Mackenzie Multi-Asset Strategies Team

Q1-2019 COMMENTARY

Market Review

Equity markets rebounded significantly in Q1 after a tumultuous end to 2018. The MSCI ACWI Index returned 12.4% in local currency terms, the biggest quarterly gain since the rebound from the financial crisis in 2009. A more dovish sounding Fed and indications of progress in the China-U.S. trade talks helped propel markets. Similarly, bond markets also experienced one of the strongest quarters in years with the Bloomberg Barclays Global Aggregate Bond Index Hedged to CAD returning 2.8%. A global slowdown in growth alongside more dovish central banks resulted in lower yields and higher bond prices.

Outlook & Strategy

Swimming in Cross-Currents

A Bad Quarter for Growth, but a Good Quarter for Asset Prices

What a difference a quarter makes. 2018 was, by and large, a good year for the economy, at least in the U.S., but a bad one for assets. From fixed income to equities and commodities, there were few places to hide in 2018. Q1 2019, by contrast, saw strong performance for most assets – and especially for those which were hurt the most last year (e.g. Chinese equities or crude oil).

However, this positive first quarter occurred amid a notable slowdown in the real economy. The most obvious place where this is happening is the United States, which in 2018 was a bastion of strength in a decelerating world. Several U.S. economic indicators – notably manufacturing activity, housing and retail sales – have begun to point to a slower pace of expansion. Some indicators are now flirting dangerously with outright contraction.

The rest of the world, which led the U.S. on the way down in 2018, has not been spared this latest economic deceleration. Europe, a perennial pain point for the global economy, remains weak and is currently exhibiting recessionary conditions. Eurozone policy makers last year pointed to 'temporary factors' when attempting to explain the slowdown, but it now appears that something deeper has been going on in the single currency area. Germany's flash manufacturing PMI for March, at 44.7, is indicative of a relatively severe contraction in the country's export-oriented manufacturing sector.

So, we are faced with a dichotomy where assets have rallied in Q1, but where the economy has been weakening. What should we make of this?

Some Positive Changes from last Quarter…

The first element to note is that this coming economic weakness was partly priced in by markets. Asset prices tend to anticipate changes in economic conditions about six to nine months ahead of time. Therefore, what matters isn't so much what happens in the economy as what markets think will happen. So far, the growth figures do not appear to have been much worse than what was already discounted by markets given the poor equity market performance in Q4 of 2018.

For our part, the Multi-Asset Strategies Team moved to a tactical underweight position in equities in October of last year, as our analysis flagged growing risks of disappointments on the economy and on earnings. We have since moved back to neutral following the corrections, as we thought market prices to be more in line with a reduced pace of economic expansion.

An important positive factor has been the Fed's sudden shift to a more dovish stance. Fed Chair Jerome Powell's first year on the job was a little bit rocky, as he experienced a few communications mishaps. In October, he said that rates were "a long way from neutral". This spooked markets, implying that many more rate hikes were in the pipeline. Then, on December 19, he said that the Fed had its balance sheet runoff "on automatic pilot". This was horrifying for markets, suggesting that the Fed would not even consider adjusting its policy in response to weakness in the data! Following these communication problems, an important adjustment came on January 4, when Chair Powell walked back those comments, saying the Fed would be "patient". This sounds like a minor adjustment, but from our perspective, it was Powell's body language which emphasized the importance of his change of mind: he read

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his more accommodative comments from a piece of paper pulled out of his suit jacket. We interpreted this as an attempt to avoid yet another communications mistake by carefully reading prepared remarks instead of improvising. In our view, this meant – and still means – that rates probably won't rise above the neutral level in this cycle. Current market pricing is now consistent with Fed rate cuts later this year. This responsiveness by the Fed increases the odds of a soft landing in the U.S. economy, as opposed to a full-blown recession caused by too much tightening.

