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Investment Newsletter

April 2019

Neal Foundly

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Is the next global financial crisis in sight?

If the last month in investment markets was a Hollywood movie the script would have gone something like this:

Lights up on the White House Situation Room…

FOUR STAR GENERAL: There's no doubt about it, Mr President, the evidence is real – we face a clear and present danger and we must prepare for action, Sir.

U.S. PRESIDENT: I guess we have no option, General. When the enemy is on the horizon, I must do my duty for the nation. <sigh>. General, give the command to move from Defcon three to Defcon two…

As any military jargon or action movie buff will tell you, defence readiness condition (or "Defcon") is a state of alert according to the level of threat or risk. Defcon two is an increase in readiness to just below the maximum of one which is full battlestations.

So why are the markets locked and loaded?

Attention!

The reason might be seen as mundane but yields for the benchmark 10-year treasury bond fell below rates on three-month bonds for the first time since July 2007.

This so-called "bond inversion" is seen as clear evidence that a recession is on the way. It's a fact that every US recession since the 1960s was preceded by a year or so with an inversion of the treasury yield curve. It is seen as clear evidence of weapons of mass (value) destruction.

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At ease

But before we stock up on baked beans and clear out the bunker, let's just take a step back.

In "normal" economic cycles, short-term yields move above long-term yields as central banks try to apply the brakes to rapid economic growth pushing short-term interest rates above the long-term yields, creating the inversion. This high cost of short-term borrowing – usually above the rate of inflation – causes lending to fall and recession to ensue.

This time around, rather than the Federal Reserve raising rates to curb inflation, the inversion has been caused by the central bank's use of quantitative easing programme (buying $3.6 trillion of the bonds in the six years since the last global financial crisis) which pushed yields down across the curve, with those on longer-dated bonds dropping more. The key difference is that longer-term yields have been pushed down rather than the short-term yields pushed up too far – this difference might seem nuanced but is actually pretty important.

Thus, while the abnormal shape of the treasury curve demands attention, these are a unique set of circumstances, making it tough to conclude with any certainty that inversion inevitably means a recession is on the way.

Dismissed?

It would be wrong to simply dismiss this important evidence, however, and it is instructive to stand back and look at the wider circumstances to determine if the next global financial crisis is over the horizon.

There are certain key common factors that build ahead of past recessions and eventually gain traction, ultimately evoking investor risk aversion and sparking the big downturns such as we saw in 2007-8:

1. Over-valuation of assets
2. Too much debt
3. Incomes weaken or fall

Let's look at these in turn.

The dear hunter

Ahead of past recessions there have often been markets that have become excessively expensive. Not just overvalued but one, two or even three standard deviations above normal, long-term values. In the last two decades, the bubbles in technology shares and house prices resulted from too much capital chasing a limited supply of assets that pushed prices sky-high that only had one way to go.

Today, it is difficult to isolate any such Dutch bulb craze-type behaviour. A few major equity markets trade near overvaluation levels but nothing approaching a bubble – many commentators have called the recovery in stock markets since the crisis as "the most reluctant bull market ever" given how wary investors have been of buying assets that are too dear.

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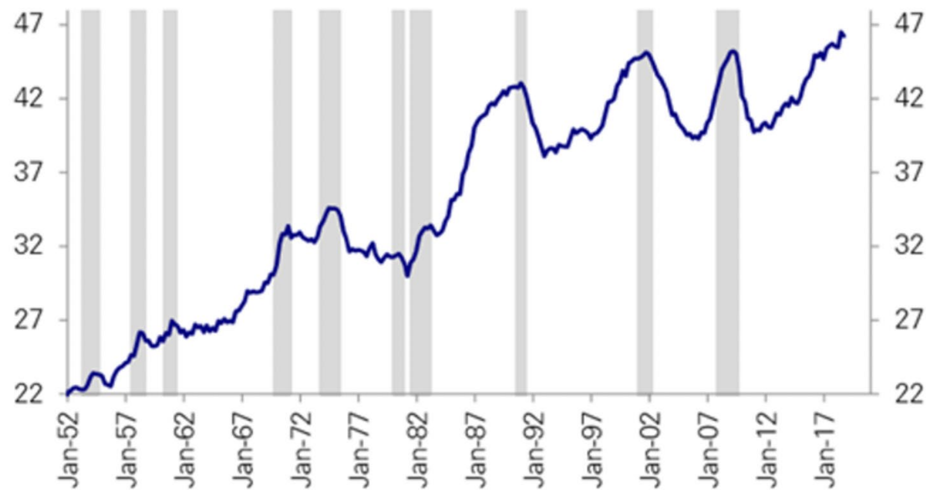
Stock piles

