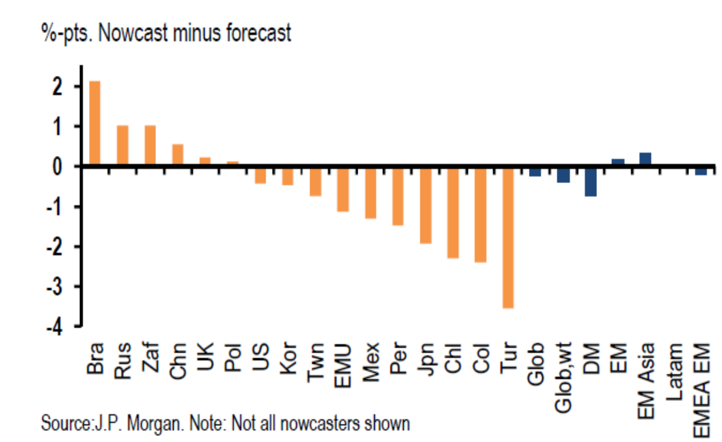
When Doves Cry

In our 2019 investment strategy, The Dreaded "R" word, we quantified the risk of an pending recession in the next 12 months as low, suggested what are the factors that have led to nearly all major asset classes having negative returns in 2018, and postulated that many of these factors inordinate adverse influence on the market will reverse in 2019 or at the least, their pernicious effects fade. We were expecting gradual mitigation of these factors throughout the quarter but certainly did not expect the confluence of many positive developments so early on in the year. What was then the worst December stock market performance since the Great Depression came roaring back to the best January since 1987!

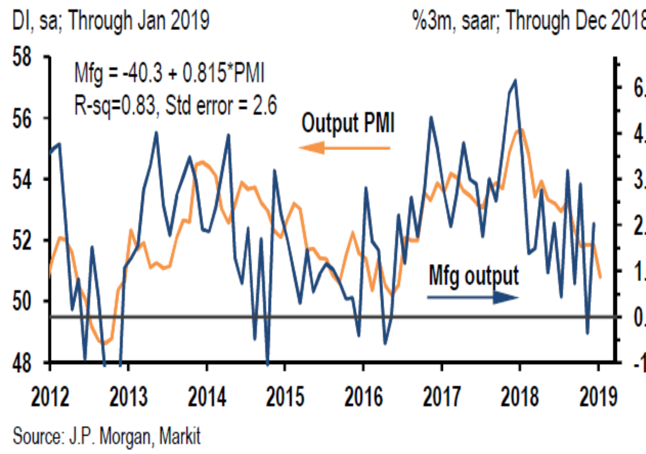
The four factors affecting stock market sentiment last year were (1) US exceptional economic, earnings and interest rate momentum vs insipid data from the rest of the world, which led to (2) strengthening of the US$ and was exacerbated by (3) US-China trade tensions and (4) the possible negative impact of Quantitative Tapering (QT) on asset prices. Of the four factors, the most important development in January was Fed's 180-degree pivot from its auto-pilot QT and its continual hike in rates to now a data-dependent response to the shrinkage of their balance sheet and further rate hikes. While the US and China appear closer to a trade deal has also lifted sentiment further, we remind readers that most of the investment strategies articulated here will be up-ended if no trade deal is done because the global economy will slip into recession with China bearing the largest brunt of the fallout.

For this edition, we focus on the implications when Fed pauses or subsequently cut its policy rates. It is paramount to establish why we think the Fed should indeed pause; a point we have made in the past editions. Since 4Q18, economic growth has weakened materially. The latest Global Nowcaster points to 1Q19 GDP growth at only a 2.4% ar pace. This is a major step down in momentum after a blistering 2018 full year growth of 3.6% and from 4Q18 estimated growth of 2.9%ar. It is also tracking behind the full-year 2019 growth forecast of 3.3%. Industrial activity, whether represented by hard data or forward surveys collaborate to this downward shift. Industrial production is now tracking at just only 1% ar growth in sharp contrast to 3.8% in 2017 and 3% in 2018. PMI output has been falling every month since peaking 3Q18 and the latest reading is at a marginal expansionary level of 50.8. Our capex story advocated in early 2017 and throughout 2018 has but stalled. The latest JPM global capex proxy is tracking close to zero growth after a sterling 5% to 10% growth in 2017 and into 3Q18. Many companies have pulled back their capex plans in view of significant disruptions to their supply chain the trade tensions have wrought.

