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Omba Advisory & Investments Limited

On The Edge

Commentary on an Unfolding 2019

Following a large correction in markets in 4Q 2018 and a Hawkish Federal Reserve we've had an about turn into a strong 1H market rally and Dovish Fed…how quickly things can change!

Central bank policy U-turns, trade wars, leadership changes, national and supranational elections, critiques on Fed independence, a decoupling between bond yields and equity prices at all-time highs in key equity benchmarks and a recent wobble – 2019 continues to surprise and excite investors.

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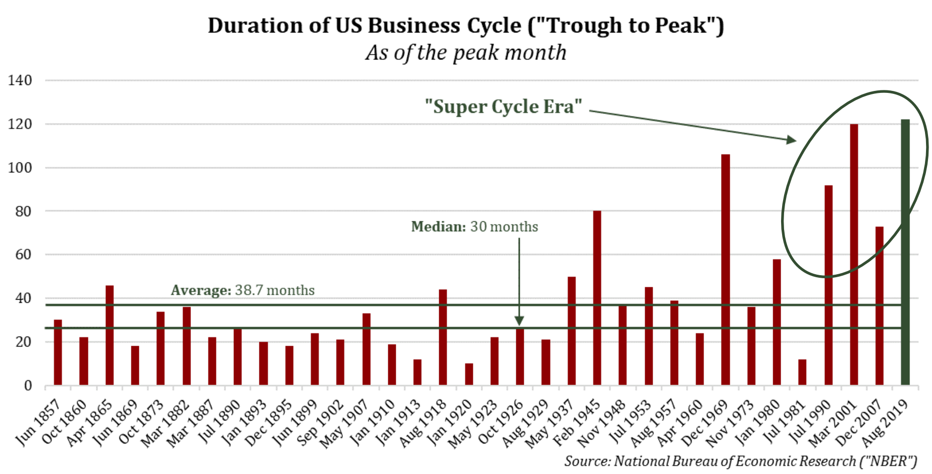
1. Introduction

Global financial markets have demonstrated strong 2019 year-to-date performance as part of a stark rebound from a meaningful fall in 4Q 2018. While many of the underlying causes for last year's crash remain front of mind – such as trade war uncertainty, signs of a global slowdown, and pockets of asynchronous growth – investors continue to ride the positive wave of late-cycle momentum. The continued expansion observed through 2019 suggests that last year's crash was simply a consolidation of investor exuberance and not an end-of-cycle omen – where a crash is typically followed by a "bear market bounce". Or was it simply a case of Fed watching? Hawkish in 4Q 2018 and then Dovish in 1Q 2019, so the party continues! Although we do not call for an outright economic downturn in 2H 2019, we want to highlight a few things that support our view of a softening global economy and increasing risks.

One key concern of late 2018 has now been alleviated: fears of abrupt monetary policy tightening through higher interest rates and the slowing / reversal of Quantitative Easing. We provide a succinct narrative of one of the most surprising evolutions of 2019: the reversal in global monetary forward guidance. As we highlighted in our **April 2019 India Outlook & Analysis** "we expect both EM monetary policy easing and EM and DM central bank policy convergence to be themes in 2019"[1]. This reversal has so far occurred as predicted, with 52 central banks cutting policy rates year-to-date whereas only 7 central banks have hiked – a very different story to 2018 when a total of 35 central banks hiked policy rates.[2] Most relevant to global markets is the increased flexibility signalled by the Fed and the ECB in the timing of their respective balance sheet runoffs, indicating they could remain supportive of looser monetary policy throughout the process.

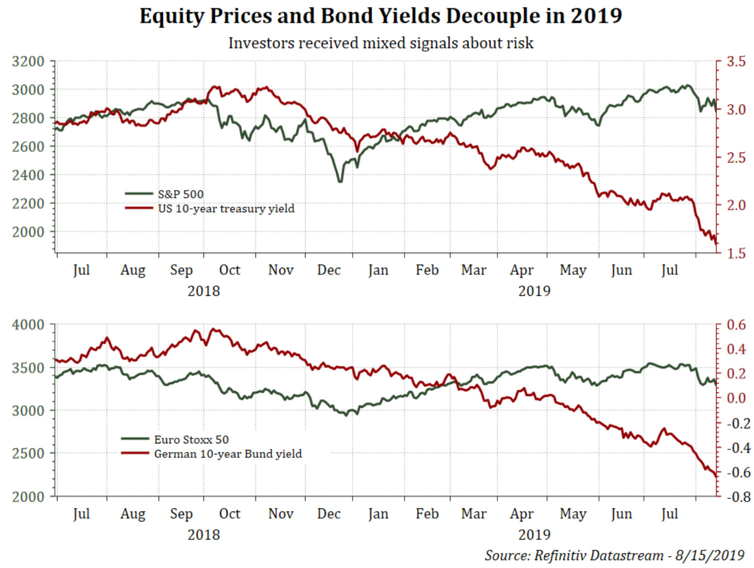
As of June 2019, investors triumphantly marked the longest US economic expansion on record and now enter the 122nd positive month since the end of the 2009 GFC, surpassing the 120-month growth period which burst with the 1999 dot-com bubble[3]. Since the 1980s we have seemingly been in the "Super Cycle Era" (the genesis of which is possibly tied to the end of the gold standard) and can be characterised as longer expansions yet more severe downturns; largely a symptom of credit fuelled expansion. As we precariously move into uncharted territory in terms of the age of the bull market, unseen levels of leverage across various sectors, and seemingly endless monetary policy engineering, we take a moment to reflect upon the tactical asset allocation of our portfolios, our thoughts on global credit and the relevance of the (peaking?) credit-cycle on the business cycle.

For now, it seems the party of higher global asset prices will continue, although we are increasingly wary of pockets of weak global growth and increasing leverage and thus prefer to position our portfolios in a defensive manner. We elaborate a little further on the relevance of the credit cycle in terms of having fuelled today's unprecedented growth and remind readers of the messy nature of an unwind.

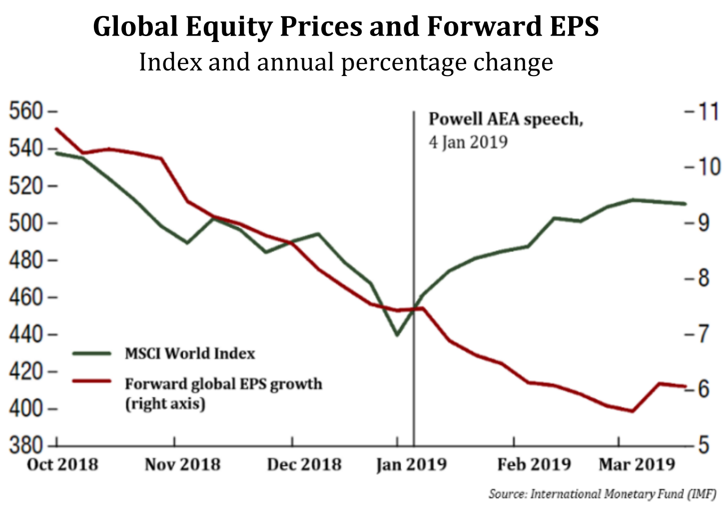


2. Growth Concerns and Bearish Signals

Despite the 4Q 2018 repricing of risk (i) bringing stretched asset valuations more in-line with fundamentals and (ii) driving a moderate tightening of credit conditions which temporarily helped to slow balance-sheet expansion of corporates around the world. Vulnerabilities to the global economy have increased since the start of 2019 as debt issuance and leverage ratios have rapidly picked up amid a softening outlook for corporate profitability.



Given the trend of downward revisions to growth and earnings forecasts, we see a continued expansion of global debt as a precursor to a bigger shock to the global economy, closely linked to ongoing trade tensions. Lots has changed since 4Q 2018 but most positively the risk of hawkish Fed policy shifted dramatically to a tone of dovishness in the first half the year, which supported a strong market bounce – particularly in the US. Once again, central bank policy is the main driver of market returns and not cheaper asset prices or booming growth.

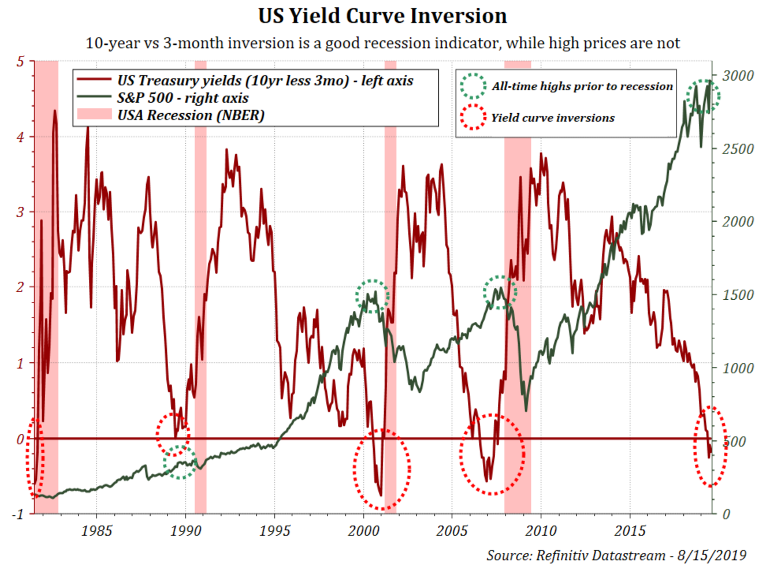


The IMF notes that risks in nonbank financial firms, and to a lesser extent banks and other non-financial corporates, across systemically important nations have all increased between 4Q 2018 and 2Q 2019[4], likely due to continued balance sheet expansion. As we have previously stated, without further yet moderate tightening of credit conditions, debt expansion will continue and the global economy will become increasingly exposed to risks of an abrupt downturn as corporate, sovereign, and household debt expansion continues to outpace fundamental economic growth. However, while a moderate tightening of credit conditions may improve long-term stability through a gradual balance-sheet consolidation, **tightening of credit conditions *occurring too quickly*** could also act as a downside catalyst for a recession in the global economy.

Investors today balance a variety of conflicting indicators in financial markets, such as equity prices trading near all-time highs – suggesting a healthy economic backdrop and stable earnings (or too much exuberance…?). At the same time US 10-year treasury yields have rapidly fallen to below 1.6% amid nervousness from investors and on expectations of further interest rate cuts, a policy tool usually reserved for full-blown recessions. Lower rates for longer means cheaper funding, which allows for further economic expansion. But some of the traditional relationships between asset prices and economic data can no longer be relied upon, such as what was experienced by investors at two of the recent Non-Farm Payrolls announcements (an important US employment figure). The S&P 500 was pushed 1.0% higher on the day of the 7 June 2019 data release, which showed weaker-than-expected jobs growth, as soft employment data spurred investors' hopes of that the Fed would deploy monetary accommodation to combat the weakening economic fundamentals. Similarly, the S&P 500 fell 0.2% on 5 July 2019 given the opposite expectations for the central bank, after a positive surprise in employment figures showed that the US added 224k jobs (subsequently revised down to 193k) compared to the 160k that economists expected. Below we discuss a few matters which are on the minds of many investors and which have come onto our radar as somewhat worrying and worth discussing as we form our view for the balance of the year.

2.1. Yield Curve Inversion

The US Treasury yield curve has been inverted since late May 2019, when the market priced 10-year debt at less than 3-month debt for the first time since 2007.



The inversion of the yield curve is arguably the most reliable indicator available for predicting a US recession within the next 12-18 months. Since the late 1960s, a US recession has followed an inversion of the 10-year and 3-month treasury yields 100% of the time (no false positives), whilst there has been only one recession which occurred without a prior yield curve inversion (only one false negative). The US yield curve has even been used to predict economic trends since the 1850s[5].

