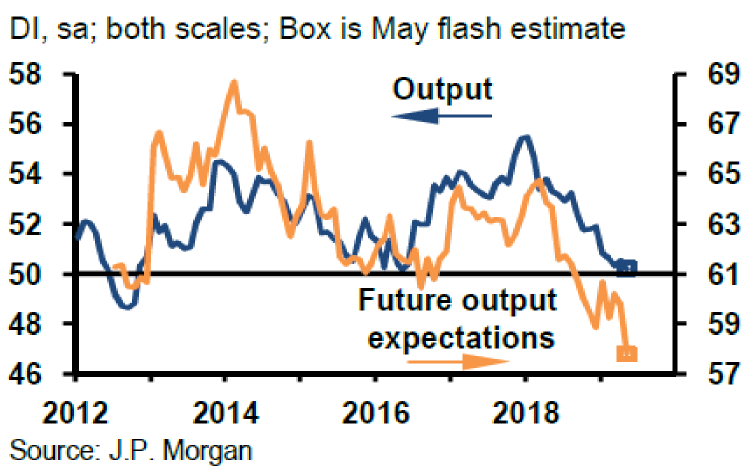
Conflated, Confused, hopefully not Concussed

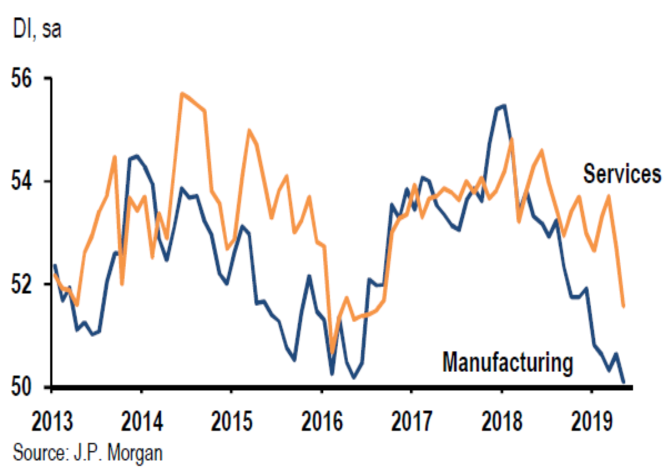
We downgraded Equities steadily from Overweight at the start of the year where we premised our bullish views on the low probability of a recession coupled with significant valuation support across many asset classes, particularly in the EM assets, to Neutral in March as the sharp rise in asset prices have gapped any valuation arbitrages. In our last month edition, The Tariff Man Strikes Again, we further downgraded Equities to Underweight drawing concerns that the manufacturing economy has already entered into recession and valuations are at best fair to steep for some asset classes but avoided postulating an outright bearish view of the global economy because the services economy remains stable. However, the latest readings on the services economy portend to possible weakness ahead and should this unfold, the view we had at the start of the year where the risk of recession is low will be increasingly challenged.

Back in March edition, Show Me The Money, when we downgraded Equities to Neutral, we commented the manufacturing sector has already slipped into contraction as indicated by the key PMI-Manufacturing surveys dipping below 50. The latest readings in May have slipped further with the addition of another sub-survey, the employment survey in manufacturing, falling below 50 in at 49.9 while the surveys on new orders, investment goods and intermediate goods remain below 50. It is worth pointing out that the surveys were conducted after the elevated tension between US-China but before the latest development of US threatening Mexico with tariff in exchange for a curb in illegal immigration. The composite of PMI-Manufacturing at 50.1 is now at its new lows since 2012. Furthermore, forward sentiment as measured by the Future Output Expectations survey has slipped below Europe's existential crisis low of 2011-2012. As expected, the global capex proxy we have been monitoring has now slipped to negative growth truncating a short-lived capex recovery from 4Q16 to 1H18.