1Q19 nowcasting coming in lower than forecast across the board

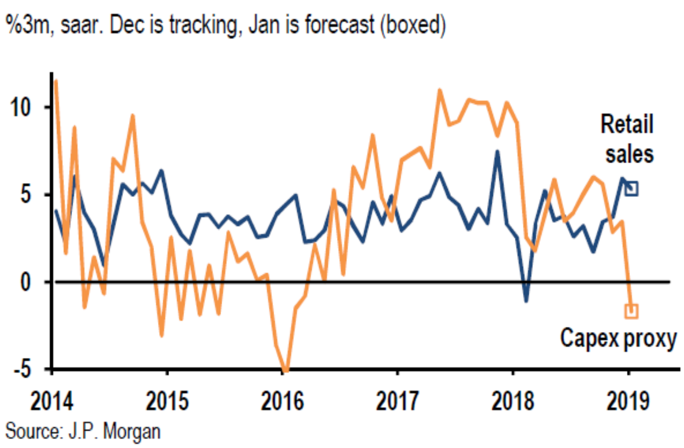


Slowdown in manufacturing is the culprit

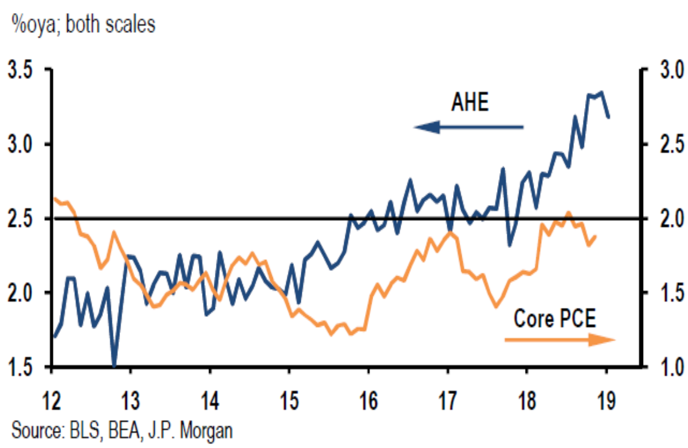


However, we are not convinced the current slowdown in manufacturing stems from more sinister and medium-term structural impediments such as lower corporate profitability, weakness in consumer spending and unfavorable global demographics. We contend instead this slowdown is a very much a sentiment induced weakness caused trade provocations and political impasse. Global retail sales proxy is still tracking at a strong pace of 4% to 5% throughout 2018 and into 1Q19. In fact, the 4Q18 global sales was the strongest gain for the year at 4.5% ar. This strength in retail spending is underpinned by full employment in many regions and rising wages for some economies. We believe the current divergence between strong retail sales and weak manufacturing output will be narrowed by 2Q19, provided there is a de-escalation of trade tension between the US and its other trading partners. The ongoing US-China and US-ROW auto tariff negotiations are particularly critical to this view and we need to constantly and accurately mark-market this view.

Global retail sales remain strong even as capex weakens



Inflation never rose above target even as wages rose



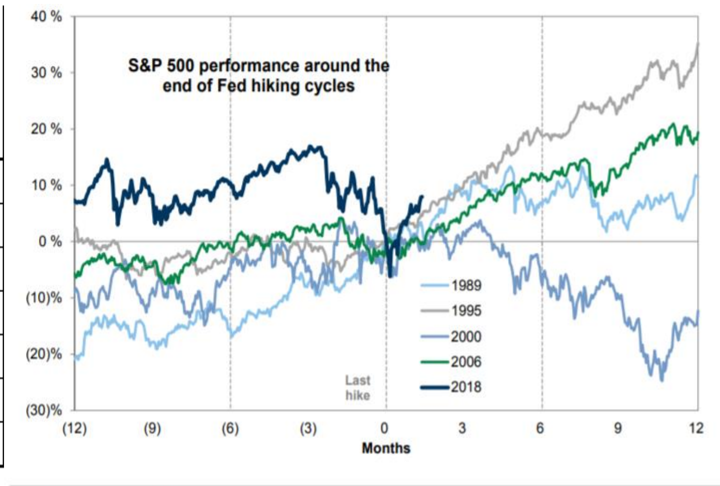
The second reason why we contend Fed pausing and engendering flexibility in their balance sheet unwind are appropriate is because Fed's measure of inflation, whether it is Core CPI, PCE, and UIG, never rose above Fed targets throughout 2018 despite a strong economy, record low unemployment rate and roller coaster oil price rise of 30% at in the first half of the year. In fact, we are now expecting global inflation to weaken in 2019 especially acutely in the first half of the year due to optical effects of higher comps, the widening of output gap, and the decline in food, agriculture and oil prices.