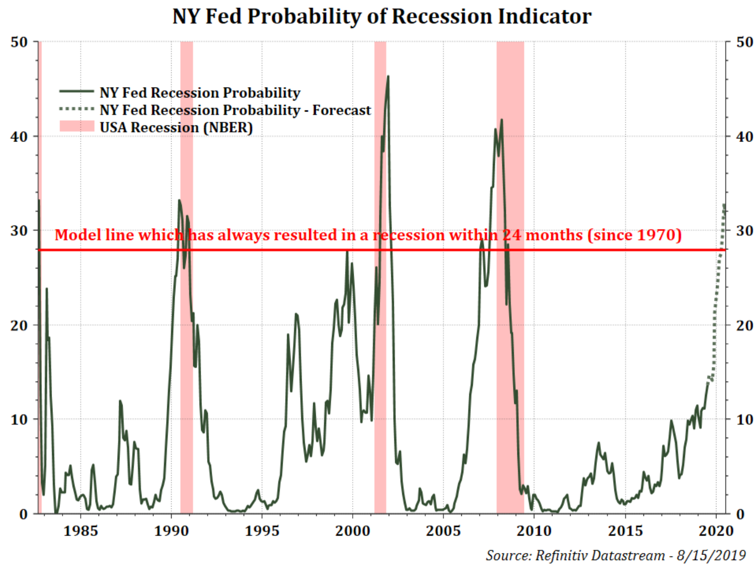
What we know definitively is that investors, in a flight to safety, are paying a premium in seeking haven in longer dated, high-quality government debt. As many risky assets are expensive on a valuation basis, this trend of safe-haven-seeking has kept German 10-year Bund yields in negative territory for much of 2019 as well as a further flattening across global yield curves.

There is an argument that "this time is different" partly because there are negative-yielding bonds in Europe and Japan and thus some of the additional bid for the long end of the US treasury curve comes from foreign investors. This has resulted in compressed term premiums and lower rates at the longer end of the curve. So, the argument goes, not only does the inverted curve not signal any recession, but the long end of the curve could be stimulatory for the US economy. Time will tell but we err on the side of the former theory that it forebodes a recession.

2.2. Federal Reserve Indicators and Slowing GDP

The shape of the yield curve is used in a variety of recession-predicting models globally and is used in at least three by the US Federal Reserve, such as the **New York Fed's recession probability indicator, which most recently suggested more than a 29% chance of recession within the next 12 months as of June 2019**[6]. The shape of the yield curve is being closely monitored by the Fed, with the majority of FOMC members likely considering it to be a relevant indicator[7].

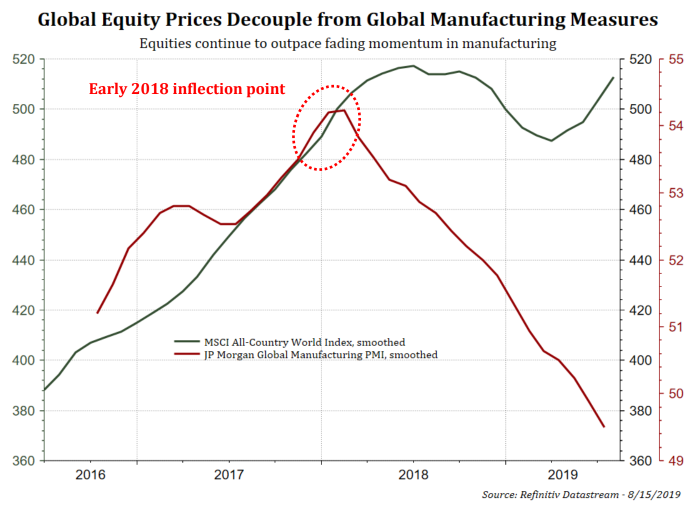
However, there are many conflicting arguments around the reliability of this indicator given the world of "ultra-easy" interest rates which, as discussed in the preceding section, suggest that depressed longer-dated bond yields may be the new normal given a lower term premium. While there is no clear consensus on any causal mechanism between yield inversion and tightening credit conditions, some argue that inversion reduces the ability for credit institutions to provide profitable longer-dated loans[8] - especially nonbank financial companies and shadow banks.



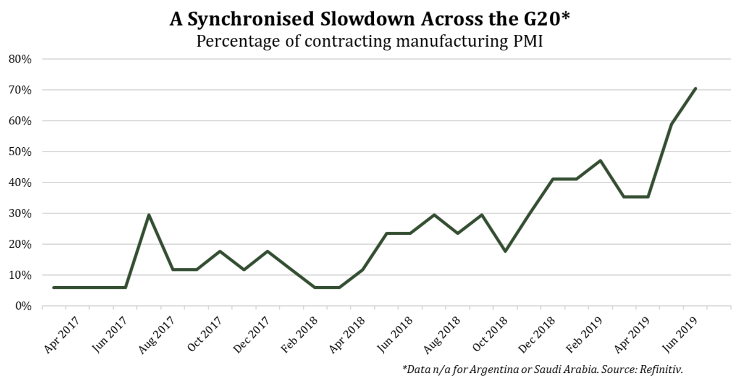
Other regional Federal Reserve indicators from the New York Fed and Philadelphia Fed also suggest a slowdown in general business activity and manufacturing (leading into our next chapter). **The New York Empire State General Business Conditions Survey recently recorded the sharpest ever recorded month-on-month drop in June, while the Philadelphia Fed Manufacturing Business Outlook Survey (in February 2019) printed the largest month-on-month drop since 2011.** Both these leading indicators for US manufacturing are flirting with outright contraction. Counter to this, July 2019 data was surprisingly improved with a reading of above zero for the NY Fed survey and a jump to 21.8 for that of the Philly Fed. However, this does not necessarily imply a reversal of the medium-term bearish trend and is possibly anomalous due to the sharp drop the month prior.

The US grew at an impressive annualised 3.1% in 1Q 2019, which appears stronger than what the following bearish fundamental points would suggest. Cass Information Systems notes that further analysis of the 3.1% headline growth number shows that inventory stockpiling contributed 0.65% percentage points, while changes in trade contributed 1.03% percentage points[9]. However, stripping out both inventory stockpiling (which is actually a pessimistic sign of slowing business conditions and is discussed in the next sections) and trade (which is highly vulnerable to global trade, and is also slowing, as discussed in the next sections) suggests that US GDP only rose a mere 1.5% year-on-year in 1Q 2019[10] - not such a rosy picture. Furthermore, the most recent revision of 2018 US GDP data downgraded growth from 3% to 2.5%[11].

2.3. Global Manufacturing is Faltering

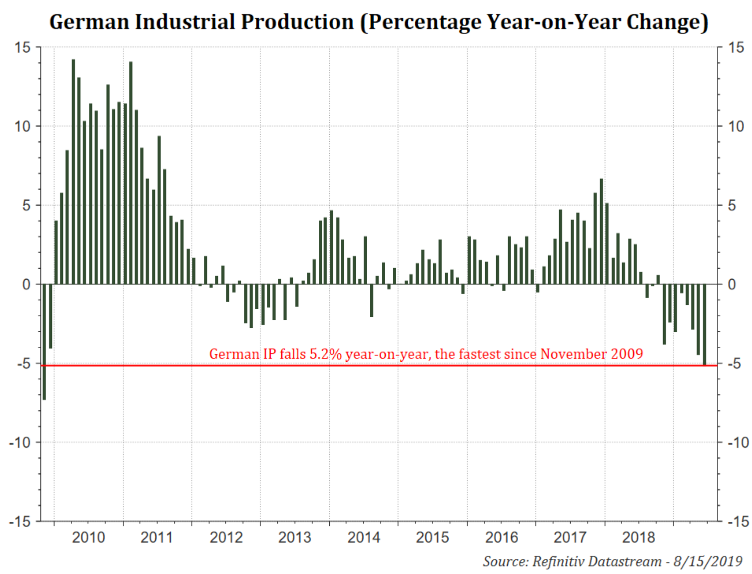


Global manufacturing has been slowing meaningfully. Alarming is both the rate at which gauges of sentiment and factory-output are falling and the synchronised manner of observable declines across the globe. Weakness isn't just limited to China or the US – who are mulling through their trade spat – but transcends geographies and is spilling over into structurally important industries such as European automakers. Various manufacturing benchmarks have been falling sharply and steadily since late 2017, such as the **JP Morgan Global Manufacturing PMI which is at the lowest level since June 2012** and indicates that business optimism is at all-time lows due to fewer new orders[12]. **Over 70% of G20 nations now show contracting manufacturing measures[13] - certainly boding poorly for the global economy.**

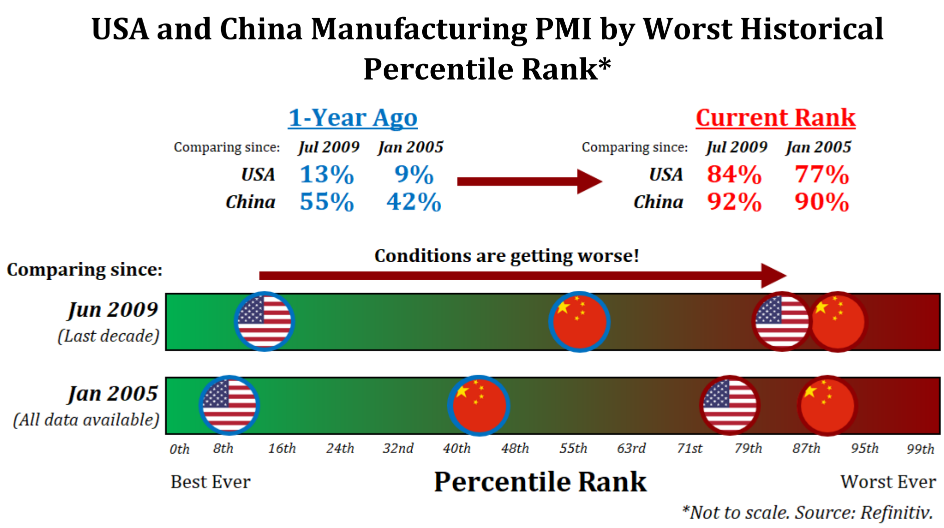


Sentiment, factory output, and new orders are also tumbling across the Eurozone, with all large European countries now in contractionary territory as manufacturing gauges show the worst numbers since 2013. Export-dependent Germany is the worst hit, with Industrial Production measures falling steadily since 2017 and, in late 2018, declined at the fastest year-on-year rate since 2009.

Weaker sentiment and slowing output measures are relevant to global growth and portfolio positioning, as the manufacturing sector is the largest single contributing factor to the volatility of GDP growth[14] - meaning it is a good predictor of growth trends. Factory output and new orders, which are closely related to exports, also speak to the state of global trade, whereby the (i) protracted and (ii) synchronised nature of the softness suggests a more structural and systemic slowdown. **The impact of trade on economic growth and corporate profitability favours a conservative tactical portfolio positioning within more defensive sectors and geographies.**



The below chart clearly shows how in the US and China conditions have deteriorated in the last year with both countries PMI numbers moving towards the worst levels seen in recent decades. The top part of the charts shows the PMI percentile since 2009 (the last decade) and the bottom chart showing since 2005 (since the measure's inception across both countries).



