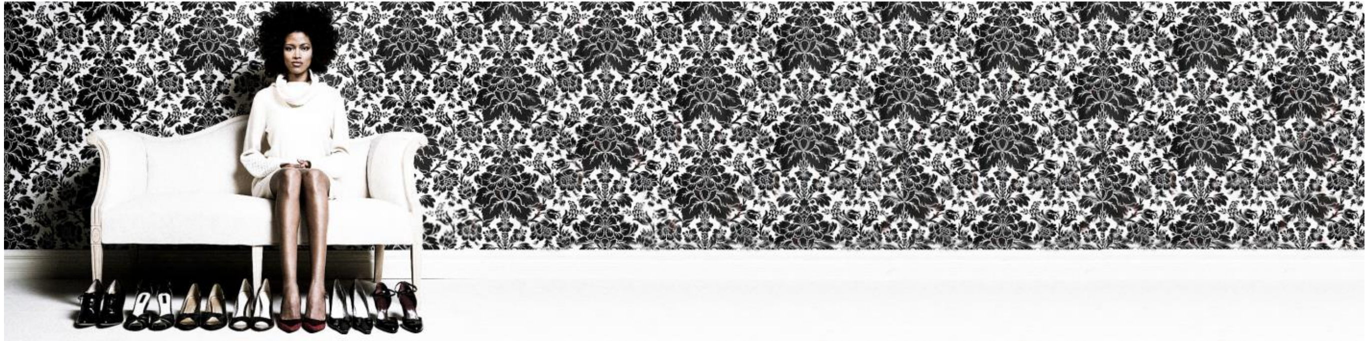
AquilaViewpoints

Market Outlook | 4th Quarter 2019



Tactical Perspective: Macro ▼ Bonds ▼ Equities ► Other Asset Classes ►

Executive Summary

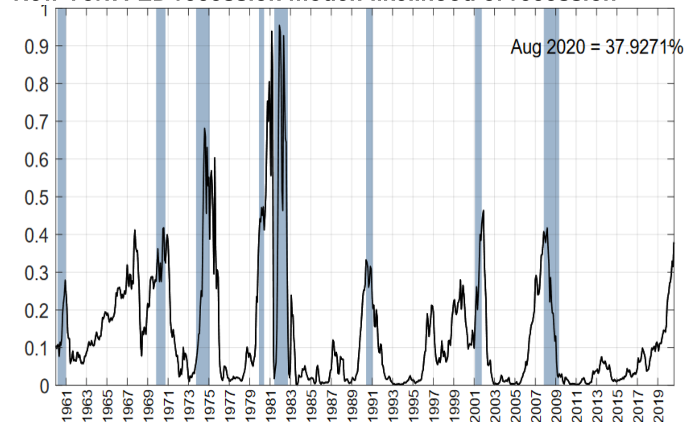
- We expect the world economy to grow by 2.9% in 2019.
- Our key regional and country growth forecasts are as follows: US: 2.1%, Euroland: 0.8%, Switzerland: 0.9%, China: 5.8%, Japan: 1.0%, UK: 0.9%.
- The economic cycle continues to lose momentum with service sectors now starting to show signs of weakness.
- As had been expected, the Fed and the ECB shifted their mon etary policies in the direction of stimulus in September.
- The Fed's FOMC is split on whether to cut interest rates further and stresses the role of data dependence in policy-setting. At most, we expect one further rate cut out of the Fed this year.
- Bonds with a face value of some $15 trillion are posting negative yields.
- We remain slightly underweight in equities and expect stock markets to remain volatile.
- Gold tends to rise as real interest rates fall. We remain committed to our gold investments.

Our macroeconomic assessment

Business cycle

- The OECD has joined the ranks of those reducing their growth forecasts. OECD forecasts now put world economic growth at 2.9% for 2019, as against 3.2% at the start of the year. For the coming year, world GDP is expected to grow 3%.
- The European economy has been particularly disappointing. The Eurozone Purchasing Managers' index for manufacturing fell in September from 47 to 45.6, compared to a predicted rise to 47.3. Meanwhile Germany's Purchasing Managers' index for the manufacturing sector, reported at 43.5 in August, fell to the shockingly low level of 41.4 in September when a slight rise to 44 had been predicted. It seems Europe's services sector is now also on a weakening trend.
- The index for US consumer confidence reported a sharp fall in September, from 135.1 to 125.1. America's trade conflicts (especially with China) as well as the more uncertain political situation have depressed confidence.

