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ECONOTE No. 81:Global equities and bonds: A simple guide for the bored and disinterested 28/2/2019

Summary	Investment Conclusions
This report is NOT meant to be the outlook for equities and bonds for 2019, but it aims to draw attention to some current trends arising from the terrible 2018 .The first, trend is the belief that we are now in a period of high interest rates, despite the fact that the Fed may have ended hiking and key EU and Japanese bond yields are still negative and with official EU and BoJ rates zero or negative. This widespread belief flies in the face of evidence, and is so naively US-centric, as to give credence to the notion that investors do not read the daily financial press nor bother to look at their screens. Secondly, the collapse of equities in 2018 seems to have reversed now, but the reversal is accompanied by metrics of G3 overbought and expensive markets so soon after the 2018 collapse. Whether this presages another collapse is a matter of conjecture, but urges caution.	Given our concerns over the post-2018 market recovery we remain very cautious on equities. The reason for the caution is that the interest rates markets do not point to higher inflation or stronger economies and the fact that Fed has now stopped hiking might be a warning of weakness than a sign of strength. G3 interest rates are unlikely to rise, especially official rates, but neither they may fall. Asian equities are still dominated by the next phase in China's cycle and its trade war with US. There are times when investment advice is boring and obvious, and this is such a time! **Neutral positions and no asset reallocation is recommended for at least the 1H.2019.**The only exception is our bullish stance on GBP, EUR, the EU and UK, with the UK staying with the EU, no Brexit.

Equites after the 2018 trauma against a poor macro outlook

Fig. 1 shows the sorry travails of 2018 and the recovery, so far, this year in the G3 equities markets. Similar experiences are recorded in all Asian and other EM markets with differing degrees of declines and subsequent rises.The G3 markets peaked around August 2018 and bottomed in December.As far as causes were concerned all the "usual suspects" were on parade: the Fed hikes, the US-China trade war, the weak state of the Chinese economy, ditto for the EU and for Japan.The strong performance of the US was not sufficient to keep the show on the road.As for the recovery, only one suspect is now absent and that is the US Fed which seems to have decided to stop hiking.The rest of the preoccupations remain.In Fig. 1 ,the S&P 500 (red) is above its 50DMA (first green line) and the first box of RSI shows it to be overbought.The S&P 500 curent P/E of 21.5 is well over its long term mean of 15.7, while the Shiller cyclically adjusted P/E reads at 30.6 nearly double its long term average of 16.6.The Nikkei 225 (yellow, second green) is also over its 50DMA and RSI(second box) is also clearly in overbought territory.As for the EU's SX5E (blue,third green line) the metrics are along the same lines, over the 50DMA and overbought (third box).However the P/E of the Nikkei at 15.9 and of the SX5E at 16.2 are less glaringly expensive compared to the US equities.The macros of the **US economy** have been strong, with GDP growth during the 4 quarters of 2018 clocking up qoq annualised at 2.2% 4.2% 3.4% and 2.6%.This was not much support to Fed hiking stance as the PCE inflation index ,preferred by the Fed ,peaked in July at 2.4 and fell for nealry half year to 1.7% in Decemebr, well below the "target 2.0%".And that has been one of the reasons that the Fed stopped, for now.**The EU economy** growth-wise did poorly in 2018 with four quarters at 0.4%, 0.4%, 0.2% and 0.2%, qoq annualised, with also inflation decelerating from a peak of 2.3% yoy in October to 1.5% in February.The inflation target of the ECB of 2.0% was also missed.

In the **Japanese economy,** the obsession with increasing money stock to accelerate inflation has not abated despite the Tokyo CPI staying, since 1Q.18, below 1.5% yoy, far from the 2.0% target, now reduced, which has never been consistently achieved since the BoJ embarked post-2008 in its accomodating monetary policy.GDP growth was shaky during 2018 with the 4 quarters at qoq annualised -0.9%, 2.2%, -2.6% and 1.4%.The **G3 central banks** are now nearer each other in their policies, with the BoJ loosening, the ECB having stopped QE but with near zero rates and the Fed on hold .