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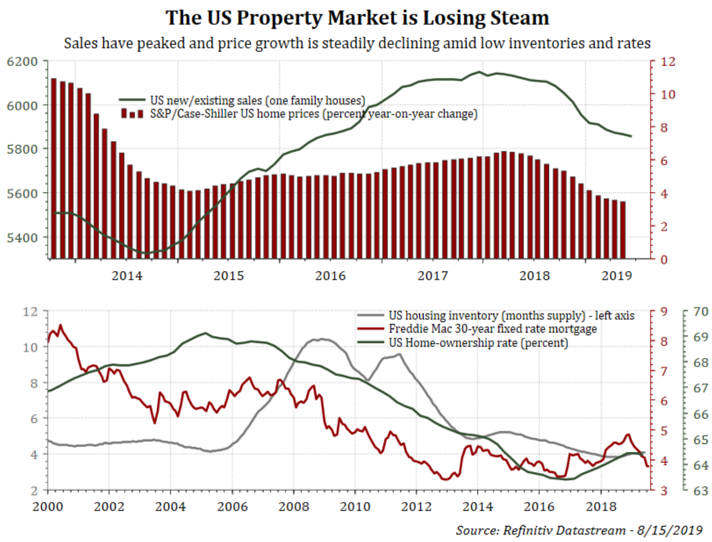
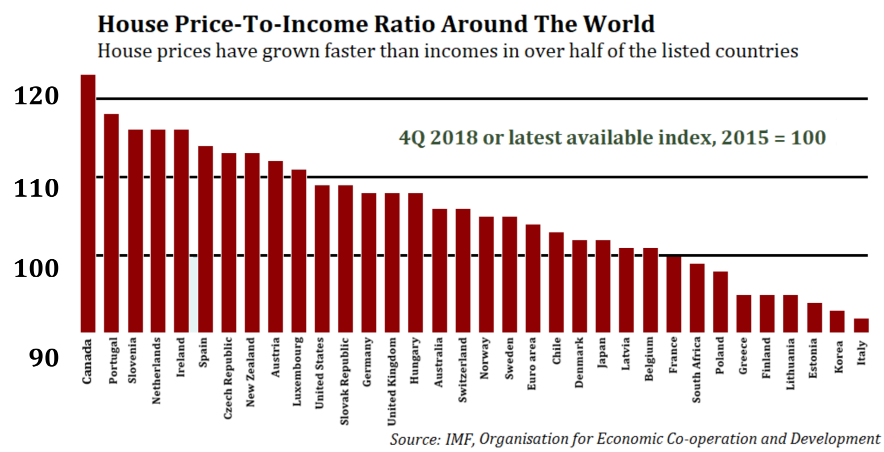
2.4. Real Assets (Late-Cycle Sectors) Show Stagnation



House prices play an important role in macroeconomics as rising prices increase the value of household balance sheets and the "wealth effect" boosts their consumption and allows them to borrow against their properties (often boosting consumption further). Housing plays the role of a consumption good, investment, store of wealth and collateral for lending and thus in many developed economies is an integral part of the macro landscape. As we remind ourselves of the impact of the property crashes building up to (and causing) the Global Financial Crisis of 2008, we thought it important to delve a little into some price corrections and bubbles occurring around the world in real estate markets. One should always be reminded of the self-reinforcing feedback loop in property, where rising prices result in lower loan-to-value ratios with these lower ratios allowing banks to extend more credit and encourage households to borrow more. The theory of "reflexivity" can be applied to this phenomenon – which states that a two-way feedback loop exists in which investors' perceptions affect their environment, which in turn changes investor perceptions.

Both commercial and residential real estate appear overvalued in key economies where the income-to-price ratio for commercial properties (known as the "capitalisation rate") is near all-time lows[15]. In today's highly leveraged economies, corporates may also be vulnerable to falls in property prices as commercial real estate is often used as collateral for corporate borrowing. Despite the slowing of price appreciation, commercial property prices still appear elevated relative to fundamentals in several countries. According to research by the IMF, the value of "House Price at Risk" in the US (an estimate of loss potential) has gradually increased since 2016 due to overly easy credit and a gradual trend of overvaluation. However, the potential loss estimated one year ahead is currently less than a 10th of that in the peak of 2007.

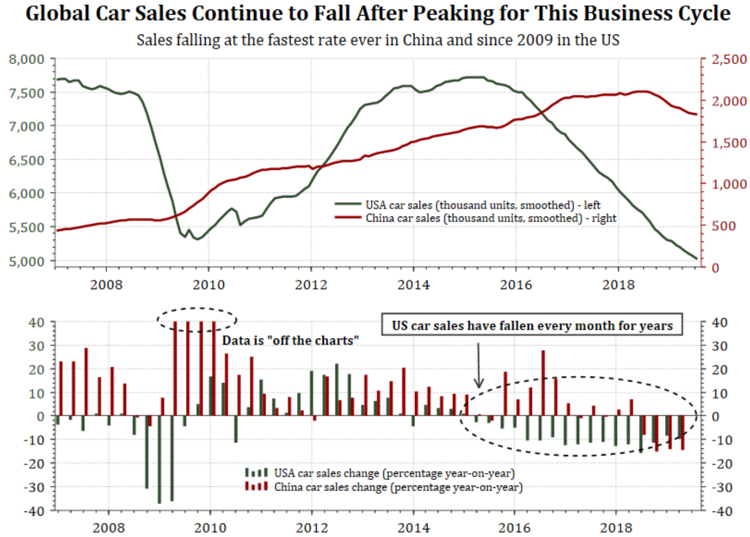


In the US, home prices are rising at the slowest rate since 2013[16] as home sales continue to fall since peaking in 2017; all despite historically low housing inventory, low homeownership (at 64%), and low mortgage rates (30-year fixed rate at 3.8%). The US property market appears to be losing steam, despite the many supportive tailwinds. A slowdown in price appreciation can be observed in the UK, China, and Japan – with the (i) protraction and (ii) synchronised manner of the slowdown again hinting at a more structural decline rather than a short-term or concentrated anomaly.

2.5. The Global Automobile Industry: Already Peaked

Motor vehicles are typically a "big ticket" expenditure item for households and thus often a good indicator of economic activity. **Global car sales seem to have peaked for this business cycle, as sales figures almost-universally trend lower across geographies.** Sales have been falling at the fastest ever rate in China, the largest market globally, and declined 15.5% year-on-year between January and May 2019 on average[17]. **In the US, year-on-year sales growth has been negative for every month since February 2015!** Growing economies such as India, which was once heralded as soon-to-be overtaking China in terms of car consumption growth, have been met by nothing other than disappointment. Car production, closely linked to manufacturing and trade, has peaked in many large economies. Last year, German and US car production measured the lowest since 2009 and 2010, respectively[18].

Global Car Sales Continue to Fall After Peaking for This Business Cycle



Source: Refinitiv Datastream - 8/15/2019

There is an argument that declining motor vehicle sales is secular as more people use ride-sharing apps, commute on foot, bicycle for health reasons, or work from home. It is not within the scope of this analysis to comment on the secular vs cyclical nature of car sales but, irrespective of which of the two reasons is causing the decline, there is an impact on GDP.

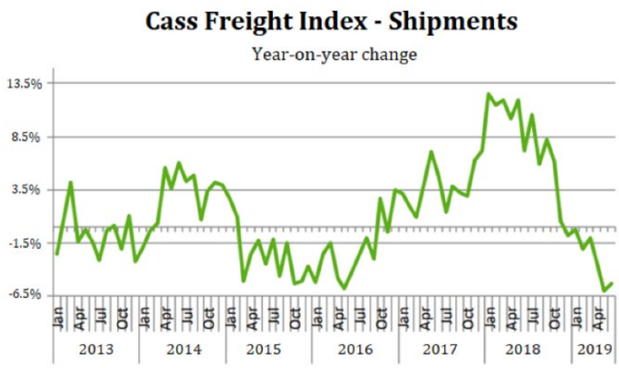
Lower car production rates, which are undoubtably related to lower factory output, have secondary impacts to economies in the form of jobs and corporate profitability. Factory closures typically occur alongside jobs cuts and falling revenues (as less output entails less saleable product). Notably, the past 6 months have seen sweeping job cuts across major global automobile firms, such as a cut to 8.1% of the total workforce for GM, 10% of all white-collar workers for Ford, and 10% of management employees for Audi. A deterioration of fundamentals suggests further cuts are possible. The automobile sector is structurally important, as a 10% decline in global auto sales could trim 0.5% from global GDP growth[19]. Automakers and automotive related industries employ about 6% of EU workers, 1.8% of German workers (directly employed)[20], and between 1% and 2% of US workers[21]. The adjacent table notes a few automaker labour cuts that occurred within the past 6 months.

Firm	Date	Where	Percentage of global workforce*
Ford	20-May	Global	**10% of white-collar workforce**
Nissan	15-May	Global	3%
Honda	13-May	UK	2%
Daimler	18-Apr	Germany	**10'000 in Germany - 3.3% of global total**
Tesla	08-Apr	US	Unknown
Fiat Chrysler	29-Mar	Canada	1%
Ford	15-Mar	Germany, UK	3%
Ford China JV	27-Feb	China	**Thousands of the JV's 20'000 workforce**
Audi	20-Feb	Germany	**10% of management**
Tesla	18-Jan	US	**7% - the first of several cuts**
Nissan	17-Jan	US	1%
Jaguar Land Rover	10-Jan	Global	Unknown
General Motors	26-Nov-18	Global	**8.1% - 14'000 and closure of several US factories**

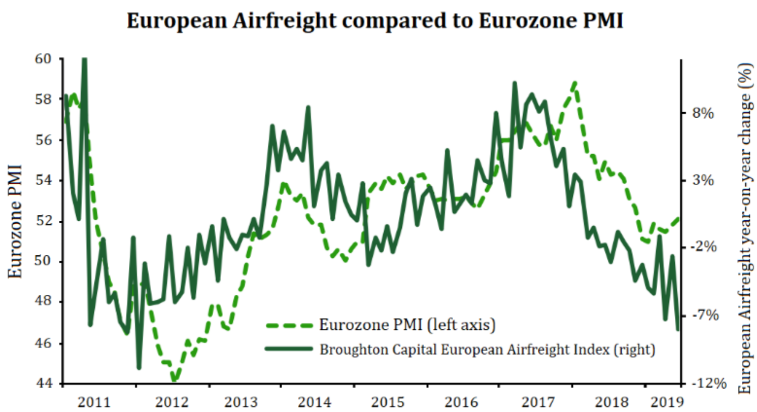
**Best estimate from data. Source: Bloomberg, Refinitiv, New York Times, Handelsblatt*

2.6. Logistics and Measures of Physical Demand

We also consider less-conventional indicators, which are both meaningful and interesting. We find that these indicators also point toward signs of slowing trade or weaker consumption. One such measure is the slowing Cass Freight Index, which tracks US activity in rail, truck, air, and other modes of domestic transport. The Cass Index fell 5.3% year-on-year in June, following a 6% year-on-year drop in May[22]. The fall is both severe and prolonged, with the Shipments index dropping year-on-year for each consecutive month since late 2018 and demonstrating negative momentum since January 2018.



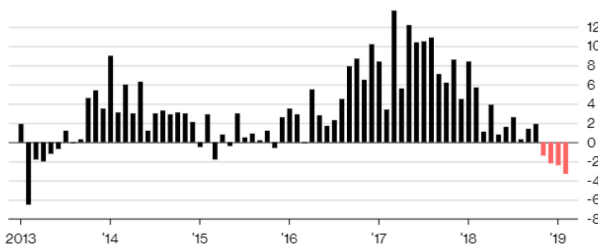
Source: Cass Information Systems Inc



Although it is valid for countries to periodically review trade terms with their partners, economic history clearly shows that open, unrestricted, and robust global trade allows for more prosperous growth. Thus, logistics activity can give a good indication of momentum in trade and provides insights into trends in demand and consumption. Today, unfortunately, the softening measure has gone from "warning of a potential slowdown" to "signalling an economic contraction", according to Cass Information Systems[23]. The chart above (European air freight versus PMI) also implies a meaningful and possibly predictive relationship between freight traffic and manufacturing.

The International Air Transport Association ("IATA") notes that **global cargo demand** fell by at least 4.7% year-on-year for February and April, the biggest drops since 2016[24]. Separate measures of European air freight in 2019 have been declining at the fastest month-on-month rates since 2013[25] suggesting a slowdown of business in the real economy. **Airport freight activity fell 2.2% month-on-month in May, falling for 7 consecutive months**. Air traffic fell across all four major German airports, which accounts for over 90% of air cargo in Europe's largest economy[26].

European Air Freight Volumes Have Been Falling at the Fastest Pace in Six Years
(month-on-month change)



Source: Bloomberg, ACI Europe

Class 8 heavy duty truck orders fell a shocking 70% year-on-year in June 2019, trending lower after peaking over a year ago in July 2018. Some sources report that trucking freight rates are "a chilling 62.6%" lower than last year[27] as a number of US trucking companies have declared bankruptcy[28] in a climate similar to 2008 when the GFC began to bite, although this is arguably also due to the likes of Amazon who are price setters and impacting the margin many of the trucking companies earn.