There is a lot of debt. Indeed, more than at the time of the start of the last crisis. In Chart 1, below, you can see the example from the US economy where non-financial corporate debt as a percentage of GDP has continued to rise beyond the levels seen at the time of last recession (recession shown as grey bars). This is clearly cause for concern, although it needs to be seen in the context of the next factor.

Chart 1: Non fin corporate debt as percentage of GDP (%)



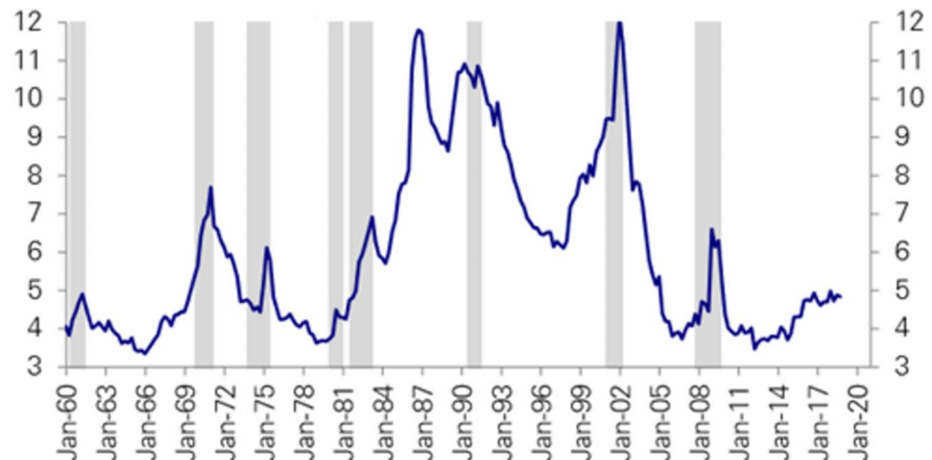
Source: BEA, FRB, DB US Euity Strategy

Incoming!

Having a high level of debt, like a big credit card balance, is manageable if interest rates are low and you have plenty of income to pay the interest charges. Because central banks have kept interest rates close to zero and there is reasonable economic growth, this is the position most economies find themselves in. Chart 2 shows this (again in the US) with the ratio of net debt to profits as almost at long-term lows.

So, everything's fine then? Well, yes and no. Whilst debt is not going to fall anytime soon, assuming interest rates are held roughly at this level, the key variable is income and growth in company profits. Here, we are watching corporate profit growth carefully but so far see no cause for alarm.

Chart 2: Non fin corporate net debt ratio to profits



Non-financial net debt = Bonds + loans outstanding minus cash holdings

Non-fin corporate profits = Non-fin domestic after tax + rest of world profits

Source: FRB flow of funds. Haver, DB US Equity Strategy

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Recent maneuvers

Regular readers of our newsletters will know that in the last 18 months we have moved a bit more defensively with larger holdings in alternatives and defined returns than long-term norms.

That said, we raised the holdings going into equity weakness in the fourth quarter of last year as part of a "volatility trade" in a FTSE 100 Index ETF. This month we sold this investment at a profit on approximately 3% of most portfolios.

We intend to reinvest some of this profit back into UK stocks with a strong bias to domestic earnings. As Chart 3 shows below, the UK (red line) has now underperformed the global MSCI World Index by a very significant margin in the last five years and is now very undervalued and unloved by global investors.

In addition, we have switched some of the weightings from Europe to US equities. European earnings growth continues to be anemic whilst US growth is proving robust and sustainable.

