decision. Where possible we aim to disclose the material risks pertinent to this document, and as such these should be noted on the individual document pages. A complete list of all the applicable risks can be found in the **Fund prospectus**. Some of the investment strategies described or alluded to herein may be construed as **high risk** and **not readily realisable investments**, which may experience **substantial and sudden losses** including **total loss** of investment.

These are **not suitable** for all types of investors. To the extent that this report contains statements about the future, such statements are forward-looking and subject to a number of risks and uncertainties, including, but not limited to, the impact of competitive products, market acceptance risks and other risks. As such, forward looking statements **should not be relied upon** for future returns. Data and graphical information herein are for information only and may have been derived from third party sources. Unigestion takes reasonable steps to verify, but does not guarantee, the accuracy and completeness of this information. As a result, no representation or warranty, expressed or implied, is or will be made by Unigestion in this respect and no responsibility or liability is or will be accepted. All information provided here is **subject to change without notice**.

It should **only be considered current** as of the date of publication without regard to the date on which you may access the information. Rates of exchange may cause the value of investments to go up or down. An investment with Unigestion, like all investments, contains risks, including **total loss** for the investor.

Uni-Global – Cross Asset Navigator is a compartment of the Luxembourg Uni-Global SICAV Part I, UCITS IV compliant. This compartment is currently authorised for distribution in Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Norway, Spain, UK, Sweden, Switzerland. In Italy, this compartment can be offered only to qualified investors within the meaning of art.100 D. Leg. 58/1998. Its shares may not be offered or distributed in any country where such offer or distribution would be prohibited by law.

All investors must obtain and carefully read the prospectus which contains additional information needed to evaluate the potential investment and provides important disclosures regarding risks, fees and expenses. Unless otherwise stated performance is shown net of fees in USD and does not include the commission and fees charged at the time of subscribing for or redeeming shares.

This document has been issued by Unigestion UK, which is authorised and regulated by the UK Financial Conduct Authority. Unigestion SA authorised and regulated by the Swiss FINMA. Unigestion Asset Management (France) S.A. authorised and regulated by the French Autorité des Marchés Financiers. Unigestion Asia Pte Limited autorised and regulated by the Monetary Authority of Singapore. Performance source: Unigestion, Bloomberg, Morningstar. Performance is shown on an annualised basis unless otherwise stated and is based on Uni Global – Cross Asset Navigator RA-USD gross of fees (90bps) with data from 15.12.2014 to 18.03.2019.