2.7. Fading Fiscal Stimulus and Low Capex Growth

As the short-lived benefits of the US tax reform continue to wane, so does the potential impetus for a pick-up in US growth. Earnings growth relies on investment in the form of capex, and we see low capex growth from US corporates in 2019 as a signal that (i) firms generally see fewer growth opportunities and are not willing to take risks due to lower business confidence and (ii) that stagnation in investment will further limit earnings growth in the medium-term.

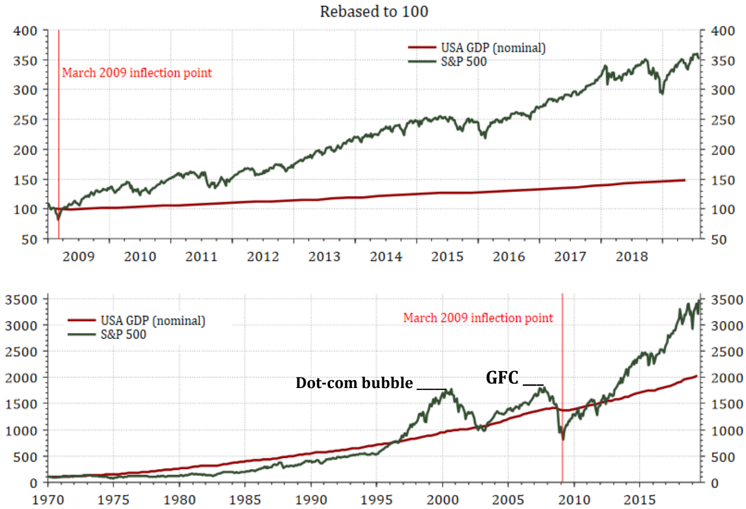
While we did see a short-lived pick-up in US corporate capex growth of +11% in 2018, it is expected to drop to just 3% in 2019[29] as the “sugar rush” of US fiscal stimulus fades with the aftermath of reform turning net negative by 2020[30]. In fact, the rationale behind the Trump tax reform was that the additional cash could be used to boost investment, build machines, and hire new staff. However, it turned out that **corporates used much of the tax reform windfall to fund share buybacks, with capex and business investment left as a secondary priority.** Low business confidence “has not broadly impacted hiring and investment plans”[31], while one business survey suggested that the Trump tax reform has “had little or no effect on most US companies’ hiring and investment plans”. Corporates have simply been unwilling to take business risks in the form of investment due to persistent concerns over global growth, as well as uncertainties in US trade policy and potential supply chain disruption, amongst other things. The bottom-line is that managers, arguably the best judges of business growth, see limited opportunities in terms of new revenue streams and are of a pessimistic disposition. Low business confidence, leading to less investment, will also inherently stifle growth opportunities. It begs the question whether or not growth outlook, as perceived by financial investors, is decoupling from that perceived by business managers?

2.8. Buyback Concerns

Share buybacks has been a buzzword in recent years. US corporates spent an unprecedented $806 billion on buybacks in 2018 and are on track to break this record in 2019 as data shows that US companies spent $205 billion on buybacks in 1Q 2019 alone. One reason for this is that buybacks are a way for firms to distribute excess cash to shareholders in the form of capital gains which is tax advantageous relative to dividends. Additionally, if companies don’t see enough growth opportunities for expansion distributing profits to shareholders (via a share buyback) increases the Return on Equity as the number of shares in issue declines.

Asset Price Growth Outpaces Real Economic Growth Since 2009

Rebased to 100



Source: Refinitiv Datastream - 8/15/2019

Corporates have thus supported stock prices because of being quick to buy dips during short-term corrections and through the concomitant mechanics of buybacks which decrease the number of shares in issue.

There are a few concerns around the way in which buybacks have been taking place:

1. **US budget stability:** buyback activity saw a large boost due to the extra cash benefit of the tax reform. This extra capital, which was hoped would spur capex growth, came at the expense of government revenue. The relevance of this revenue shortfall is clear as fiscal discipline of the US government remains in the spotlight after the White House and Congress recently reached a deal to raise the debt ceiling, again! The IMF notes that financial vulnerabilities have increased in the sovereign sector since the GFC. It therefore seems that both the US government, who provided the tax windfall and the borrowers (US corporates) may be more exposed to future shocks (due to increased leverage) as this two-way relationship has helped both parties take on more risk.
2. **Debt-fuelled buybacks:** the increased prevalence of debt-funded buybacks, as opposed to those where excess earnings or cash remittance back to the US are used, raises concerns over the sustainability of the strong stock price appreciation. **Cheap money is allowing corporate borrowers to buy stock at or near all-time highs, despite firm management generally having lower business confidence and a more pessimistic growth outlook.** This may leave some companies more exposed to risks of tightening credit as their debt burdens increase.
3. **Incentives misalignment:** executive renumeration is often based on stock price targets, resulting in a possible conflict of interests. Higher stock prices can be observed independently of increased profitability in the case of buybacks, where earnings growth is driven by the Earnings Per Share ("EPS") boost that occurs due to their anti-dilutive nature, and thus management focus more on short-term EPS numbers and stock price performance rather than the long-term success of the firm.
4. **Risks of policy intervention:** reforms could bring buybacks to a screeching halt, especially given the disdain for buybacks from key members of US Congress (Bernie Sanders notably calling the action "corporate self-indulgence"). US corporates were the largest net buyer of US stocks in 2018, and thus a reduction of this flow could meaningfully hurt price momentum in the S&P 500, which is often strongly supported by buyback activity during short-term corrections.

3. Why we Might be Wrong with our Bearish Slant

Although many financial organisations such as the IMF, Brookings Institute, and ECB all agree that global risks are tilted to the downside, not everyone agrees that we are destined for an outright recession within the next 18 months. Some, including Jay Powell of the Federal Reserve, think (or at least publicly communicates) that we are simply in a temporary economic lull within the context of a larger economic expansion – which is to say that our current negative narrative may be short-lived. These medium-term bulls discount the reliability of the US yield curve inversion as a recession predictor due to distortions that have arisen from supressed term-premiums, given low or negative Eurozone and Japanese yields (with which we somewhat agree), although some commentators also go as far as saying that the current global manufacturing recession could reverse soon as China reflates (we are less optimistic).

While indicators like yield curve inversion and fading US fiscal stimulus are interesting to note, we are primarily concerned with trends in fundamental activity such as slower manufacturing, industrial production and tightening of global trade flows. Without a recovery in capex growth, trade flows, and manufacturing activity, we see a low probability of a "second wind" extending this current economic growth cycle past 2021. We think that for the slowdown in economic growth observed between 2018 and 1H 2019 to reverse (and go down in history as just a temporary "mid-cycle" slump), we need to see a pickup in:

- **(i)** **capex** (driving a more positive earnings growth outlook);
- **(ii)** **trade flows** (spurring global demand for goods production);
- **(iii)** **and manufacturing sector activity** (the single largest contributor to GDP volatility).

Although a consolidation and strengthening of corporate, household, and sovereign balance sheets would be beneficial in mitigating the severity of an economic downturn, it is not a requirement for the growth cycle to extend past 2021.

To entertain the debate of alternative opinions, we note a few factors which could support a reversal of today's economic slowdown.

3.1. Accommodative Central Banks - a Credit-led Recovery

Financial markets have indeed been supported by easier credit conditions in 1H 2019. With the start of direct monetary easing by the Fed and dovish commentary from both the Fed and ECB, the long and short end of yield curves have been pushed lower.

Fed Chair Powell's pivotal AEA speech in early January - where he hinted at a shift in monetary policy outlook - almost timed the bottom for US equities and the start of a one-way rally in Treasuries, which has only accelerated in recent months. Powell's initial comment of being "prepared to adjust policy quickly and flexibly" has since proved to have been modest and has materialized in a full policy U-turn with the FOMC recently announcing a 25bps cut at their July 2019 meeting – the first such cut in 10 years. Promises of easier monetary conditions have a clear power over investor sentiment, and risky asset prices have moved in lockstep with the evolving Fed's public dialogue and investor expectations. We argued earlier in the year that the Fed's dovishness should not be perceived as bullish but rather bearish as they clearly saw deteriorating economic conditions. This has now become more apparent as poor recent economic data and the ongoing trade war has unnerved investors.

However, these easier credit conditions allowed some corporates to consolidate and strengthen their balance sheets in an orderly manner, especially as refinancing cliffs kick in from 2020/21 onwards. Stronger financial positioning could provide much needed impetus to earnings growth. Although it could be argued that because many US corporates are already so levered, lowering the cost of credit will not cause much of a demand reaction.

In summary on this matter, easier credit should be a catalyst for increased capex and consumption but it is often because of poor capex, manufacturing activity and retail sales that a rate cut environment exists and thus we worry it is too late for current rate cuts to boost economic activity on the basis that we are "mid-cycle".

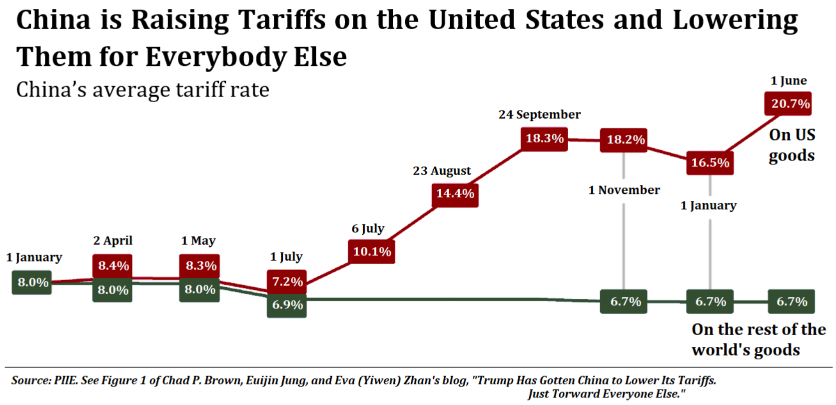
3.2. Trade War Resolution

Trade war resolution would have a hugely beneficial impact on asset prices in several ways. The causal logic is described in the graphic below.

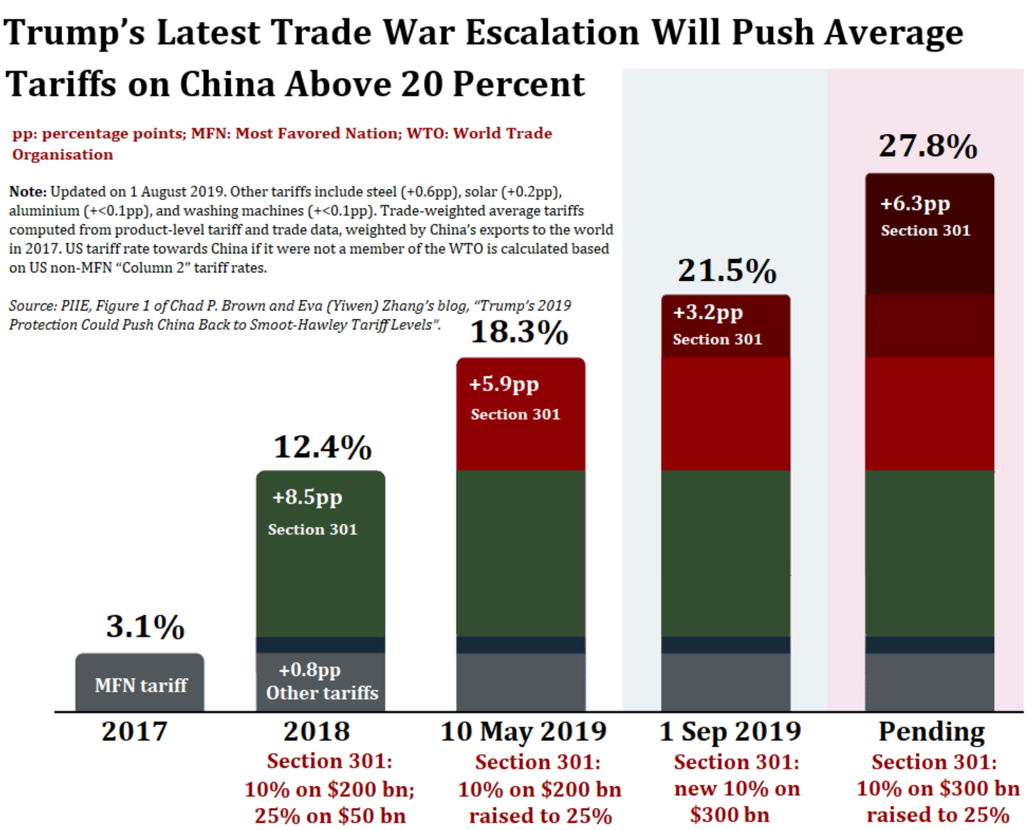
(i) **Short-term sentiment-driven rally:** financial investors across regions will have renewed appetite for risk assets due to a better growth outlook.