There have only been four occasions in recent economic history has the Fed pivoted from its hiking cycle either via a pause or a reversal in favour of rate cuts. They were in 1967, 1987, 1995, 2016 and of course now. We analyzed what happened across various asset classes during these occasions. Equities (as measured by S&P) rebounded by 10% 6 months post pause/cuts, US investment-grade credit spreads tightened by 30bps while the Dollar index fell by 3% and Gold rallied 3%. Within equities, value consistently outperforms growth by as much 3.8x better while dividend strategies outperform non-payers but not as much value versus growth. Small caps vs large caps difference in performance is less obvious on these various occasions. If past is our guide, equities have more room to rise than bonds, Short the Dollar and Long Gold is a good commodities pair, and dividends payers vs non-payers, small cap vs large caps performances have yet to even follow historical precedents.

What happens when Fed pauses or hiking cycle ends? More to go for equities and further weakness for US$

	Historical Performance 6 months after (1967, 1987, 1995 and 2016)	Current bounce
S&P500	10%	2.7%
US High grade credit	30bps	4bps
Dollar Index	-3%	0.6%
Gold	4%	0.2%
Equities growth vs value	3.8x	2.1x
Dividends vs non-payers	0.4x	-0.20x
Small vs large cap	0.5x	-0.12x

Source: JPM and NDR



Source: Goldman Sachs Global Investment Research

The sectors that performed well were Material, Energy, and Communication Services. They not only have decent gains but have high probability of positive returns. It is worth noting the rally can however sustain further should the current Fed pause migrate to cuts in interest rate. In such a development, sector leadership alters to Financials, Healthcare, and Consumer staples instead. The interest rate futures market has now moved from 1 hike in late 2019 in early January to no hikes for 2019 and a 25% probability of a cut by Jan 2020. However, this is not our base case scenario, we retained that there will be one more hike in late 2019 as our view that the current slowdown in manufacturing activity will eventually reconcile with a resilient services sector.

Sector leaderships can alter should current Fed pause turns to cut.

SECTOR PERFORMANCE AFTER LAST FED HIKE BEFORE PAUSE AND END OF TIGHTENING CYCLE					
PAUSE			END		
S&P 500 Sectors	6 Month Median Gain %	Batting Average	S&P 500 Sectors	6 Month Median Gain %	Batting Average
Materials	6.8	100	Financials	12.0	100
Energy	2.4	75	Health Care	11.8	71
Communication Services	0.3	75	Consumer Staples	16.2	57
Consumer Staples	0.8	50	Utilities	7.6	57
Industrials	0.5	50	Communication Services	7.6	57
Utilities	-1.8	50	Energy	6.1	43
Financials	-2.3	50	Industrials	5.2	43
Health Care	-1.0	25	Information Technology	1.0	43
Consumer Discretionary	-1.2	25	Materials	5.4	29
Information Technology	-3.5	25	Consumer Discretionary	12.4	29
S&P 500 Index	-0.7	N/A	S&P 500 Index	8.9	N/A

Real Estate sector excluded due to lack of history. End of cycle cases: 04/25/1974, 02/15/1980, 05/05/1981, 02/24/1989, 02/01/1995, 05/16/2000, and 06/29/2006. Fed pause = at least five months in between increases in the target rate. Pause cases: 08/14/1973, 11/01/1978, 12/05/1980, and 12/16/2015. Source: Dow Jones Indices

Ned Davis Research, Inc. T_IF19_03.2

Asset Allocation Strategy

With many asset classes swiftly recovering from Dec's low, we revert to the equipoise of a weakening macro-economic environment versus how much of that weakness is already priced into the valuations of various asset classes. We still believe the market is pricing too much risk versus economic realities. Using JPM regression model on the returns of multi-asset portfolio against PMI composite, there is still 10% disconnect that can be gapped quickly if US-China does conclude a win-win bilateral deal and/or the Chinese economy inflects as we are expecting by March/April. The additional risks we are monitoring include the expiration of the détente between President Trump and the Congress with regards to the wall-for-government funds and the renegotiations between the US and Japan/Europe on auto tariffs.

