A RETURN TO GREATER BALANCE

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02/04/2019 | DIDIER SAINT-GEORGES

We have no grounds since the beginning of March to alter our basic views. The collision between a slowing world economy and monetary policy tightening has happened – unquestionably so. With the economic slowdown unfolding, central banks have seen the writing on the wall and continued to soften their stance in March.

Some observers are banking on a powerful, 2016-style economic upswing; others fear we are sliding helplessly into a recession. But the stock market seems to be operating on the more modest assumption that economic growth will settle in at a pace that is mediocre enough to ensure the continuation of favourable monetary policy.

THE GLOBAL ECONOMIC SLOWDOWN IS NO LONGER CONTROVERSIAL

Apart from China, the world economy has continued to lose momentum, and most leading indicators for cyclical trends tend to point in a bleak direction. What our analysts observed on a visit to China last month bears out our view that the country should manage to stabilise the pace of its output growth, particularly in the industrial sector.

The response of fixed income and equity markets to these rather uninspiring conditions reflects a bearish overall view of the economy – even as the first "green shoots" are becoming apparent. In addition to the first tangible signs that Chinese manufacturing output was steadying, the share of downgrades to analysts' corporate earnings expectations, while still constituting a sizeable majority, has declined slightly.

THE MARKET OUTLOOK

Going forward, the main question-mark facing investors is to what extent monetary and fiscal policy, which is now more supportive, will succeed in stemming the economic slowdown under way, or even reversing it as in 2016.

The fiscal outlook is a mixed bag across the globe. In Europe, it is favourable by and large, due mainly to social pressure in France, political determination in Italy and dwindling economic momentum in Germany. In China, infrastructure and military spending, which are entirely under central government control, should be adequate to the task. In the US, however, the 2017 tax reform has indeed provided support, but is unlikely to exceed 0.6 points of GDP this year.

Regarding monetary policy as well, the outlook is similarly positive yet low-key. After the Federal Reserve's U-turn, the vast majority of central banks around the world have expressed a willingness to ease off again if need be, citing globally low inflation expectations to back up their views. The trouble is that they have very little leeway to reverse course, in the short term at any rate.

We can therefore plausibly assume that the global economic slowdown will continue on a subdued note for a few more months, accompanied, at least initially, by favourable but relatively toothless monetary policies. That outlook may be enough in the short term to sustain equity investors' confidence that the economy will gradually recover and bond markets will steady.

As we pointed out last month, unless an external political shock occurs, building a balanced portfolio that includes a slightly larger share of cyclical stocks, but still a majority of carefully selected names with predictable earnings growth, will be the key driver of our funds' performance in the next few months.

IN THE MEDIUM TERM

Events in 2018 highlighted how dependent equity markets have become on investors' confidence in the power of central banks to provide them with the liquidity they so crave. That addiction to "monetary manna" increasingly highlights the issue of central bank credibility. The uncomfortable fact of the matter is that the upbeat sentiment among equity investors today derives in part from the repeated failure of central banks to anchor inflation expectations at acceptable levels – as that failure is why central bankers have to keep trying to reflate the economy.

The cautious mindset that currently dominates the market opens up room for taking a moderate amount of short-term risk, particularly in light of the first signs of economic stabilisation that have emerged over the past few weeks. But the equilibrium in financial markets, above all in forex markets, rests today on basically shaky foundations. Considerable caution is therefore required in the medium term.

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