Manufacturing PMI pointing to further weakness

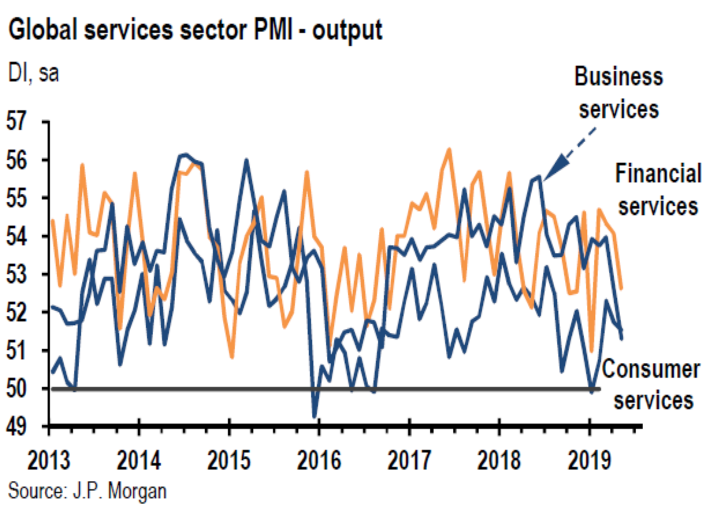


Services PMI is now following Manufacturing decline

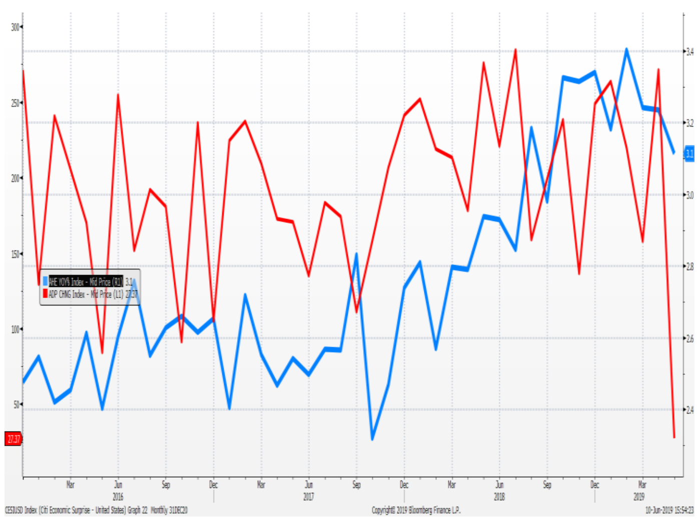


Our call throughout the past few months of no recession has been predicated on the continual strength in the services economy, which is the larger part of global engine accounting on 64% of global economy (80% in the US and 54% in China and that representation is rising quickly), in contrast manufacturing accounts for 31%. We also expect employment opportunities to continue to grow and we certainly lean on a US trade policy that centers on rebalancing deficit and not a trade policy that conflates electoral promises with trade imbalances nor not a trade policy designed to contain other regional superpowers while retaining US hegemony. Though for the latter, we did write in May 2018, the ingredients for potential confrontations between the US and China are ominous and could denigrate beyond trade in the Thucydides Trap. Since last month, the incoming data is seriously challenging our sanguine view that the service economy will provide the ballast needed to stabilize overall growth even as manufacturing retrenches. The latest Services PMI has slipped 1.1 pts to 51.6 putting it at the lowest level since 2016. Under the hood, the various sub-surveys within PMI-Services are worse than the headline. All the three services sub-sectors, the business services, financial and consumer surveys fell in May. This week's US May report jobs send a chilling signal corroborating our concern the service economy could begin its slide from hereon. US May job reported only 75,000 increase in nonfarm employment last month, well short of expectations of 175,000 increase and it also included downward revisions for the previous two months by another 75,000 jobs. While the decline in jobs creation in the government was expected, it is the sharp slowdown in growth in both manufacturing and services industries that presents a clear concern as private sectors account for more than 80% of total employment. Accompanying this report, we also see US wage growth has peaked in Feb and has been on a downtrend since.