(ii) **Medium-term pick-up in economic activity and GDP growth:** trade policy stability would encourage production managers to feel more comfortable with making medium- and long-term fixed investments (capex growth, factory builds, hiring etc) due to decreased risks of supply chain disruption and margin pressure through surprise tariffs, or general demand slowdown.

However, we see geopolitical risks as being skewed towards further trade escalation and assign a low probability of an outright resolution before the end of 2019. But, having said that, the positive impact that any resolution would bring cannot be overstated as one can see from the 2 charts from the Peterson Institute for International Economics[32].



We find it interesting to note that despite President Trump's tweets, which relate to the positive impact of increased tariffs on China (and Europe) for the US, the effects are not as positive as portrayed. Firstly, it is the US consumer who would be paying more due to increased tariffs and thus one could argue it is a tax on the consumer. Secondly, it has been reported that despite US tariffs on China, the Chinese economy grew at 6.2% in 2Q 2019, while the US grew at 2.1%. Furthermore, it has been reported[33] that "between July 2018, when the US first imposed tariffs, to the end of June this year, US exports to China slumped $33 bn, or 21% of the total. In contrast, Chinese exports to the US grew by $4 bn, or 1%".



3.3. Improving Global Geopolitics…unlikely

One thing which has really surprised us in recent years is the ability of the markets to generally shrug off geopolitical matters. There are of course some negative impacts to local markets, for short periods in most instances, before someone "buys the dip" and bets on peaceful and smooth resolution. We thought it interesting to note the number of contemporary geopolitical hotspots or domestic political issues, which, if resolved within a short period, could be an impetus for risky assets (highly unlikely though!).

United Kingdom – Brexit – this ongoing stalemate and lack of an end in sight has recently resulted in further GBP weakness.

Hong Kong protests – what started as a protest against an extradition bill has escalated into demands for much more.

Iran/ Saudi Arabia/ US/ Israel tensions – Iran recently threatened to close the strategically important Strait of Hormuz, a narrow waterway carrying a fifth of the world's traded oil, following an escalation in tension between these countries.

India/ Pakistan/ Jammu & Kashmir – India's Prime Minister, Narendra Modi, recently revoked Article 370 of the Indian constitution: a 70-year-old provision that had given autonomy to the state of Jammu and Kashmir. The government also introduced a bill to strip the region of statehood and divide it into two parts, both under direct control of the central government.

North Korea – North Korea has conducted five weapons tests since July 25, all of them in violation of United Nations resolutions.

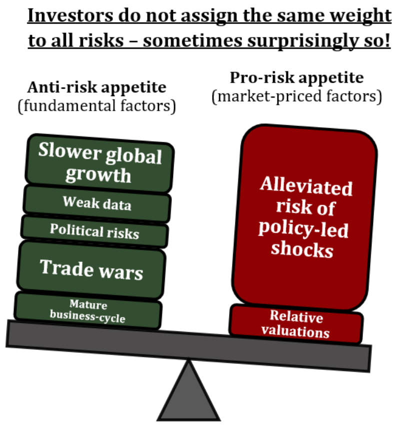
South China Sea – the disputes involve both maritime boundaries and islands and involve a number of countries including China and it's Pacific Ocean neighbours.

Japan/ South Korea – Tokyo placed controls on exports of three chemical materials to South Korea and subsequently both countries have downgraded each other in terms of preferred trading partners.

US/Russia nuclear arms control regime – earlier this year the US said it was suspending one of the last major nuclear arms control treaties with Russia.

4. Credit Market Commentary

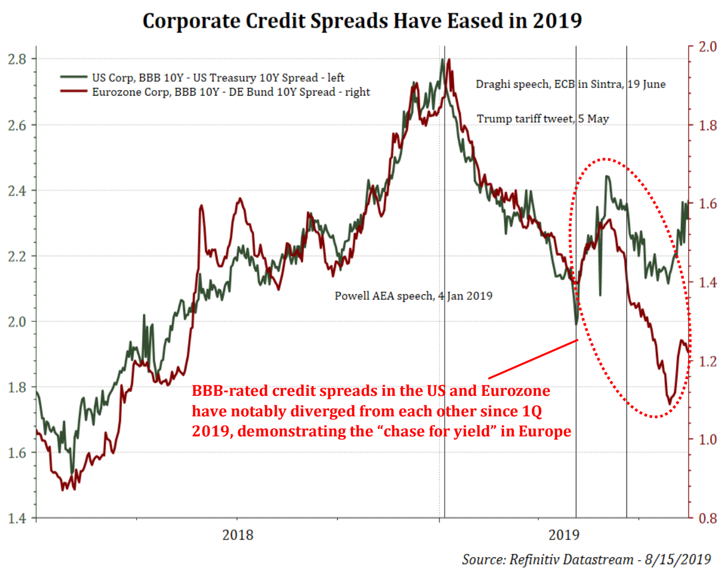
Global investors appear sanguine in their outlook of the maturing credit cycle and (sometimes surprisingly) demonstrate very pro-risk behaviour as they balance greater risks (growth slowdown, trade wars) with an outlook for looser monetary policy. So far this year investors have taken more risk in both equity and credit markets in 1H 2019, pushing some key benchmarks to all-time highs, like the S&P 500 which touched 3,000 for the first time in early July 2019.

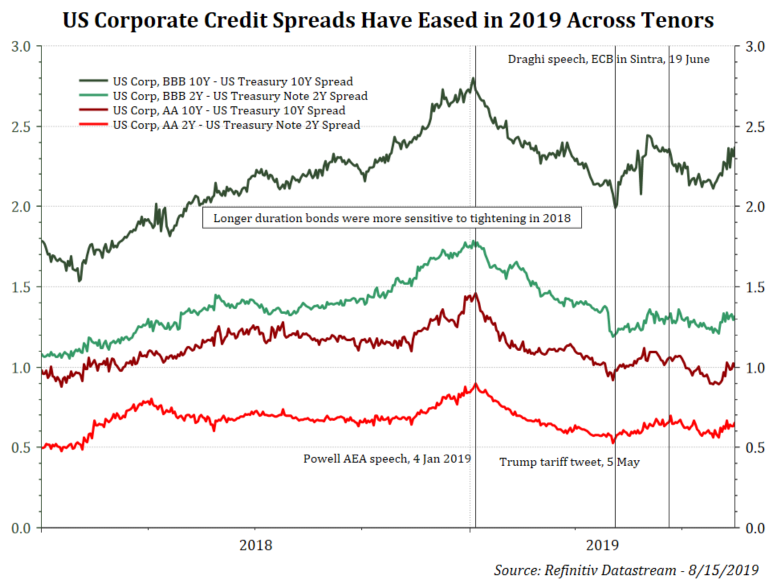


We unenthusiastically confess that the euphoria makes sense: perhaps the second greatest global macroeconomic risk, behind trade-war escalation, has been somewhat removed as concerns that policy-driven credit tightening (the late 2018 stance of the Federal Reserve) will push markets into a full-blown downturn, looks increasingly unlikely. **However, this market-positive shift in sentiment is bittersweet** as it implies the continued building of the excess risks as households and corporates once again increase leverage (or at least don't decrease leverage). We see credit markets as being most vulnerable to these excesses, and hence we revisit some of the credit and interest rate metrics we looked at earlier in the year via some charts below.

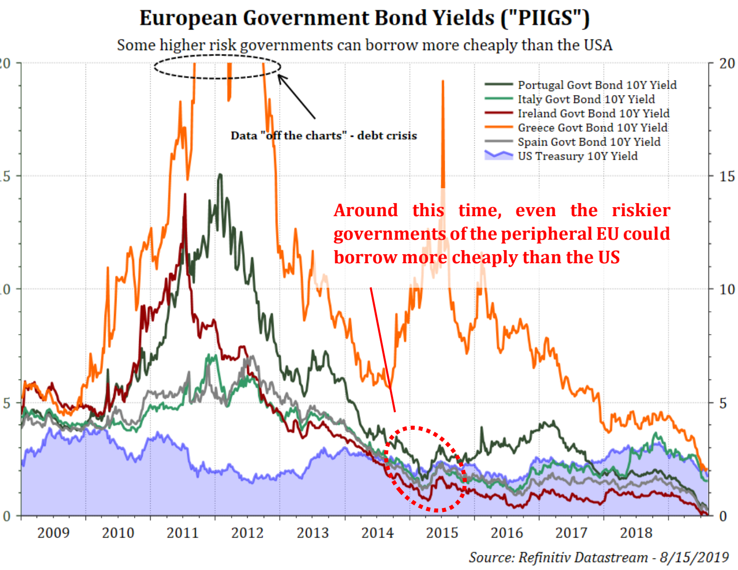
4.1. Debt Markets and Rates

As can be seen in the RHS chart credit spreads across both the US and Eurozone and both for AA (higher quality) and BBB (lower quality) Investment Grade bonds over the respective sovereigns have compressed but what is interesting to note from the lower chart is the convergence of yields in the Eurozone across the credit spectrum (i.e. less compensation for taking higher risk).



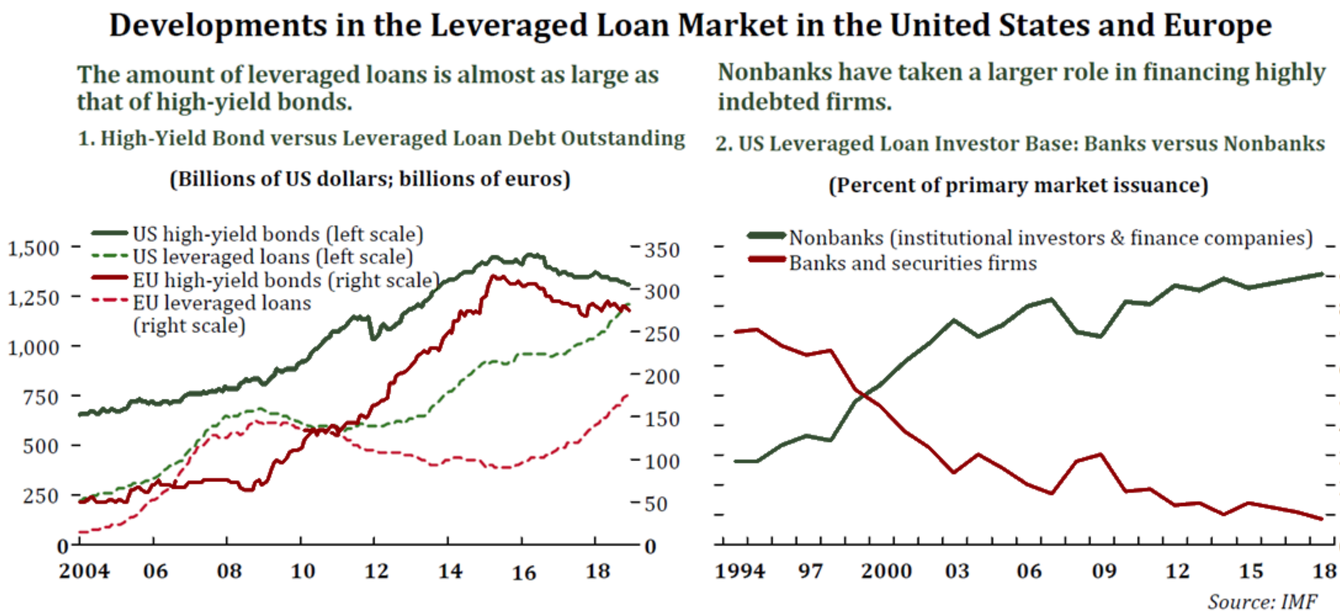


What we see in this chart is that US 10-year yields have remained reasonably stable when compared to their European counterparts but more recently European countries can fund themselves at lower rates than the US. US 10-year yields have been higher than even some of the riskier European countries' 10-year yields which has more recently resulted in a strong dollar as many investors have preferred to own higher yielding US paper.



