Weekly Strategy

Multi Asset Navigator

UNIGESTION

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Whiplash Metallica, 1983

The first quarter of this year has been an exceptional period for risky assets given their recovery from the previous quarter's sell-off. As we have communicated for some time now, we have serious concerns about the slowdown in global growth, which we believe has reduced the risk/reward of growth-oriented assets, even with the significant shift in monetary policy. The market rally has only made us more concerned as many assets now look to be pricing in an optimistic scenario that is at odds with the macro data and even other asset classes. We believe the upcoming corporate earnings season may be a key driver of asset performance over the next few weeks, potentially confirming the slowdown we have seen for some time and whiplashing markets out of their complacency.

WHAT'S NEXT?

A bumper quarter for risky assets is behind us

With Q1 2019 behind us, it is helpful to take stock of just how remarkable the recovery in risky assets has been. After selling off by 13% in Q4 2018, the MSCI ACWI index returned over 12% this past quarter (in total return terms). The S&P 500 index completely reversed its 14% loss, while the EuroStoxx 50 index did the same for its 12% loss. Looking at the S&P 500's quarterly returns since 1990, and excluding recessions and their immediate recovery, Q4 2018 was the third worst quarter, while Q1 2019 was the sixth best quarter. It was also the best quarter since the 2009 post-crisis recovery. In emerging markets (EM), the MSCI Emerging Markets index overturned its 7% loss at the end of 2018 by rallying just under 10% this past quarter. At the same time as equities rallied, the Barclays Global Aggregate index was up 3% (hedged to USD), WTI Crude rose 30% and the price of copper was up 11%. Even gold rose slightly at about 1%. Interestingly, the US dollar rose modestly against developed world peers, with the DXY index up a little over 1%. However, as proxied by the JP Morgan EM FX index, it spent most of the quarter down against EM currencies, before recovering strongly at the end of last week and closing out the quarter flat.

While we took a tactical positive view on growth assets at the beginning of the year, largely due to the valuation gap we saw in equities and credit, as well as metrics that suggested the December 2018 sell-off was overdone, we became more and more cautious as the quarter progressed. We have discussed our reasoning for why we believe the recovery is fragile at length already, but to briefly summarise:

- Global growth has decelerated consistently since early 2018, led by the developed world, and is now just below potential with few signs of stabilisation.
- Markets priced in a more accomodative monetary policy months ago, leaving little room for a dovish surprise. Indeed, recent statements by Fed members suggest a fairly neutral stance, not the dovish tilt markets are expecting.
- From a cross-asset perspective, investors do not seem to be repricing growth higher, as real rates fell even as the growth premium embedded in equities rose.
- Technical factors like low liquidity, systematic buying and short covering look to have reinforced the positive momentum in markets.
- Equity flows have been largely flat year-to-date, suggesting risk appetite may not be as strong as returns suggest.

Looking ahead, the corporate earnings season should tell us much

The earnings season for this past quarter is set to kick off over the next few weeks, giving a view into how the slowdown has affected the top line for firms and their resilience in supporting the bottom line. As a first step, it is critical to assess what market prices are discounting and compare that to one's own expectations. Regarding market pricing, our preferred measure is implied earnings growth, which uses the classic Gordon Dividend Discount Model to back out the dividend (and hence earnings) growth necessary to justify the current price. Looking at the MSCI World index, we see that about 10% of earnings growth is currently implied over the next year, while the MSCI EM index is currently priced to see earnings contract by 1%. But our picture for earnings growth this year is quite different. For example, a bottom-up aggregation of analyst earnings estimates has earnings growth for the MSCI World index at 2%, whereas the MSCI EM index is aligned with market pricing and expected to see earnings shrink by 1%. Our own calculations, based on the historical relationship between our proprietary Growth Nowcaster and earnings growth has the MSCI World index at 6% and MSCI EM index at 2%. This is part of the reason we prefer EM equities to their developed peers, as the former's pricing does not look disconnected from fundamentals and has room for an upside surprise.

There are additional reasons why we are cautious about equities as we head into this earnings season:

- Many investors are rightly concerned that we may be at peak profitability, especially in the US where profit margins have continued to climb and are the highest they have been since 1990. This is especially concerning as operating margins, which exclude the impact of taxes and hence the corporate tax cut of 2017, have been flat since mid-2017 and remain close to their post-1990 peak.

- Firms have been strongly reducing guidance, with more than 140 firms in the S&P 500 index already reducing their 2019 EPS guidance this year, of which 67 reduced it by more than 2%. Many of these firms are in cyclical sectors, which are likely feeling their top line pinched.

Given that market expectations look to be outstripping the macro reality, a bumper quarter for equity returns is already behind us and there are few supports for increased profitability, we are concerned that equity returns will see asymmetric downside during this earnings season, with firms missing their estimates selling off more strongly than those beating rallying higher.

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