As Chart 4 shows, the European automotive industry in particular is struggling with the structural shift to electric vehicles. Many of the top car makes that command high premiums for their highly-engineered internal combustion engines are trying to weigh up how they can make as much money from what is effectively a mobile battery.

The fact that automobile sales in China fell for the first time in almost three decades last year (and are continuing to do so this year) has not helped their predicament.

The bottom line is that we do not naively dismiss the yield curve inversion as a precursor to recession. However, we look at the broader picture – yes, we are at the later stages of this current economic cycle and we are positioning the portfolios appropriately, but equally we do not react just because a smoke-signal goes up.

We are in a state of heightened readiness but also cautiously optimistic.

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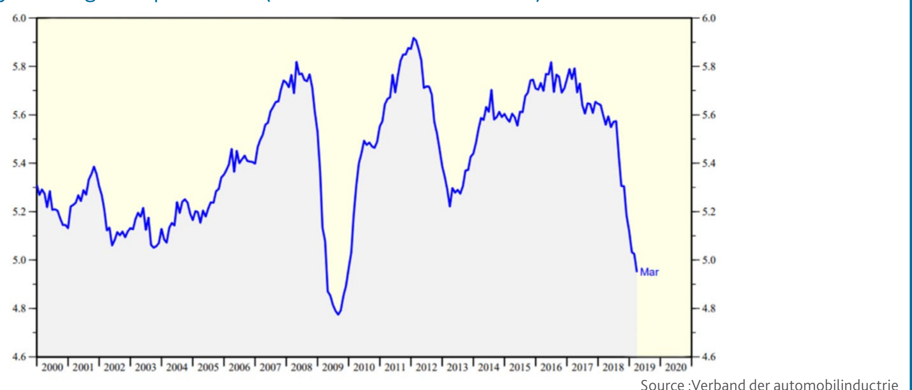
Chart 3: MSCI UK vs MSCI World

Chart 4: Germany: Passenger car production (million units, 12-month sum)



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General economic overview

In contrast to the gloom and doom in the fourth quarter of last year, many economic indicators are showing modest growth so far in 2019. Several key imponderables still exist for markets, including the important US/China trade negotiations and postponed Brexit decision.

Having tightened monetary conditions last year, a number of central banks have put these policies on hold or even moved to loosen money supply to facilitate more growth.

The UK economy is in a "Goldilocks" state at the moment, i.e. with growth not too strong nor too weak to justify changes in interest rates whilst the Brexit situation remains unresolved.

Equity markets

Reflecting the improvement in economic data, the major stock markets have continued to push up in April. The US market, where most companies report profits on a quarterly basis, has been one of the best performers as many corporates have announced figures ahead of expectations. The key areas that offer the best value are the Japan stock market and UK domestically-focused stocks which have been widely sold since the Brexit referendum and now trade on low valuations.

Fixed interest

Until some resolution is found to the Brexit situation, we would not expect there to be any changes to interest rates in the UK. In the US, the markets are discounting modest interest rate reductions later this year but we believe they may simply be held at the current levels. Credit conditions also remain relatively benign at the moment and so we expect reasonable returns from fixed interest. We generally prefer corporate bonds to gilts.

Commercial property

The trends of rising prices for industrial properties and very weak conditions for most retail units is continuing. We are looking to see if this dislocation is producing any fresh investment opportunities, but the overall portfolio is weighted much more to offices and away from London properties. We remain underweight property and relatively defensively positioned.

Cash

With interest rates remaining at record lows, returns on cash will remain below average for the foreseeable future.

Balanced asset allocation

For a typical balanced portfolio, we are underweight fixed interest and property, and slightly underweight traditional equity. This is balanced by additional holdings in defined returns and alternative equity, giving an overall risk/return profile roughly in line with our long-term average position.

These represent the collective views of Equilibrium Investment Management (EIM). The value of your investments can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested. We usually recommend holding at least some funds in all asset classes at all times and adjust weightings to reflect the above views. These are not personal recommendations so please do not take action without speaking to your adviser.

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