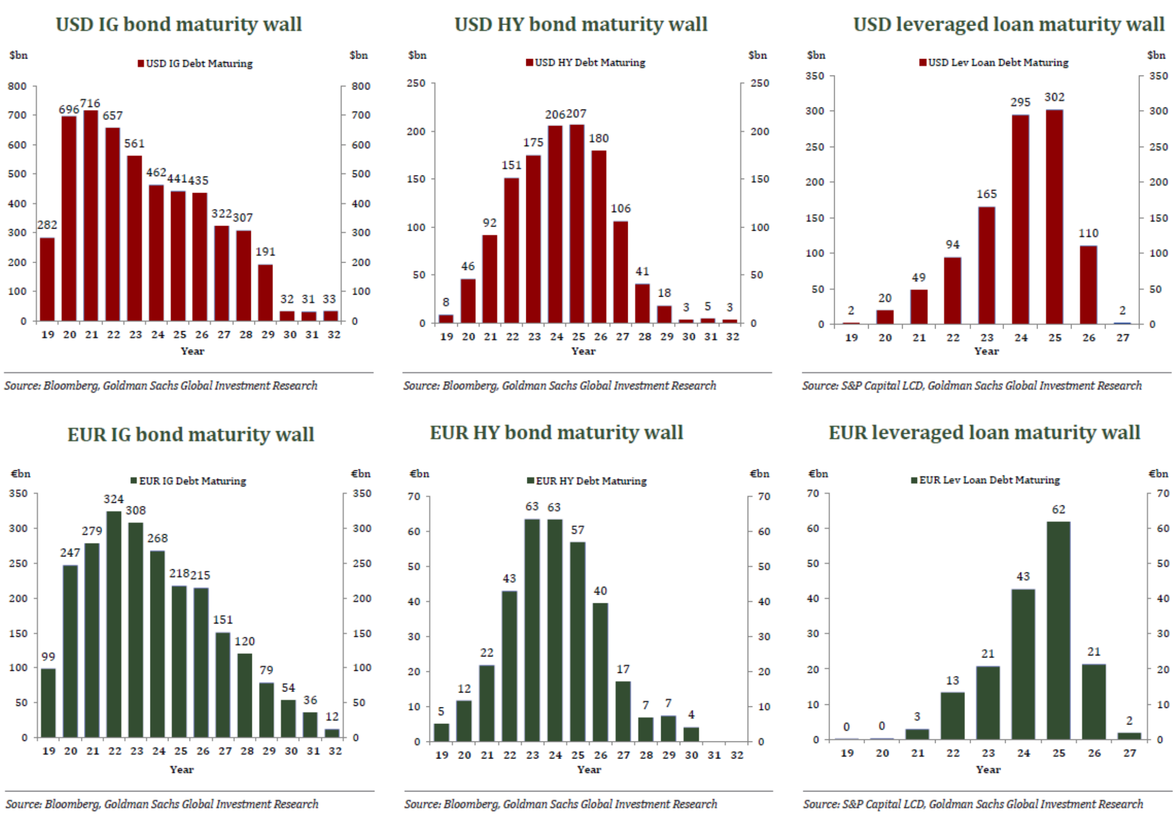
The very low European yields are a consequence of low ECB policy rates, low inflation and ECB quantitative easing programmes. This dynamic supports the theory that US yield curve inversion is partly a result of suppressed yields in Europe and Japan and buyers have shifted to long(er) US bonds. This begs the question – Can US rates go negative too? Additionally, what is astounding is that in the US and Europe both risky assets (like equity) and less risky "safe haven" assets (like government bonds, where yields have compressed) have done very well over this period.

Charts like the below worry us, as one can clearly see an increasing amount of outstanding debt with a particularly larger uptick in leveraged loans in recent years whereas the amount of outstanding High Yield debt seems to have stabilised at these higher levels. On the RHS chart it is clear that non-banks have taken an increasingly important role in financing but, as some have warned, might come with consequences as many of the loans are more covenant light than would have traditionally been granted and thus more susceptible to a poor outcome in default scenarios (i.e. lower recovery rates).

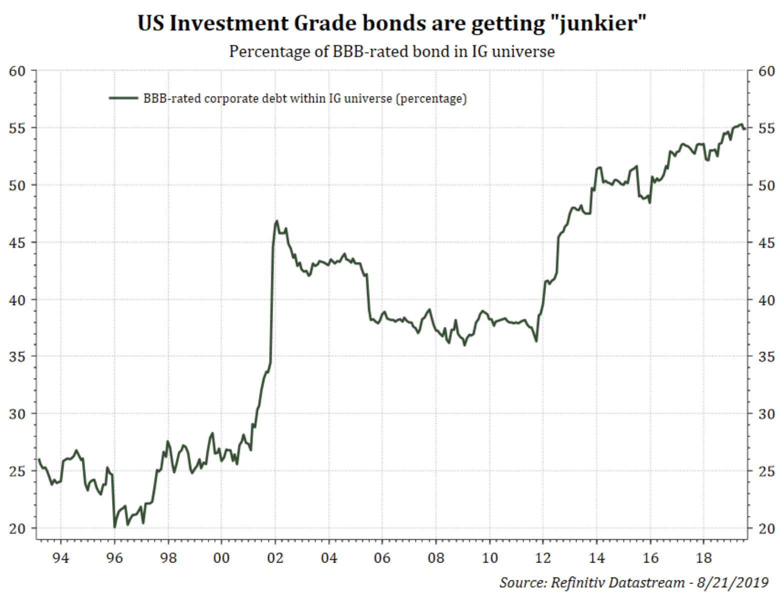


On a more positive note the debt party might not end for a while as the refinancing "cliffs" only kick in from 2020 onwards and later for most of the riskier debt. Thus, with a more dovish Fed it is possible debt doesn't "blow up" for some time. Investment Grade faces the cliff sooner – see next set of charts (top LHS).

IG, HY bond and leveraged loan maturity walls

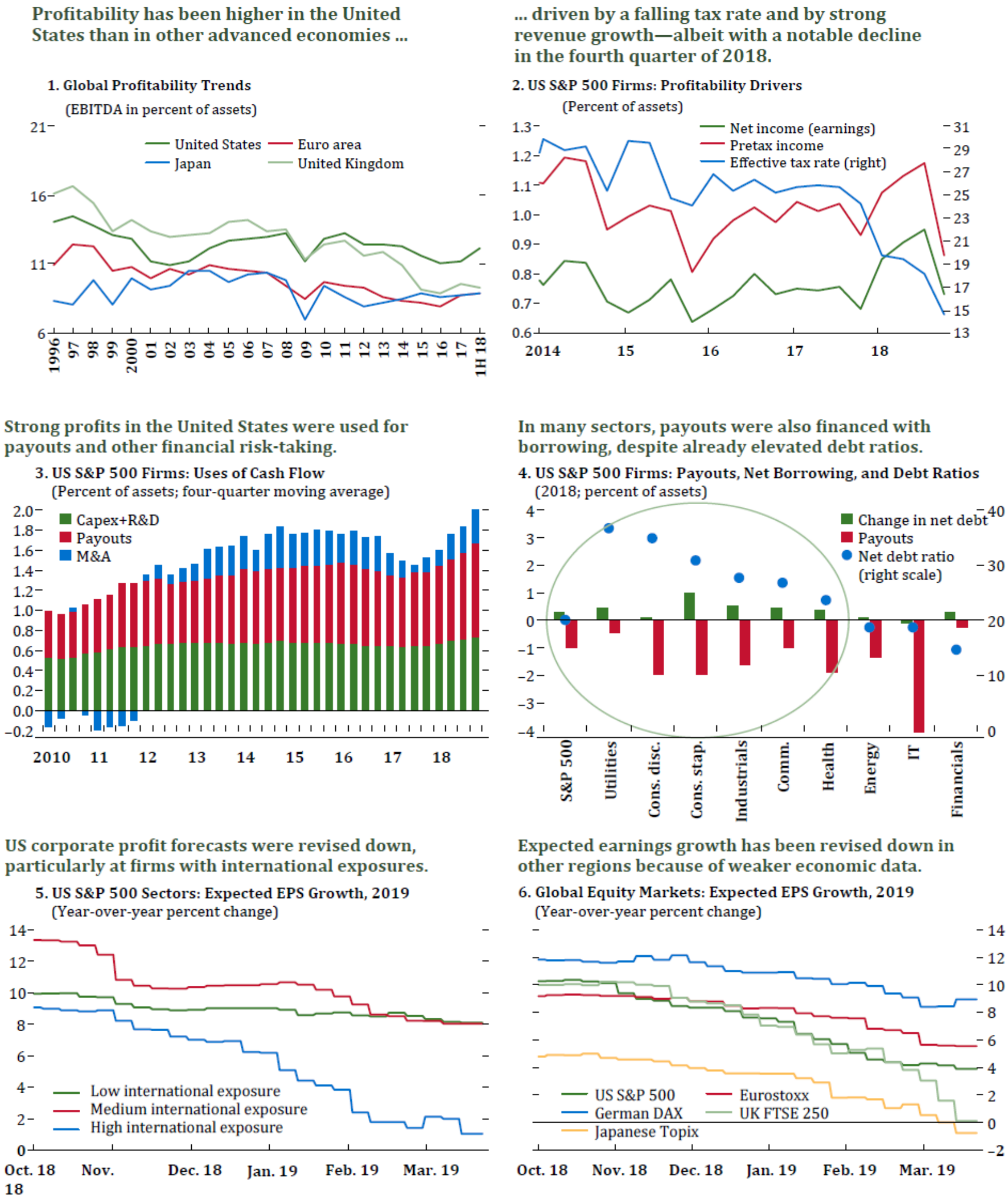


In the chart to the right we can see that the percentage of Investment Grade (higher quality debt) that is rated BBB (i.e. the lowest level of perceived quality before being classified as "junk") is at the highest level in decades. So, although the Investment Grade universe is safer than High Yield and Leveraged loans, their universe is facing the refinancing "cliff" sooner and their overall quality is declining. Thus there could be a scenario where Investment Grade issuers, when coming to market in a weaker economic and earnings climate, become High Yield issuers after facing downgrades which can cause further knock-on effects to other issuers.



And although the S&P500 bond issuers, most of which would be Investment Grade, don't face the refinancing cliffs until 2020, the previous US goldilocks scenario might be coming to an end as 4Q 2018 and subsequent 2Q 2019 earnings numbers from corporates have been declining. The boost in profitability for US firms has been in large part to falling effective tax rates in the Trump administration and not necessarily by increased productivity and volume gains.

