Global Investment Committee Outlook: Moderately Cautious on Global Equity

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How Were Our June Meeting's Predictions?

It certainly has continued to be a wild ride for investors, with political developments having caused just as much volatility as economic ones. Unfortunately, political considerations are hard for most people to predict, but they are clearly of great importance to markets, so our clients wish to hear our opinions and we do our best to give experienced and objective advice. So, while we clearly did not foresee all the conniptions, our view that political developments, including the tariff war, BREXIT and other geopolitical issues would worsen substantially and, thus, be troublesome for the markets has turned out to be reasonably accurate. Indeed, in late June, we reversed our long history of thinking that markets would look past political troubles and so, we made a rare prediction that global equity returns would be slightly negative ahead. For long-term global investors, this did not mean turning bearish, just cautious. This caution was warranted as the MSCI World Index rose only 1% in USD terms since then through our September 26th meeting date, vs. our expectation of a 1% decline through end September. In-between was often gut-wrenching volatility and uncertainty. Meanwhile, our favored benchmark global bond index rose 1%, nearly exactly as much as we expected, in USD terms (although each region's bonds were stronger than we expected, the USD was also stronger than expected, which reduced the USD-termed index return).

Global Growth Should Moderately Disappoint

As for our meeting on September 26th, we were, like in June, quite evenly divided between a rather benign global scenario and a continued moderately-cautious scenario, but ended up choosing the latter. Clearly though, we have some bias towards a slightly better outcome.

Global GDP continues to be in a soft patch, primarily caused by the fears and direct effects of the U.S.-China trade/technology war. So, the question continues to be how long the war and soft patch last and what will central banks do about it? We continue to be moderately pessimistic on both fronts. China and the U.S. will likely only make a moderately effective deal and while central banks have made small moves to prevent sentiment from declining, they are cautious about promising too much, especially as both the Fed and ECB are torn down the middle as to how much, if any, additional accommodation should be given. In the most vivid example, members representing nearly 60% of Eurozone GDP were against re-instating QE, but Draghi rammed it through, saying there was broad consensus and, thus, no legal need for a formal vote.

Equity markets dipped sharply in August, but then recovered as new U.S.-China talks were announced, coupled with some mild truce moves (although China's agricultural purchases are due to desperate shortages), and a no-deal BREXIT seemed to have been prevented for a while. However, we still expect that these and other issues will not proceed well and will likely decrease economic growth, corporate profits and risk appetite, though not harshly so. Additionally, we expect the upcoming U.S. election to be a much greater worry for markets and for some parts of the economy. We now also expect Trump's re-election odds to be seen next quarter as only a 50% chance, which will worry investors about the somewhat anti-business Democratic Party gaining power, as even without control of both Congressional houses, a Democratic President could institute major changes via Executive Actions and the power of the bureaucracy and regulatory agencies, much as Trump has conducted for instituting his agenda.

As for detailed numbers, the G-3 and Chinese economies should grow below consensus through September 2020, while we expect central banks to reduce interest rates and add other accommodative actions, but only to a very slight extent. Consensus forecasts for CY19 GDP for the G-4 have declined (except for Japan) since our June meeting, but we expect them to decline a bit further and that those for CY20 are a bit too high too. U.S. GDP, at a 1.3% Half on Half Seasonally Adjusted Annualized Rate (HoH SAAR, as used in all references below) in the 4Q19-1Q20 period and 1.5% in the 2Q20-3Q20 period, should undershoot economist-consensus expectations of 1.6% and 1.9% respectively. Personal consumption and government spending will likely be the only major contributors to growth, while inventories should be quite volatile and unpredictable, especially due to autoworker strikes and Boeing's problems. Meanwhile, the Eurozone should grow 0.4%

and 0.8%, respectively, vs. consensus of 0.8% and 1.1%, and Japan's will likely be -1.0% and 0.6% respectively, vs. the current consensus of -0.8% and 0.9%. Japan's forecasted weakness is due to the VAT hike in October, although we expect the front-loading of spending before such and subsequent dip to be quite moderate this time compared to the 2014 hike when Japan's economic stability and consumer/corporate confidence was much less sturdy. Recently initiated government fiscal stimulus will also help buffer growth. For CY19, growth for the U.S., Eurozone and Japan should be 2.2%, 1.0% and 0.8%, respectively. Lastly, China's official GDP should be approximately 5.0% and 4.8% HoH SAAR, respectively, with CY19 GDP at 5.9%, as the trade and tech wars will reduce growth despite added fiscal stimulus. Overall, these G-4 GDP results should disappoint risk markets, and corporate profit estimates should continue to show further deceleration in the 4Q19 and will likely show only moderate growth in the first half of 2020.