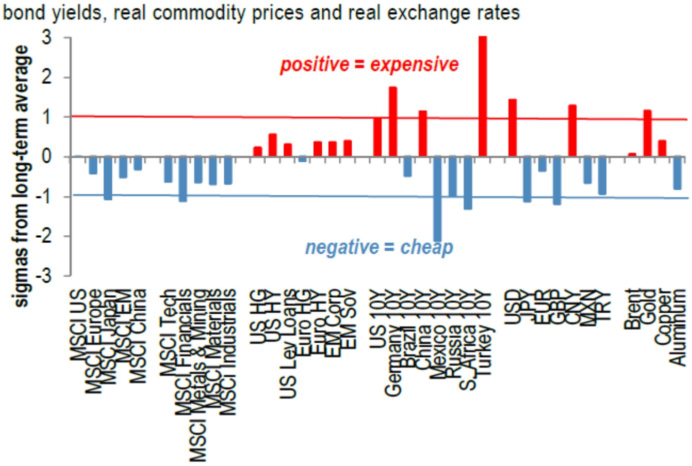
10% disconnect between markets and economic realities

Level of JPM global composite PMI versus year-on-year returns on a multi-asset portfolio of S&P500, Treasuries, US HG Credit, EM Local Bonds & Commodities.

Source: J.P. Morgan

Equities cheap, rates, US$ and Gold expensive, credits fair

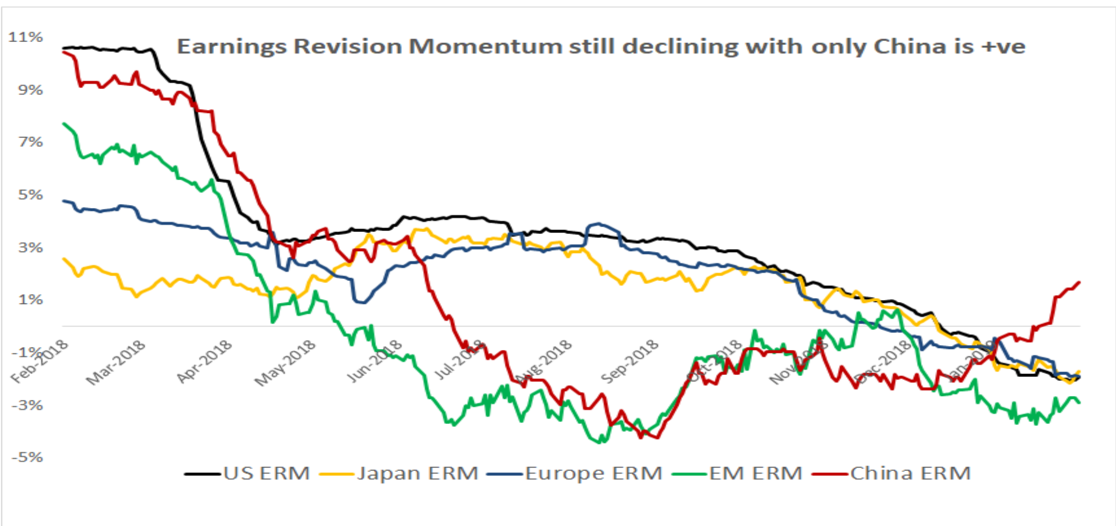
Deviation from long-term average for equity forward P/Es, credit spreads, real bond yields, real commodity prices and real exchange rates