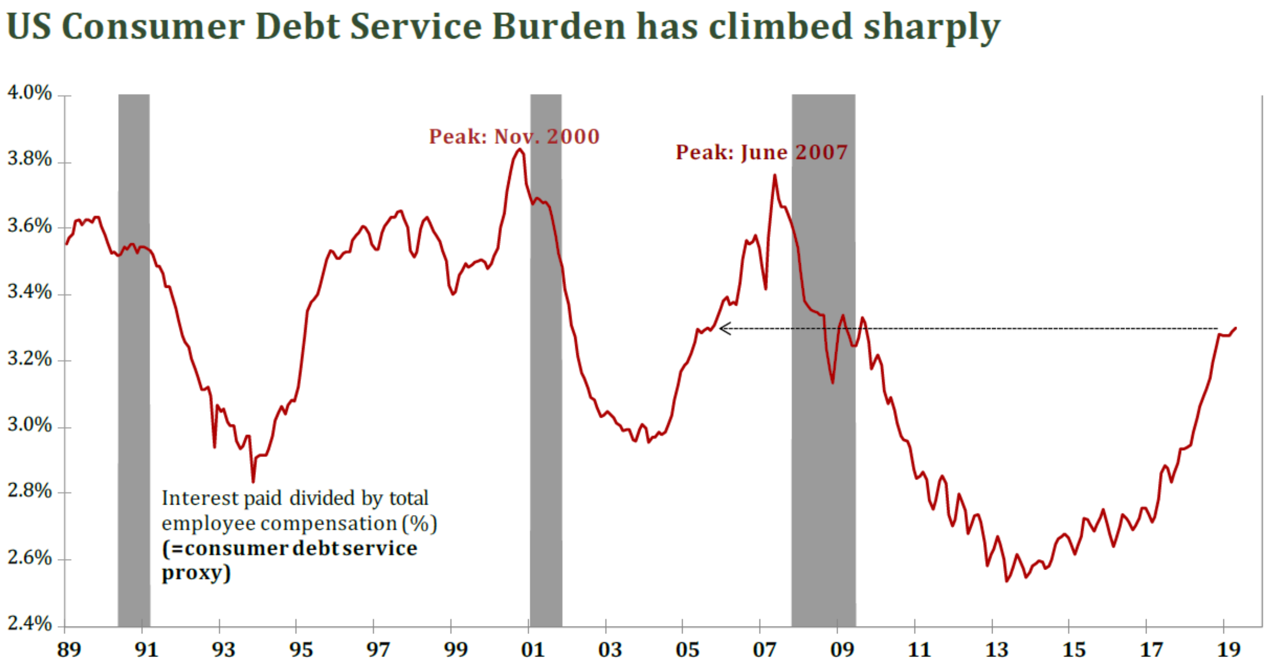
Corporate Profitability Indicators in Advanced Economies



Sources: IMF, Bloomberg Finance L.P.; S&P Capital IQ; Thomson Reuters Datastream; Thomson Reuters I/B/E/S; and IMF staff calculations.
Note: In panel 1, the sample from S&P Capital IQ includes about 20,000 firms in the euro area, Japan, the United Kingdom, and the United States. In the euro area, they represent 23 percent of total debt in the total corporate sector; in Japan, 40 percent of total debt; in the United Kingdom, 36 percent of total debt; and in the United States, 76 percent of debt, measured as loans and debt securities. Capex = capital expenditure; Comm. = communications; Cons. disc. = consumer discretionary; Cons. stap. = consumer staples; EBITDA = earnings before interest and taxes, depreciation; and amortization; EPS = earnings per share;
IT = information technology; M&A = mergers and acquisitions; R&D = expenses for research and development; SGA = sales, general, and administrative.

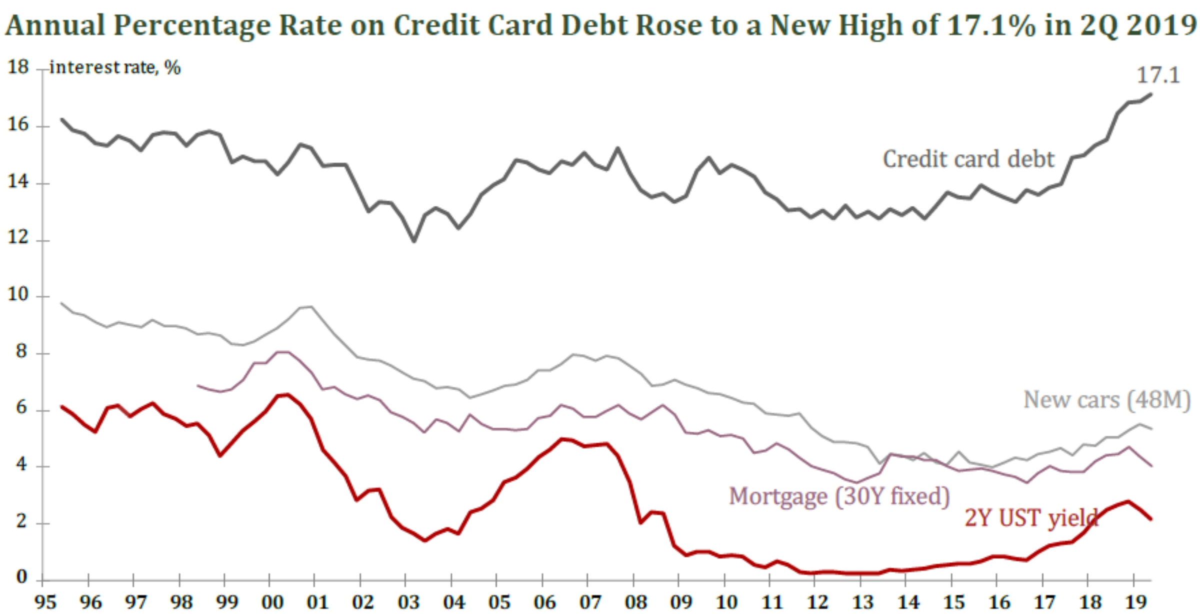
4.2. US Household Debt

This chart clearly shows how the US consumer debt burden has been rising slowly but surely to 2006 levels, optically worrying but the consumer still has some time to go before reaching the 2007 peaks.



Source: Pictet WM-AA&MR, Federal Reserve.

The below chart breaks down the different aspects to the consumer debt with credit cards being particularly worrying.



Source: Pictet WM-AA&MR, Federal Reserve.

4.3. The ECB

Mario Draghi, the President of the ECB – known for his appetite to communicate aggressive policy "bazookas" and commitment to do "whatever it takes" – has had seemingly no trouble in setting a new path for the bank despite his November 2019 position handover to current IMF chief Christine Lagarde. Lagarde seems like an apt choice for the role as she won respect in her ability to crisis-manage since taking over the top role at the IMF in 2011. Similarly, she will be coming in as a fire-fighter as the underlying Eurozone economic backdrop has deteriorated over 1H 2019, prompting the observed policy reversals communicated by Draghi over the past few months.

The ECB has recently seen an abrupt shift from gradually normalising monetary policy after (attempting at) ending their QE-style Asset Purchase Programme ("APP") in December 2018. Amid mounting expectations from investors, it all came to a head at the 17–19 June ECB Forum on Central Banking in Sintra, Portugal, when Draghi clearly communicated a more accommodative monetary policy outlook. The key takeaways, below, were reiterated at the 25 July 2019 meeting:

i. The ECB sees a greater urgency in supporting the Eurozone and has both the ability and willingness to use available policy measures to meet policy objectives, not limited to:
   - **Forward guidance:** it is communicated that conditions do not need to improve to warrant more accommodative measures by stating that ***"in the absence of improvement... additional stimulus will be required"***, whereas it was previously understood that action would only be taken if conditions deteriorated. As we moved into 2019, it was communicated that rates would be unchanged until mid-2020 – this is no longer the case.
   - **Rate cuts:** now back on the table as guidance included the use of ***"or lower"*** in policy communication; markets expect a 10bps cut from the current -40bps deposit rate at the September 2019 meeting. Futures now indicate a 100% implied probability of a cut to the ECB deposit rate.
   - **Asset purchases:** the ECB is now expected to resume purchases given ***"considerable headroom"*** in its ability to increase the size of its balance sheet, with self-imposed limits posing no real-world limitation. We do not see these self-imposed limits as being concrete or restrictive of future policy, which is in-line with various ECB communications. **Some economists expect monthly asset purchases amounting to EUR 50bn (EUR 10bn on sovereign debt, EUR 40bn on corporate debt).**

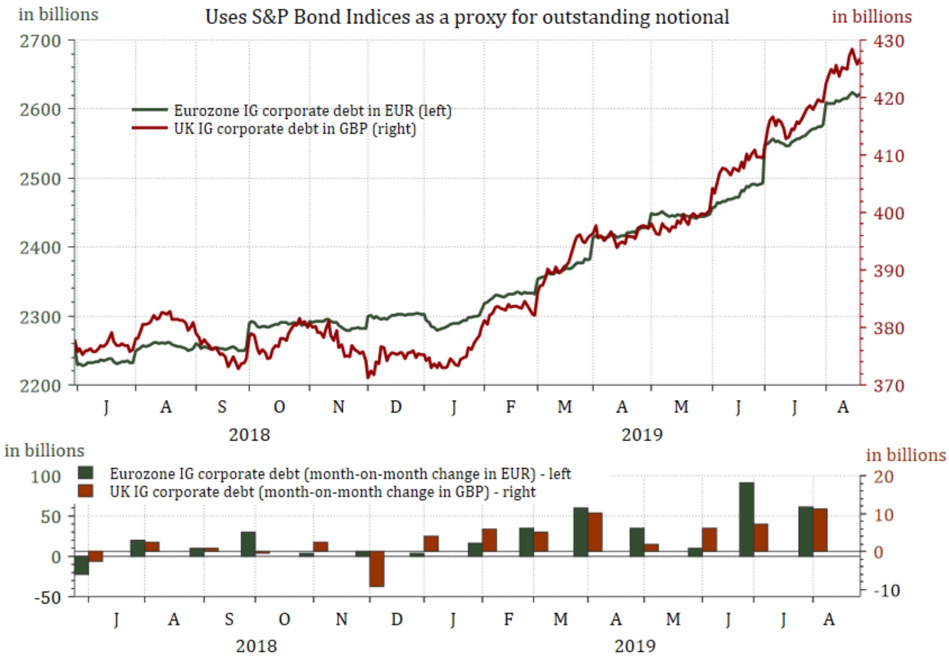
ii. A policy reversal, which is in-line with investor expectations, has been prompted by:
   - **A sharp fall in European inflation expectations:** long-term inflation linked swaps were trading at all-time lows ahead of the Sintra meeting and clearly below 2016 levels; a time when the Governing Council previously exercised monetary accommodation. A sharp reversal from the upbeat view of higher inflation held at end of 2018.
   - **Eurozone growth concerns have taken central focus:** amid ubiquitous softening in manufacturing activity and more specific concerns around German Industrial Production (a strong driver of weaker inflation expectations).
   - **Positivity:** growth momentum in France and Spain appears to be robust and continued Eurozone-wide wage gains and strong employment growth should provide moderate support to inflation.
   - **European-centric political risks re-surface:** as **Brexit-talks continue to drag on** and tensions rise ahead of the **2020 Italian budget negotiations in September 2019**, compounding more global risks around trade wars and the potential implementation of tariffs on European automobiles and manufacturers.

iii. The ECB has tasked a committee to examine policy options with respect to ***"mitigating measures"***, which is ECB-speak for **tiered rates** as negative interest rates have been criticised for hurting bank profitability (although Draghi blames the high cost-to-income ratios of the banks instead). Despite this, moving deeper into negative territory comes with its own risks and side effects, and hence it is regarded as a less preferable policy tool compared to asset purchases.

As can be seen from the chart below it is not only US Corporate Credit issuance which has risen significantly but GBP and EUR corporate bond issuance has risen in 1H 2019 taking advantage of lower European bond yields. The below chart shows the extent of negative yielding EUR bonds.