All three services PMI slipping in past few months

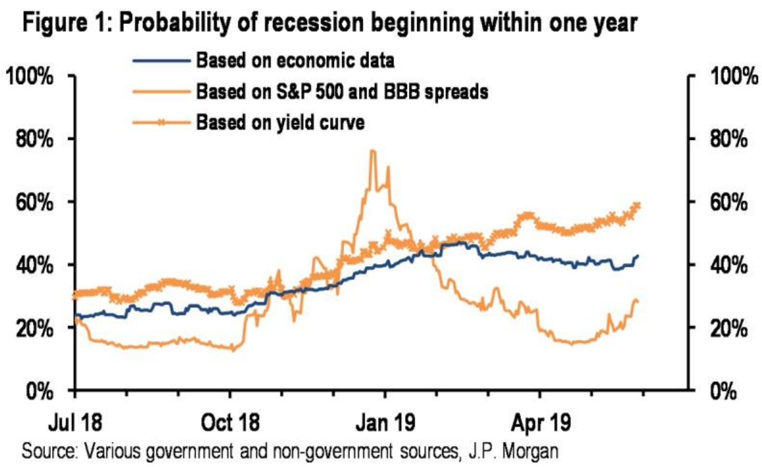


US Employment (Red) declined sharply, Wages (Blue) peaked

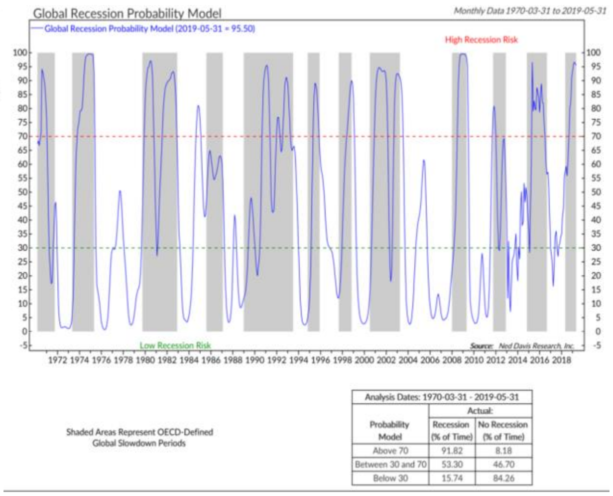


As the metastasis of a recession builds, it is not surprising recession prediction model from various firms are signaling a higher probability of recession or the least a slowdown in the coming 12 months. JPM's recession model is back to January's high at 40%. In our 2019 strategy piece, The Dreaded "R" Word, we shared that JPM's signaling efficacy of predicting a recession within 12 months improves when it is above 40%. Similarly, Net David Research model shows probability of a recession and certainly a slowdown is very elevated now.

