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Marketing Material

A cycle like no other

The economy looks good now, the outlook less so. That's nothing new in this atypical cycle. Caution is warranted.

"Many leading indicators paint a gloomy picture yet services and consumption remain strong. The signals from the bond market are troubling – and political risks appear to be growing too. We remain cautious."

Stefan Kreuzkamp
Chief Investment Officer

What a good run markets are having! And why not? The labor markets in the U.S. and parts of Europe are extremely strong. So are corporate earnings, at least for now. Companies have solid balance sheets. Loan defaults remain rare. Oil is affordable. There's no risk of interest-rate hikes. And, U.S. President Donald Trump is always ready to talk to anyone – though quite a few people don't appreciate his well intended suggestions.[1] What more could investors wish for? Well, a few things come to mind. That starts with an array of disturbing warning lights flashing in front of us.

The most glaring of the warning lights is that the U.S. yield curve has inverted, which in the past has usually signaled an approaching recession. The U.S. Federal Reserve (the Fed) is clearly nervous – hence, it has already embarked on preemptive "insurance interest-rate cuts." In Europe, meanwhile, the European Central Bank (ECB) will probably adopt a whole new package of monetary measures in September, and new calls for fiscal stimulus are also doing the rounds. Another uncomfortable reality is that global manufacturing is making that nasty rattling sound you hear before the engine stalls. The overall economic situation is therefore not all that reassuring – as confusing perhaps as the messages coming from the U.S. President, who demands cheaper money from the Fed at the same time as boasting of a booming U.S. economy.[2]

It's not just the U.S. President who is struggling to reconcile the apparently good economy and the many warning lights on the dashboard. Complicating things still further for investors is that many don't have to think back very far to remember some very costly mistakes. Those who took heed of the warning signals in the past and got out of the equity market quickly lost out – because every setback since 2009 has proven just a brief pause in the enduring rally. This makes everyone more cautious now about predicting recession or saying the bull market is over; but even the bulls themselves are not suggesting that recessions have been banished forever.[3]

The troubling gap between the happy economy and the anxious mood is perhaps most powerfully demonstrated by the yield curve. In August, the spread between 2- and 10-year U.S. government bond yields went negative for the first time since 2007. This has happened nine times in the U.S. since 1956 and

1 In August, Danish Prime Minister Mette Frederiksen refused to accept Trump's request to buy Greenland. Fed President Jerome Powell also consistently refuses to fully comply with Trump's interest rate cut wishes.
2 See tweets from August 14, 23 and 24 for comments on the U.S. economy. See tweets from August 3, 7, 8, 14, 15, 19, 21, 23, 27 and 28 for comments on the Fed.
3 By recession we do not mean a technical recession in the sense of two consecutive negative quarters, but a longer term period of high unemployment and capacity underutilization.

recession has tended to follow, within two years. And yet we are wary of taking this historical evidence at face value and concluding that a U.S. recession is around the corner now. The factors (economic, political, monetary, technical and demographic) that provoked each previous inversion were somewhat different each time. The current inversion reflects especially unusual circumstances:

1. Central banks are distorting financial markets with their continuing pursuit of unorthodox monetary policies, such as quantitative easing and negative interest rates. One result is that bonds worth more than 16 trillion dollars now yield negatively worldwide – half of all outstanding bonds with investment-grade status outside the U.S. That clearly extorts downward pressure on long-term U.S. interest rates, which may reduce the predictive power of the yield curve.
2. The two largest economies in the world are locked in a trade dispute that shows no sign of ending.
3. That dispute is having global knock-on effects. As China focuses on stimulating its domestic economy, raw material exporters such as Australia, European machinery and car exporters and U.S. mobile-phone companies are all feeling the impact.

Worrying, too, is the recklessness with which many countries, and especially the United States, are driving up their national debt, and the rise of populist governments pursuing protectionist economic policies. How these governments might react in more trying economic times is a further concern.

There are, then, many good reasons to be concerned about the medium term, but we believe that it remains too early to talk about an imminent crisis. There is too much positive data, a reflection of the length of this already record-breaking upswing. One reason for that may be the steadily growing service sector, which does not have inventory and investment cycles as large as those of the manufacturing sector. In addition, the good labor markets mean consumers are still spending heavily. Finally, the slight economic slowdown we are experiencing reduces the risk of overheating and means central banks have again softened their policies.

For our investment choices this poses a dilemma. It might seem tempting to swing back towards risky assets, especially as we don't expect any further slowdown in global economic growth in the coming year. But the worrying signals from the bond markets – negative nominal interest rates in Europe, negative real interest rates in the U.S., the inverted yield curve – should not be ignored altogether.

In short, we remain cautious. We see low-single-digit return potential for equities, coming primarily from dividends. Our regional preferences are not strong. In the medium term, U.S. stocks might continue to outperform the rest of the world, as they have done for 10 years. But their premium valuation and optimistic earnings estimates make them vulnerable to setbacks. We do not think it wise to focus on equities simply because the alternatives are unconvincing. Now that positive surprises from the central banks are hardly possible, we believe only an improvement in broad macroeconomic data is likely to increase the price potential of equities again.

In bonds, we have lowered our target yields compared with the previous quarter and do not rule out further periods of falling yields. However, we expect interest rates to rise slightly over the next 12 months. At the moment, bond investors have little choice but to put their money into assets which still offer positive yields at an acceptable level of risk. In our view, these are investment-grade corporate bonds and long-dated U.S. government bonds. Selectively, we also like emerging-market bonds.

We don't see any major currency imbalances at the moment, despite all the political risks, and we keep our 12-month target of 1.15 dollars per euro. Should investor risk aversion increase, we would expect the yen to appreciate because of its reputation as a safe haven. The British pound, too, could appreciate if a disorderly Brexit is avoided, which is our central scenario. In the case of oil, we expect sideways trading. Gold may continue its recent rally, though less strongly.

Look at our forecasts to see our 12-month outlook in numbers.

GLOSSARY

Brexit is a combination of the words "Britain" and "Exit" and describes the possible exit of the United Kingdom of the European Union.

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

The euro (EUR) is the common currency of states participating in the Economic and Monetary Union and is the second most held reserve currency in the world after the dollar.

The European Central Bank (ECB) is the central bank for the Eurozone.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

Investment-grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

The Japanese yen (JPY) is the official currency of Japan.

Monetary easing includes measures such as lowering interest rates, implemented by Central Banks with the aim of facilitating GDP growth or inflation.

The pound sterling (GBP), or simply the pound, is the official currency of the United Kingdom and its territories.

Quantitative easing (QE) is an unconventional monetary-policy tool, in which a central bank conducts broad-based asset purchases.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The spread is the difference between the quoted rates of return on two different investments, usually of different credit quality

The U.S. Federal Reserve, often referred to as "the Fed", is the central bank of the United States.

A yield curve shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

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