Weekly Strategy

What's Going On Marvin Gaye, 1971

As we have communicated previously, we believe growth-oriented assets are at risk this year from a slowdown in global economic activity, even if a widespread recession seems unlikely. Central banks, led by the Fed, have already adjusted monetary policy and communication to respond to this risk as well as others. Over the past few weeks, macro data has confirmed the slowdown is real and more dramatic than many had thought. But don't tell that to the markets, which have continued to rally in spite of the bad news. So we find ourselves asking, what's going on?

WHAT'S NEXT?

Disappointing macro data…

Our cautious view on growth assets has been primarily driven by the deterioration in our proprietary Growth Nowcaster. By construction, this indicator assesses the current state of global economic growth by looking at a broad range of economic data across regions and avoiding the reporting lag issues of official GDP data. Thus when we saw a strong deceleration in our Growth Nowcaster, we were confident that official data, once released would confirm our convictions:

- Putting aside skepticism some may have on the veracity of the figures, the end of January saw China's official growth for 2018 come in at 6.6%, the lowest level since 1990. Although this was in line with market expectations, the rate demonstrates their easing measures have yet to turn the Chinese economy around.
- In Europe, the recession concerns we raised previously are now coming to light. As reported at the end of last month, Italy is in a technical recession after its economy shrunk by 0.2% in Q4 2018 after a contraction of 0.1% in the previous quarter. Germany, once the bulwark of the Eurozone economy, managed to barely avoid a recession itself by growing just ever so slightly in Q4 2018 after having contracted by 0.2% in Q3 2018. And last Friday, the IFO Business Climate and Expectations indices both came in below consensus. The latter, which provides a six-month forward view, is now at levels not seen since the Eurozone sovereign debt crisis.

Importantly, US economic activity has remained strong through Q3 2018. At the same time, our US Growth Nowcaster significantly declined in the last couple of months of 2018, and so we will be watching closely the 4Q 2018 GDP numbers when they are released this Thursday.

…hasn't stopped equity markets from rallying

After the significant sell-off in 4Q 2018, when markets started pricing in a decent likelihood of recession, many have seemed to brush of this disappointing data and continued their January rally. So far this month, the S&P 500 is up 3.3%, while the EuroStoxx 50 is up 3.5%. The Hang Seng Index has climbed 3.1% and the broad MSCI ACWI is up 2.6%. There are some important exceptions, as indicated by the MSCI Emerging Market Index, which is up just 0.8% on the month. But much of this underperformance is due to idiosyncratic political risk in countries such as India, Turkey, Brazil and Russia. Is the market seeing through this macro data and expecting growth to rebound, either due to a pickup in demand or possibly more accommodative monetary policy?

The rally looks to be fragile and driven by technicals

Looks can be deceiving, and we believe the recent equity market action is a good example of this tenet. By taking a few different perspectives and examining a broader universe of market data, it looks to us like this rally has less to do with macro fundamentals or repricing of growth and more to do with positioning and thin liquidity. In particular:

- <u>Cross-asset</u>: While equities have rallied strongly, other growth-oriented assets like credit have been largely flat. For example, the Barclays US Corporate High Yield Index is up just 1.2% while their Investment Grade Index is up 0.3%. Baa spreads are essentially flat on the month. Indeed, our market-pricing based growth factor, built from a principal components analysis on cross-asset returns, has been treading water since mid-January, suggesting the equity rally is not being driven by a broad growth repricing.
- <u>Positioning</u>: Looking at implied equity betas for a variety of investors suggests that positioning remains relatively light with mutual funds, equity long/short hedge funds and risk parity funds all below or around their historical average beta. Interestingly, the largest changes in implied betas has been for Commodity Trading Advisors and macro hedge funds. Their beta has been negative over the year thus far, but moved sharply to 0 during the intial strong rally in early January and again this month, suggesting they may have faced a short squeeze and bought equities, further driving up the market. In the short term, equity markets may get a further boost as risk-based and trend-following strategies buy equities due to their lower volatility and February and December 2018 dropping out of momentum signals.
- <u>Flows</u>: After a sharp pullback from global equity long-term mutual funds and ETFs in December, flows to these funds have been essentially flat this year. Institutional flows also seem to have turned negative in the last few weeks, suggesting the rally is not benefitting from investors coming back to the market after the December sell-off.
- <u>Liquidity</u>: As indicated by the Hui-Huebel Ratio, a measure of the amount of volume driving price changes, liquidity in S&P futures dried up in December. It started to recover in mid-January but still remains very low from a historical

perspective. In Europe, the EuroStoxx 50 was up about 1% this week despite volume being about 35% below its 15-day moving average. In our view, this lack of liquidity is a key reason that equity markets have pushed higher and could be very problematic if there is a turn to bearish sentiment.

Until we see a turnaround in the macro context or the market align pricing to the data, we will maintain our cautious stance on growth assets for the medium term, as we believe the recovery in equity markets is not about underlying fundamentals, which continue to deteriorate and disappoint, but rather technical factors that could easily reverse.

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IMPORTANT INFORMATION