JPM Recession models have picked up

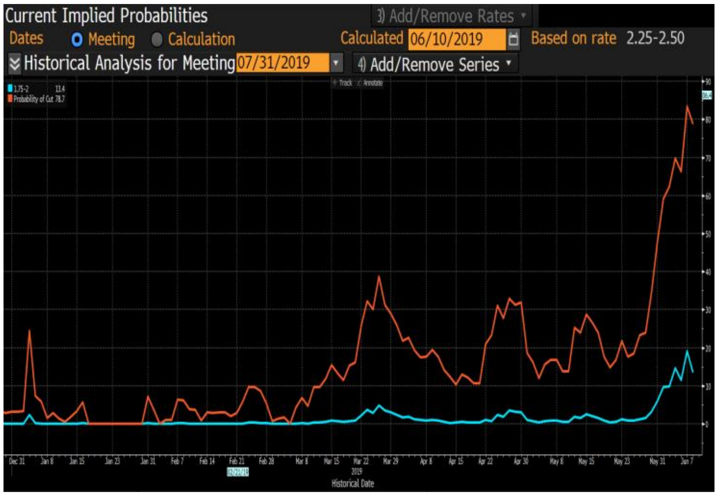


NDR model shows an elevated risk of slowdown/recession

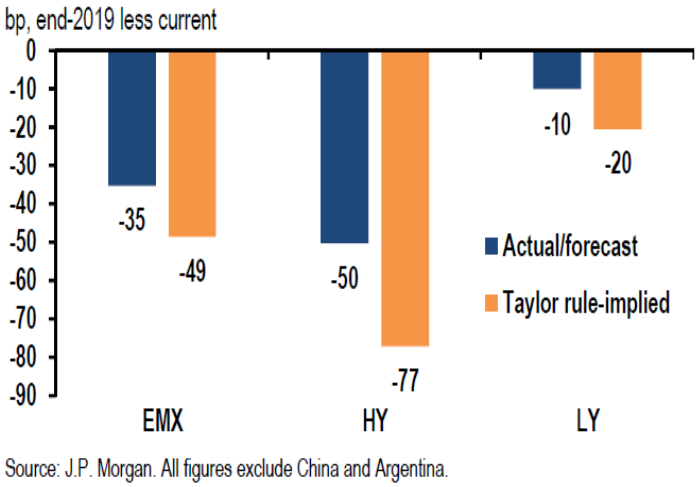


The weakness in manufacturing sector appears to be spilling over to the service sectors coupled with a trade narrative as confusing and bellicose as it has been, it is no wonder market is now expecting the economy to slow materially. IMF has recently lowered its 2019 forecast from 3.5% to 3.3% but have kept its 2020 forecast of 3.6%. We doubt 2019 forecast will be met and the 2020 forecast is riddled with too many unknowns. 2Q19 nowcasting is tracking only 2.3% and if we add back 1Q19 growth of 2.9%, it implies 2H19 growth will have to come in at 3.4% per quarter, which is very unlikely unless we have a trade deal between US-China. Not surprising, the market is pricing 80% probability (orange line in bottom left chart) Fed to cut rates by July and 32% chance (light blue line) an additional cut by December. The expectation of Fed easing is not unwarranted given the US core PCE inflation is running way below Fed's target of 2.0% at 1.62% in 1Q19. In the past quarters, several Fed governors have also articulated their preference for a temporary overshoot in inflation. If the Feb eases, it will also provide some respite for many countries to pursue an expansionary monetary policy. If we based off Taylor's rule, there is the scope of EM countries to ease as much as 49bps from now till year-end with high yielding counties easing the most.

80% chance of first Fed cut by July



Other EM central bankers likely to follow Fed's cut



Equities: Underweight. Looking at past Fed cut cycles from the Volcker era in the 1980s till current, equities tend to generate positive return unless the cuts by Fed could not stave off an impending recession, with 1984 as the only exception when the economy deteriorated further but S&P still managed to generate 14% positive returns. 67% of the time when Fed cuts, S&P returns are positive with median and average returns of 14% and 9% respectively. The only 3 occasions when the SPX registered negative returns post-Fed's first cut were in 1981, 2001 and 2007 which also coincided with the economy slowing even further 12 months after Fed began its easing cycle.

S&P past performances post Fed first rate cut

	20/5/1980	28/4/1981	2/10/1984	19/10/1987	29/10/1990	6/7/1995	29/9/1998	31/1/2001	31/10/2007
Reasons for cuts	Volcker Inflation fight	Volcker Inflation fight	High unemployment and slowing growth	Black Monday crash	Saving and Loans Crisis	Slowing growth	LTCM Crisis	Dot Com Bust	Slowing US housing
GDP Change 12 mths after	5.10%	-2.00%	-4.30%	1.90%	-2.10%	1.30%	0.60%	-5.60%	-6.60%
S&P 12 mths return post first cut (%)	29	-7	14	14	17	23	23	-12	-18

Source: GS and Bloomberg

There is wide sectors dispersion of returns during the first 12 months of a first Fed cut. Staples, Consumer Discretionary and Materials have the highest episodes of positive returns though Staples is the only sector that generated positive returns in all seven episodes where we have breakdown of sectoral performances. It also has the highest average and median returns during this period. The next sector that has performed well is Consumer Discretionary with 86% positive returns and median/average returns of 14% and 11%. Surprisingly, a defensive sector like Utilities fared poorly with only 57% positive returns and relatively lower median/average returns of 11% and 3%. Not unexpected, Info Tech whilst has 71% of positive returns, it has the lowest median and one of the lowest average returns profile. The empirical data provides important positioning cues. If you are in the camp that we are heading to the next big recession, Staples are the best and only sector to own, Utilities and Info Tech are to avoid. Alongside Consumer Discretionary, we would also consider Healthcare a sector to own given the structural trends of aging demographics, rising affluence, increasing mortality and advances in medical science providing us ample of opportunities to invest in this structural wave. We are actively exploring a third-party manager that we can capitalize on this view.