New York FED recession model: likelihood of recession



Source: New York Fed

Monetary policy

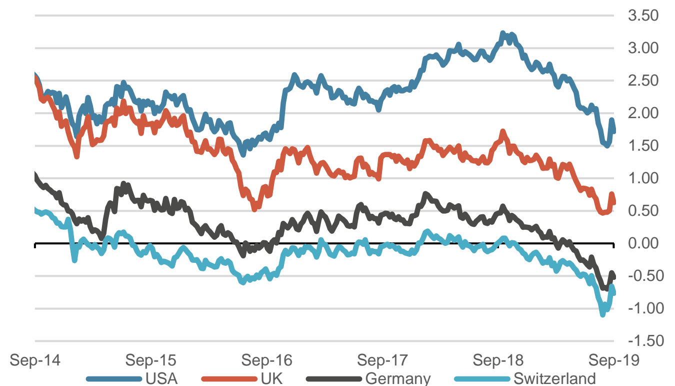
- In September, the ECB reduced its key policy rate from -0.4% to -0.5%. Also the ECB's bond-buying program will be restarted. As from November, the ECB will be buying bonds at the rate of Euro 20bn. a month.
- At the same time "forward guidance" has become more aggressive. And it is hoped that, with better access to long-term credit, Europe's banking system will become more robust.
- Today's very low interest rate policies are resulting in a very unequal distribution of wealth. With very high prices for equities, bonds and property, those who already own these assets, often financed by credit, are doing very well. Meanwhile savers and the poor are disadvantaged.
- Thus, in September the ECB delivered what the markets had been expecting. According to Reuters, economists surveyed prior to the ECB's September policy meeting had been expecting an interest rate cut of 10 basis points, renewed bond-buying of the order of Euro 30bn. a month, easier credit facilities for Europe's banks and the promise that European interest rates would be kept very low "for longer".
- As expected, the Fed cut its key policy rate for a second time by 25 basis points at its September meeting. However, the Fed also stated that the hurdles for further interest rate reductions are "high" given the very strong US labor market and that a severe economic downturn is not currently in Fed forecasts.

Our investment policy conclusions

Bonds

- After the sharp decline in bond yields towards the end of the summer, there has been some consolidation in yields at slightly higher levels. It looks as though recession fears – which in August led to such panic-buying of “safety” investments that the yield on the 10-year Treasury fell to 1.5%, with the yield curve partially inverting – have dissipated to some extent.
- With a large portion of Europe’s bond markets now trading on negative yields, there is the obvious question as to who will now buy these bonds given the certainty of loss if they are held to maturity. Are Europe’s bond investors succumbing to hopes that the future will provide “even dumber” investors to whom positions can be sold on at even higher prices? We have a highly unstable situation in Europe’s bond markets.

10 year government bond yields years, in %

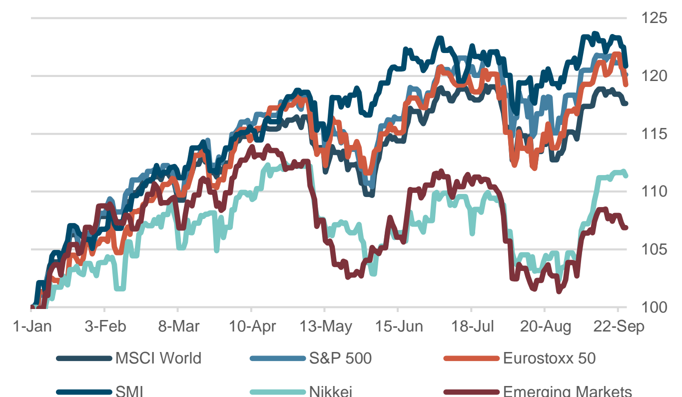


Source: Bloomberg Finance L.P.

Equities

- This year’s motto for equity investors seems to be: “ignore the macro data and trust in the central banks”. Thus some major markets have recently been able to drift back up towards all-time highs.
- On an index unit basis, analyst expectations for 2019 earnings for S&P 500 companies are now around $165. If the US economy does not succumb to recession, it is likely that US corporate earnings will accelerate somewhat next year. From a valuation perspective, today’s interest rates might imply a P/E ratio for the S&P 500 between 17 and 19. In turn, this suggests a level for the index between 2800 and 3100.
- Overall, we remain underweight in equities as an asset class. But we will be inclined to view any substantial setback in the markets as a buying opportunity, with a focus on quality companies.

Equity markets, perfomance year to date, indexed



Source: Bloomberg Finance L.P.

Forex

- The ECB must take care that, with its decision to become more expansionary in September, the euro does not become too weak against the US dollar. Should this happen Washington might seek revenge, perhaps through the introduction of higher tariffs on European cars imports. From this perspective, the $1.10 mark against the euro seems to be a good support level.
- In general terms we think that the US dollar will continue to move sideways against the other major currencies, even though on a purchasing power basis the US unit is trading at a new high. This has infuriated the US President who has been putting strong pressure on the Fed to reduce interest rates sharply. Latterly, Washington’ rhetoric has moderated somewhat – perhaps in assent to the motto that “the best country deserves the strongest currency“.
- Euro weakness – a reflection in part of the ECB’s recent measures and developments in the UK – has unsurprisingly boosted demand for the Swiss franc. Despite this, forex trading suggests the Swiss central bank has read recent market trends well.

EUR/USD, last two years

Source: Bloomberg Finance L.P.

Disclaimer. Produced by Investment Center Aquila Ltd. The information and opinions contained in this document are based on sources that we consider to be reliable. Nevertheless, we cannot vouch either for the reliability or for the correctness or completeness of these sources. This information and these opinions constitute neither a request nor an offer or recommendation to buy or sell investment instruments or to conduct any other transactions. We strongly recommend that prospective investors consult their independent financial advisor before making decisions based on this document in order to ensure that their personal investment objectives, financial situation, individual needs and risk profile and any additional information provided in comprehensive advice are properly considered.