Finally, hints from the White House on the trade front seem to indicate that some progress has been made in the negotiations with China. Meanwhile, in China, we have also begun to note a push toward selective, targeted stimulus measures. The Chinese policy leadership is forced to grapple with a deterioration in the external environment and a slowdown in its main export destinations (North America and Europe). This is pushing policymakers to apply some domestic stimulus, bolstering Chinese markets.

… but Don't Get Ahead of Yourselves

Despite these positives, it isn't time to become euphoric just yet. First, it is worth taking stock of valuations. We analyze several valuation metrics across many markets, so no single indicator can summarize the entire evolution of valuations across equities. However, for illustration purposes and for simplicity, it is helpful to consider a simple forward price-to-earnings ratio on the S&P 500. After a tax cut-induced 'sugar rush', the S&P 500 was trading at 18x forward earnings at the start of 2018 – a high for the current cycle. It corrected to almost 14x by December 2018. Following the recent rally, we are now back to 16.5x. This is nothing extravagant, but it leaves less room for further improvements in case corporate earnings disappoint.

Another element which we think investors shouldn't ignore is the direction of the U.S. dollar. Emerging market currencies have shown some resilience in recent months, but the U.S. dollar has remained stubbornly strong against its developed market peers such as the euro and the yen. As an example, many investors would have expected the recent dovish Fed shift to push the euro much higher. It didn't. This is concerning, because 1) it highlights persistent economic weakness in non-U.S. developed economies such as the Eurozone, and 2) it squeezes companies and sovereigns which borrow in U.S. dollars. We have been underweight the euro against the U.S. dollar since last year for this very reason: we think the Eurozone economy is too weak to withstand any tightening by the European Central Bank. This remains our view. However, if the dollar continues to appreciate, it will represent a financial tightening for economies and markets.

Political risks also remain. There have been some recent indications that we are getting close to a deal between the U.S. and China on trade and sentiment has improved on this front. Any deterioration in tone from the U.S. or Chinese administrations would leave markets vulnerable to a reversal. With the Mueller Report out of the way, attention will now shift gradually to the 2020 U.S. Presidential campaign, which will highlight the deep divisions between the Republican incumbent and his Democratic challengers. Closer to home, the federal election campaign is approaching and the recent turmoil engulfing the Liberal government is likely to make the political news more volatile in the coming months.

Finally, the current soft patch in growth will need to bottom out at some point, or markets will need to revise growth expectations lower. Three scenarios are currently in play: 1) a 2016-like V-shaped rebound in global growth; 2) a 'soft landing' and stabilization at a lower level; or 3) slippage into recession. We do not think that the vigor of the 2016 rebound will be repeated, partly because China does not have the ability or willingness to stimulate as aggressively as it did then. Still, we view the country's current targeted stimulus approach as sufficient to allow the Chinese economy to experience something closer to an 'L-shaped recovery', or a stabilization.

The Elephant in the Room: Yield Curve Inversion

Another cause for caution is the current message sent by the U.S. yield curve, more specifically the spread between the 10y U.S. Treasury yield and the rate on the 3m Treasury bill. We just witnessed the first U.S. yield curve inversion since 2007, meaning that the 3m T-bill currently yields more than the 10y Treasury bond. This is typically interpreted as a sign of impending recession.

For this phenomenon to be more meaningful in terms of signalling a recession, the yield curve inversion would need to remain in place for more than just a few days or weeks. For example, if the Fed were to cut interest rates soon, the curve would probably re-steepen in response. This is similar to what happened in 1998, when the 2s10s yield curve spread (10y bond yield minus 2y bond yield) inverted briefly, but re-steepened in response to three Fed cuts. An equity market rally also ensued. However, if the Fed does not cut rates in response to recent economic weakness, the curve is likely to remain inverted, signalling a growing chance of recession.

The Bottom Line

These cross-currents are why, despite the strong performance of equity markets in Q1, the Multi-Asset Strategies Team is not adopting a more aggressive position in our asset allocation and are instead choosing to maintain a neutral position between equities and fixed income. We will be watching macro and market developments closely in the coming months and stand ready to adjust our tactical allocations in response.

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