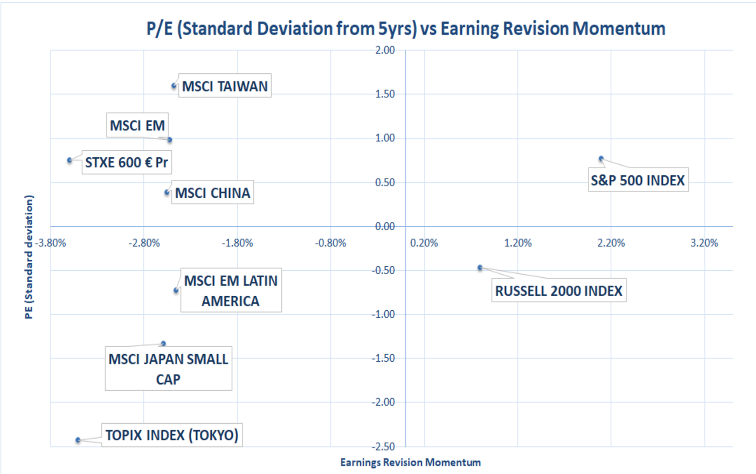
Past S&P sub-sectors excess returns post first Fed Cut

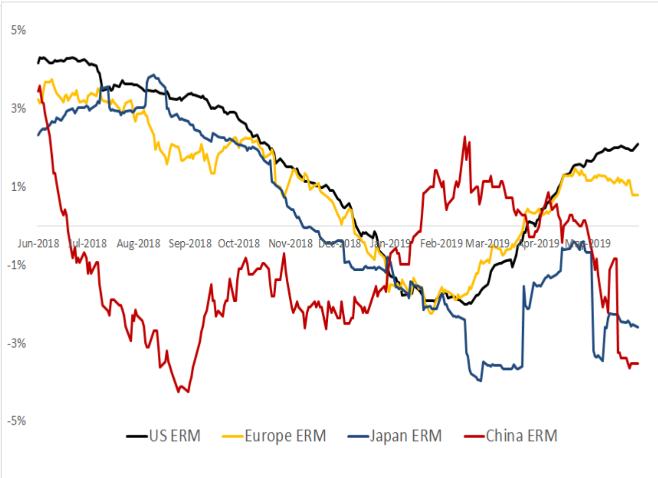
Positive return (pp)	2/10/1984	19/10/1987	29/10/1990	6/7/1995	29/9/1998	31/1/2001	31/10/2007	Median	Average	% Positive
Healthcare	29	10	26	38	-3	-9	-12	10	**11**	71%
Staples	22	22	30	27	7	0	7	**22**	**16**	**100%**
Industrials	14	13	18	42	25	-6	-19	**14**	**12**	71%
Energy	7	15	23	24	12	-9	-11	12	9	71%
Discretionary	14	26	11	15	26	1	-19	**14**	**11**	**86%**
Financials	18	13	5	29	10	-11	-40	10	3	71%
Materials	12	20	8	2	14	6	-8	8	8	**86%**
Utilities	23	12	15	11	-5	-24	-13	11	3	57%
Comm Services	22	12	15	16	36	-15	-25	**15**	9	71%
Info Tech	0	-3	9	10	71	-26	-18	0	6	71%

Source: GS and Bloomberg

In terms of regional preferences, we prefer markets where valuation is not expensive relative to its 5-year history and is experiencing positive earnings revision momentum. This leaves us only with the US markets as the rest of the other regions are experiencing negative revision in earnings in the past 1.5 months.