European corporate debt issuance picked up in 1H 2019

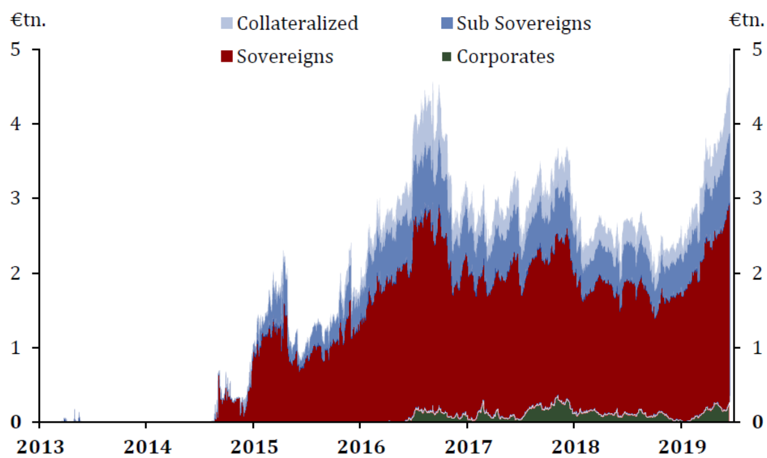
Uses S&P Bond Indices as a proxy for outstanding notional



Source: Refinitiv Datastream - 8/21/2019

Nearly €5 tn of EUR-denominated bonds trade with negative yields

EUR notional outstanding for all EUR-denominated bonds that trade with yields below 0%



Source: iBoxx, Goldman Sachs Global Investment Research

5. Conclusion

The number of indicators which point to a slowing global economy are growing. The intervention of easing monetary policy and expansionary fiscal policy may not be enough to avert this slowdown, and we remain cautious.

In light of the macro-economic climate, we have positioned our portfolios to be underweight equity vs our strategic allocation, 2%-5% in favour of bonds, which has also worked well in recent weeks. In our positioning within our EUR and GBP portfolios we have been overweight to US treasuries, which we have since removed in the quarter following the strong US Dollar and strong moves down in US rates. This positioning worked well. Within equities we removed our position in European Oil and Gas in the quarter as we worry about further declines in oil prices and the lack of meaningful oil price spikes despite Middle East tensions.

Within our equity allocations we have the following overweight positions vs our strategic allocation:

- US Consumer Staples
- European Healthcare
- European Value stocks
- Spanish Equity
- Indian Equity

During periods of risk-on we look to continue to build our defensive positioning. We also look to where on the yield curve will best provide superior risk-adjusted returns.

Appendix A – Economic Data

Important data since 2Q 2019 showing a softening economic climate. Key economic measures showing either a worsening of readings or an increase in expectations misses.

Date	Country	Indicator Name	Period	Actual	Reuters Poll	Prior	Beat/Miss	Change
1 Apr 2019	United States	**ISM Manufacturing PMI**	Mar	**55.3**	54.5	54.2	Beat	Improved
5 Apr 2019	United States	**Average Earnings MoM**	Mar	**0.2%**	0.3%	0.4%	**Miss**	**Worsen**
8 Apr 2019	United States	**Factory Orders (m-o-m)**	Feb	**-1.0%**	-0.6%	0.1%	**Miss**	**Worsen**
16 Apr 2019	United States	**Industrial Production (m-o-m)**	Mar	**0.1%**	0.2%	-0.5%	**Miss**	Improved
22 Apr 2019	United States	**Exist. Home Sales % Change**	Mar	**-4.9%**	-3.8%	11.2%	**Miss**	**Worsen**
26 Apr 2019	United States	**GDP Advance**	Q1	**3.2%**	2.0%	2.2%	Beat	Improved
26 Apr 2019	United States	**U Mich Sentiment Final**	Apr	**97.2**	97.0	96.9	Beat	Improved
30 Apr 2019	United States	**Consumer Confidence**	Apr	**129.2**	126.0	124.2	Beat	Improved
1 May 2019	United States	**ISM Manufacturing PMI**	Apr	**52.8**	55.0	55.3	**Miss**	**Worsen**
2 May 2019	United States	**Factory Orders (m-o-m)**	Mar	**1.3%**	1.5%	-1.0%	**Miss**	Improved
3 May 2019	United States	**Average Earnings (m-o-m)**	Apr	**0.1%**	0.3%	0.2%	**Miss**	**Worsen**
15 May 2019	United States	**Industrial Production (m-o-m)**	Apr	**-0.6%**	0.0%	0.1%	**Miss**	**Worsen**
21 May 2019	United States	**Exist. Home Sales % Chg**	Apr	**0.0%**	2.7%	-4.9%	**Miss**	Improved
28 May 2019	United States	**Consumer Confidence**	May	**131.3**	130.0	129.2	Beat	Improved
30 May 2019	United States	**GDP 2nd Estimate**	Q1	**3.1%**	3.1%	3.2%	In-line	**Worsen**
31 May 2019	United States	**U Mich Sentiment Final**	May	**100.0**	101.5	102.4	**Miss**	**Worsen**
3 Jun 2019	United States	**ISM Manufacturing PMI**	May	**52.1**	53.0	52.8	**Miss**	**Worsen**
4 Jun 2019	United States	**Factory Orders (m-o-m)**	Apr	**-1.2%**	-0.9%	1.3%	**Miss**	**Worsen**
7 Jun 2019	United States	**Average Earnings (m-o-m)**	May	**0.3%**	0.3%	0.1%	In-line	Improved
14 Jun 2019	United States	**Industrial Production (m-o-m)**	May	**0.2%**	0.2%	-0.6%	In-line	Improved
21 Jun 2019	United States	**Exist. Home Sales % Chg**	May	**2.9%**	1.2%	0.0%	Beat	Improved
25 Jun 2019	United States	**Consumer Confidence**	Jun	**124.3**	131.1	131.3	**Miss**	**Worsen**
27 Jun 2019	United States	**GDP Final**	Q1	**3.1%**	3.1%	3.1%	In-line	Unchanged
28 Jun 2019	United States	**U Mich Sentiment Final**	Jun	**98.2**	98.0	97.9	Beat	Improved
1 Jul 2019	United States	**ISM Manufacturing PMI**	Jun	**51.7**	51.0	52.1	Beat	**Worsen**
3 Jul 2019	United States	**Factory Orders (m-o-m)**	May	**-1.3%**	-0.5%	-1.2%	**Miss**	**Worsen**
5 Jul 2019	United States	**Average Earnings (m-o-m)**	Jun	**0.3%**	0.3%	0.3%	In-line	Unchanged
16 Jul 2019	United States	**Industrial Production (m-o-m)**	Jun	**0.2%**	0.1%	0.2%	Beat	Unchanged
23 Jul 2019	United States	**Exist. Home Sales % Chg**	Jun	**-1.7%**	-0.2%	2.9%	**Miss**	**Worsen**
26 Jul 2019	United States	**GDP Advance**	Q2	**2.1%**	1.8%	3.1%	Beat	**Worsen**
30 Jul 2019	United States	**Consumer Confidence**	Jul	**135.7**	125.0	124.3	Beat	Improved
1 Aug 2019	United States	**ISM Manufacturing PMI**	Jul	**51.2**	52.0	51.7	**Miss**	**Worsen**
2 Aug 2019	United States	**Average Earnings (m-o-m)**	Jul	**0.3%**	0.2%	0.3%	Beat	Unchanged
2 Aug 2019	United States	**Factory Orders (m-o-m)**	Jun	**0.6%**	0.8%	-1.3%	**Miss**	Improved
2 Aug 2019	United States	**U Mich Sentiment Final**	Jul	**98.4**	98.5	98.4	**Miss**	Unchanged
15 Aug 2019	United States	**Industrial Production (m-o-m)**	Jul	**-0.2%**	0.1%	0.0%	**Miss**	**Worsen**

Date	Country	Indicator Name	Period	Actual	Reuters Poll	Prior	Beat/Miss	Change
1 Apr 2019	Eurozone	**Markit Manufacturing Final PMI**	Mar	**47.5**	47.6		**Miss**	
3 Apr 2019	Eurozone	**Retail Sales (m-o-m)**	Feb	**0.7**	0.2	0.8	Beat	**Worsen**
12 Apr 2019	Eurozone	**Industrial Production (m-o-m)**	Feb	**0.0**	-0.6	1.7	Beat	**Worsen**
29 Apr 2019	Eurozone	**Business Climate**	Apr	**0.4**	0.5	0.5	**Miss**	**Worsen**
30 Apr 2019	Eurozone	**GDP Flash Prelim QQ**	Q1	**0.4**	0.3	0.2	Beat	Improved
2 May 2019	Eurozone	**Markit Manufacturing Final PMI**	Apr	**47.9**	47.8	47.5	Beat	Improved
6 May 2019	Eurozone	**Retail Sales (m-o-m)**	Mar	**0.2**	-0.1	0.7	Beat	**Worsen**
14 May 2019	Eurozone	**Industrial Production (m-o-m)**	Mar	**-0.2**	-0.3	0.0	Beat	**Worsen**
28 May 2019	Eurozone	**Business Climate**	May	**0.3**	0.4	0.4	**Miss**	**Worsen**
3 Jun 2019	Eurozone	**Markit Manufacturing Final PMI**	May	**47.7**	47.7	**47.9**	In-line	**Worsen**
5 Jun 2019	Eurozone	**Retail Sales (m-o-m)**	Apr	**0.1**	-0.4	0.2	Beat	**Worsen**
6 Jun 2019	Eurozone	**GDP Revised QQ**	Q1	**0.4**	0.4	0.4	In-line	Unchanged
13 Jun 2019	Eurozone	**Industrial Production (m-o-m)**	Apr	**-0.5**	-0.5	-0.2	In-line	**Worsen**
27 Jun 2019	Eurozone	**Business Climate**	Jun	**0.2**	0.2	0.3	**Miss**	**Worsen**
1 Jul 2019	Eurozone	**Markit Manufacturing Final PMI**	Jun	**47.6**	47.8	47.8	**Miss**	**Worsen**
4 Jul 2019	Eurozone	**Retail Sales (m-o-m)**	May	**-0.6**	0.3	0.1	**Miss**	**Worsen**
12 Jul 2019	Eurozone	**Industrial Production (m-o-m)**	May	**0.8**	0.2	-0.5	Beat	Improved
30 Jul 2019	Eurozone	**Business Climate**	Jul	**-0.1**	0.1	0.2	**Miss**	**Worsen**
31 Jul 2019	Eurozone	**GDP Flash Prelim QQ**	Q2	**0.2**	0.2	0.4	In-line	**Worsen**
1 Aug 2019	Eurozone	**Markit Manufacturing Final PMI**	Jul	**46.5**	46.4	46.4	Beat	Improved
2 Aug 2019	Eurozone	**Retail Sales (m-o-m)**	Jun	**1.1**	0.2	-0.6	Beat	Improved
14 Aug 2019	Eurozone	**Industrial Production (m-o-m)**	Jun	**-1.6**	-1.4	0.9	**Miss**	**Worsen**

Date	Country	Indicator Name	Period	Actual	Reuters Poll	Prior	Beat/Miss	Change
17 Apr 2019	China	**GDP QQ SA**	Q1	**1.4**	1.4	1.5	In-line	Worsen
17 Apr 2019	China	**Industrial Output YY**	Mar	**8.5**	5.9	5.3	Beat	Improved
30 Apr 2019	China	**NBS Manufacturing PMI**	Apr	**50.1**	50.5	50.5	Miss	Worsen
15 May 2019	China	**Industrial Output YY**	Apr	**5.4**	6.5	8.5	Miss	Worsen
31 May 2019	China	**NBS Manufacturing PMI**	May	**49.4**	49.9	50.1	Miss	Worsen
14 Jun 2019	China	**Industrial Output YY**	May	**5.0**	5.5	5.4	Miss	Worsen
30 Jun 2019	China	**NBS Manufacturing PMI**	Jun	**49.4**	49.5	49.4	Miss	Unchanged
1 Jul 2019	China	**Caixin Mfg PMI Final**	Jun	**49.4**	50.0	50.2	Miss	Worsen
15 Jul 2019	China	**GDP QQ SA**	Q2	**1.6**	1.5	1.4	Beat	Improved
15 Jul 2019	China	**Industrial Output YY**	Jun	**6.3**	5.2	5.0	Beat	Improved
31 Jul 2019	China	**NBS Manufacturing PMI**	Jul	**49.7**	49.6	49.4	Beat	Improved
1 Aug 2019	China	**Caixin Mfg PMI Final**	Jul	**49.9**	49.6	49.4	Beat	Improved
14 Aug 2019	China	**Industrial Output YY**	Jul	**4.8**	5.8	6.3	Miss	Worsen

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