Fig.1: G3, Stock metrics, S&P, Nikkei and SX5E, 2017-2019

Source: Bloomberg,

Now for the interest rates

It essential to clear out first and for all, that the hiking period, 9 rises, of the Fed from Dec.2015 to date was not reflected in the actions of the central banks of the other G2 economies.The benchmark rate of the ECB is 0.0% while Japan's stands at -0.1%.The ECB has stopped buying bonds as part of QE but has indicated that it will roll over maturing debt thus not withdrawing liquidity from the market.As for the BoJ, it continues with its policy of maintaing 10Y Japanese govies at 0.0% yields. It now follows as a matter of fact that since Dec.2015 the world did not switch to higher interest rates.Far from it.The UST yields did increase and they do influence global rates, especially for countries with USD-linked exchange rates.The latter is now a vanishing breed with the exception of Hong Kong and, partially of China which controls the USD/CNY range by market action and capital controls.UST yields (red and mauve in Fig.2) have risen in the last three years but German bunds (light and dark blue) have stayed flat as have Japanese govies (yellow and pink).But far more importantly both Japanese and German 2Y and 10Y bonds yield range currently from a few basis points above zero to negatives ! As Fig.2 shows both the 2Y and 10Y Japanese govies show negative yields

Fact Box: Away from US-centrism. Here is China and the Asians

China's appalling equities performance in 2018, possibly the worse globally, has given hopes about its equities on the basis of the inverse Newtonian principle that "whatever goes down can also go up". The recent (March 2018) spate of reflationary measures, including VAT and social security tax cuts, extensive loans to SMEs, as well as the four PBOC cuts in reserve requirements during 2018, should boost the economy suffering a cyclical downturn and not from a major shock from the US tariffs, although these did not help. As for the rest of the major and minor Asians, their equities also performed poorly in 2018 and are now recovering, but, as always, macro performances are quite differentiated. Politics will also play a part, a major one in India with general elections during April-May and the Thai long-delayed and disputed elections to be held also at the end of March.

the German bunds yields are negative for 2Y and positive for 10Y.As a broad summary consider the following.Five major economies register right now positive 2Y yields, in order of magnitude, from China (2.63%), US, Australia, UK to Italy (0.38%). Nine other ecocnomies register negative yields, also in order of magnitude, from Germany (-0.57%), Belgium, Austria, Finland, France, Sweden, Portugal, Japan and finally to Spain (-0.16). Hardly a period of "rising rates" let alone positive rates, and this is not a matter of opinion or of the use of the English language, but the result of an obsessive US-centricity of commentators and of investors. What this tells us is that USD fixed income assets does have a differential yield attraction, which will now remain flat with the Fed not hiking and with the ECB and BoJ maintaining their very easy monetary stance and, definitely, not lifting rates. Interest rates in the rest of the world will depend on forex policies and not slavish dependence on the Fed.The AUD/USD, for example, has been kept weak by repeated cuts by the RBA in the official rate with no sign of relief yet.

Fig.2: G3 2Y and 10Y bond yields, 2015-2019

Source: Bloomberg

If in doubt, stay out.

What this melange of data, policies and trends tells us is that the recovery in the US economy has been strong in 2018 but was also associated with extremely poor equity results.It is easy to forget that strong macros do not make for strong equities.Doubts have now been rasied as to the sustainability of this high level of US growth into 2019, coupled with concerns over earnings prospects, the lingering doubts over the next Fed move and the end stages of the US-China trade war.As for the EU, the economy remains weak, politcal uncertainties remain (Brexit,Italian coalition government and Spanish elections in April) but at least the ECB is in no hurry to hike rates.China's economic cycle might have bottomed , and will be helped by the recent fiscal and monetary policy boost.Whether this will be sufficient to justify a recovery which undid one year of declines in less than two months, remain to be seen.Which brings us to fiixed income.Here the trend argues for neutrality as there will be no further hikes (the Fed and the rest) but no cuts either in a non-US enviromenrt dominated by negative rather than just low interest rates.The investment conclusions are hardly encouraging,there are no strong arguments to add to equities or fixed income assets and the USD is unlikely to strngthen if the Fed has now stopped for a long period.

However, we have long stood by our forecast that the UK will not exit the EU and will actually stay in, reversing the chaotic two year period of indecision over a catastrophic and ill-advised decision to leave.Post March 29th , the Brexit day, the outlook for the GBP, the UK economy, the EUR and the EU in general will improve remarkably and will stay bullish.

Andrew Freris (writing completed on 28/2 and revised 7/3)