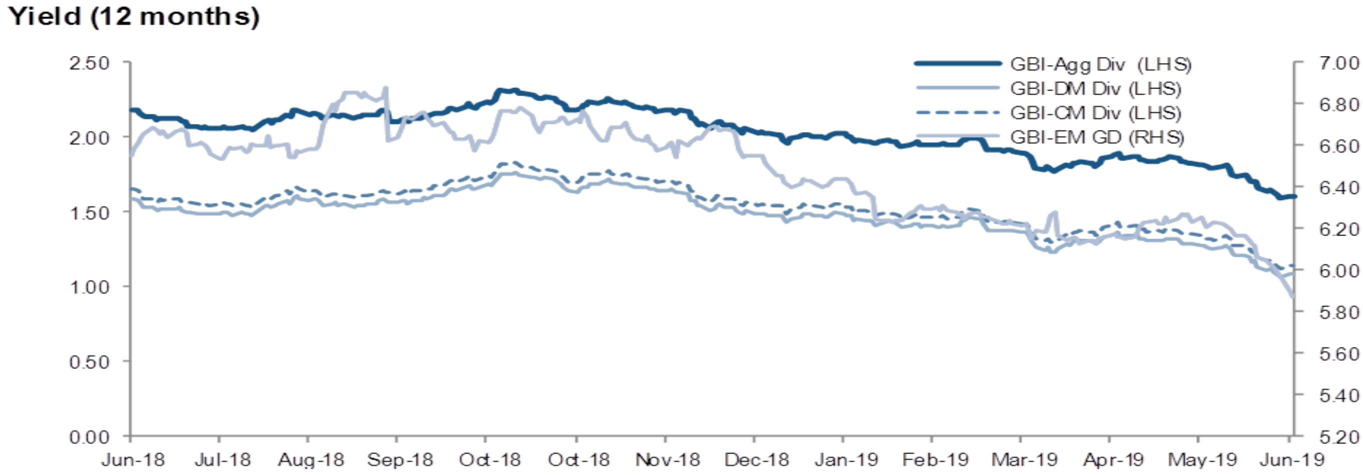
Only US equity markets offer valuation support and positive earnings revision momentum





Fixed Income: Remains Neutral because the compression in spreads on the back of central bankers easing belies the risk of a sharp economic slowdown that may be beckoning. While we have added Government bond in recent months, they merely serve as a portfolio hedge as 10% of the global sovereign market are yielding negative returns. The aggregate yield as measured by the JPM GBI Index now hovers at only 1.3% while EM yield is 5.90%, levels that take it back to 2017 lows when US ten-year yield was at 2.10% to 2.30% versus current 2.12%. There is simply not enough cushion to own high yielding debt at current levels. Our focus will remain using Govies as hedges, tilting the portfolio to investment grade debt while extending duration slightly for such high-grade debt. Our high yield debt exposure is limited to shorter duration or to managers that have exhibited discipline in risk control during the difficult period of 2018.

Just not enough cushion to hold corporate debt.



FX: Ambivalent at best! The direction of USD will have an inordinate impact to the rest of the world attempts to ease their monetary conditions. While our analysis indicates the rest of the world will likely ease in tandem with the Fed and therefore should provide a good bid for EM assets classes especially for EM Bonds, if our worst case scenario of deteriorating service sector ensues, the dollar smile and flight to quality will kick in again like it did in 2008. We will have to monitor USD carefully though our fundamental analysis does suggest moderate dollar weakness in the short-term as the Fed looks to ease against a weakening US economy.

Commodities: Neutral with Gold as a safe-haven hedge. We maintain our view that Oil will see a deluge of supply when US pipeline is de-bottlenecked in 3Q19 and will be exacerbated by weakening demand dynamics.

Alternative Investments: We have recently added an event trader that have shown consistent returns that are not correlated to the overall equity markets. This serves as an important diversifier to our Global Anchor Portfolio *(speak to your advisor if you want to understand more)*

Cash: We intend to hold larger than normal cash level and will use options opportunistically to hedge or enhance returns.

Featured Picture/Quote:

The first ever movie Charlie Chaplin spoke. [The Great Dictator (click to watch)]

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