Source: J.P. Morgan

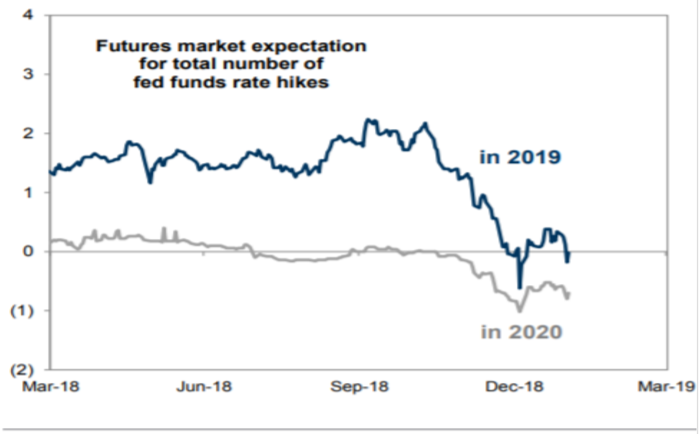
Equities: We been taking profit from our overweight view on Equities though valuations are still below its long-term averages especially in Japan, Tech and Financials. We are expressing our overweight views in Equities via options rather outright owning the underlying. Aside from Japan, EM Equities and Tech where we are currently overweight, we have also been building up our defensive sectors such as healthcare, utilities, and telcos. We have also enlarged our dividend portion of our portfolio via global REITs, insurers and selective dividend paying oil majors.

Earnings season so far has been mixed with 71% of US companies reporting better than expected results but that is in line with historical beats. The US EPS is growing at 14% yoy and surprising on the upside by 3%. Only 58% of Europe are beating estimate but their earnings season has only just started. Europe's EPS growth is only 4% yoy with just 1% higher beat from consensus. In Japan, 62% have reported and overall growth is weak at -5% yoy while surprising on the downside by -3%. Only 30% of Asia has reported with poor earnings growth at only 2% yoy, with just 25% of them beating versus 59% missing; Korea is the biggest reason for the miss while Chinese corporate results are not due till early March. Our ERM model continues to trend down with only China's seeing positive ERM. This bearish indicator is the reason why we are not an outright bull and prefer to express upside optionality and downside protection via call and put options respectively and are being nimble and trading more than usual.



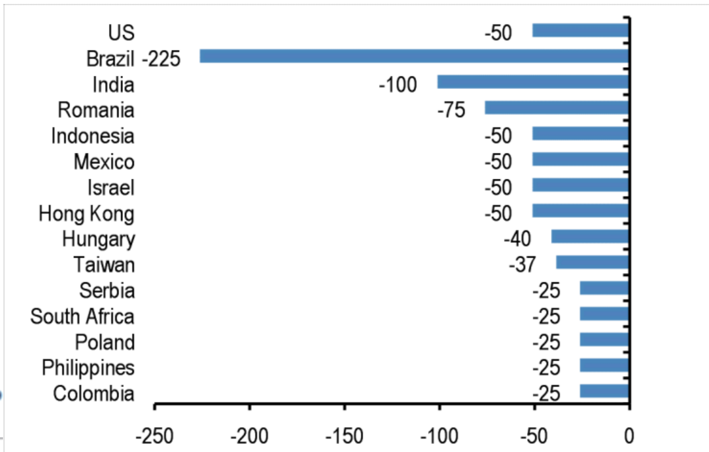
Fixed Income: Upgrade to Neutral but prefer equities over fixed income due to equities having cheaper valuation and higher potential of capital appreciation. Fixed income in the form of rates and credits have rallied quickly and remains expensive relative to equities. Even EM credit, where most of our fixed income exposure is now, have become less attractive. We remain selective in credits preferring EM debt managers that are total return-oriented while bar-belling with US Treasuries and an income-oriented but low volatility investment grade fixed income manager. We extended our duration risk particularly in markets where we believe central bankers' next move are to pause or cut rates. India, Indonesia and Australia stand out as those preferred markets. We continue to prefer investment grade over high-yield single issuers when we are selecting individual bonds.

Market pricing no Fed hike in 2019, we say 1 more



Source: FactSet, Goldman Sachs Global Investment Research

JPM see more EM CBs cutting policy rates now



FX: Expect USD to weaken as US exceptionalism fades and Fed pauses.

Commodities: Neutral. Our preference to express this sanguine oil view by investing in high dividend paying oil majors. We took profit on Gold, but we will look to add back on as a diversifier to a spectrum of risks such as an extended Fed pause, rise inflation expectation or bouts of global confidence crisis.

Alternative Investments: No new additions for now.

Cash: Cash level has been raised post profit taking on our equities and reducing our beta-oriented Fixed Income ETFs. We intend to hold large cash level as an alternative until political risk abates.

Featured Picture/Quote:

As an ardent fan of the royal Purpleness, this is my favorite track, Paisely Park, Prince. What is yours?

Admission is easy, just say you
Believe and come to this
Place in your heart
Paisley Park is in your heart

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Risk Disclosure

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