There is absolutely good reason for continued concern about many geopolitical issues, especially regarding China, the Middle East and BREXIT. The trade war with China will likely see some truce fairly soon, with continued talks ahead, but such will not, in our view, prevent tariffs on all remaining goods from gradually rising to 25% by June 2020 (the same as our June meeting's forecast). We expect that China will meaningfully retaliate against such, with some of such being just the populace avoiding U.S. products, but major Yuan devaluation is unlikely. The auto trade dispute between the U.S. and Europe/Japan is also unsolved, but Trump may feel that he cannot battle them while confronting China, and will take heart that their FDI in the U.S. auto industry is increasing substantially, even for hybrid/electric models. This dispute, however, could well impact Chinese autopart exports to the U.S., which are quite substantial, to a large degree. The aggressive implementation of WTO-approved tariffs by the U.S. on Europe for Airbus subsidies is also likely to increase protectionist fears in economies and markets. Meanwhile, we expect the "technology war" will continue to be a global economic inhibiter in the name of national security. There is also the possibility that North Korea could become a hot issue again. In Europe, there never seems to be an end to the messy politics in the region, and BREXIT will likely continue to worry markets (although we do not forecast a hard BREXIT next quarter). The crisis between the U.S. and Iran is quite scary indeed, although Trump seems unwilling to take the first military shot. The Houthi militia/Iran alliance's attack on Saudi facilities was a huge event, but the Saudis have acted calmly so far and there are even hints of ceasefire talks ahead. Lastly, within the U.S., while market uncertainty related to impeachment and recriminations by both parties may rise sharply at times, the chance of a major U.S. political upheaval remain slim in the next two quarters, but worries about the presidential and congressional 2020 elections will become more of a worry for markets.

Central Banks: Not a lot more to be done, barring crisis

Our G-3 forecasts for the 3Q19 were right on target although we did not specifically make a prediction on ECB QE. We continue to expect 4Q19 BOJ and ECB cuts of 10 bps and 25 bps for the Fed, but we now expect one more Fed 25 bps cut in the 1Q20. The Fed is also likely to allow the balance sheet to expand further, but will not likely call it QE because it could be temporary and for technical reasons, as the Fed does not wish to seem over-stimulative. We expect the PBOC to be dovish too, but not radically enough to cause Yuan devaluation. As for inflation, we expect U.S. Core CPI to be 2.1% YoY next March and September, with higher import tariffs adding to inflation while decelerating housing rent and new statistical methods should be headwinds for inflation. We expect the headline CPI to be 1.9% in those periods, with oil prices rising due to increased Middle East concerns, but with food and utility prices declining. Relatively stable inflation numbers, and the outlook for such continuing to be so, should keep central banks from cutting too much. There is a chance, however, of currency-stability considerations pushing rates down even further. As for overall commodity prices, the Bloomberg Index should also move upward in the next few quarters, primarily led by a recovery in oil and the large weight for gold, which we expect to rise further.

Mixed USD and Further Declines in G-3 Bond Yields

Given our scenario, we expect G-3 bond yields to continue declining in the next few quarters. For U.S. 10Y Treasuries, our target for end-March is 1.55%, while those for 10Y German Bunds and JGBs and are -0.65% and -0.35%, respectively. For next September, we expect 1.50%, -0.65% and -0.35%, respectively. Regarding forex, we expect only minor moves for the Yen and Euro in the 4Q19 quarter, but for the USD to weaken in the 1Q, with the Yen strengthening to 105 by March-end and 103 by next September, with the EUR rising to 1.12 and 1.14, respectively, as the ECB becomes much less dovish than the market expects, with the hawks having more sway over the new (and relatively inexperienced in monetary affairs) President Lagarde. Last but not least, our call for the AUD:USD is for 0.66 and 0.65, respectively.

This all implies (coupled with our forex targets) that including coupon income, the FTSE WGBI (index of global bonds) should produce a 1.7% unannualized return from our base date of September 20th through March in USD terms and 2.9% through next September. Thus, we continue our moderately enthusiastic stance on global bonds for USD-based investors. For Yen-based investors, however, the index in Yen terms should return -1.2%, and -1.9% for those periods, with JGBs returning 1.5% and 1.4. **There are likely some good opportunities for overseas bond investment for Japanese investors, but not on a passive, index based method that concentrates on the largest markets.**

As for a performance review, through September 20th, the MSCI World Index in USD terms rose 1% from our June 21st base date vs. our -1% expectation for end-September. All of our equity index targets were exceeded, but the USD was stronger than we anticipated (which usually helps non-U.S. equity index returns), so USD-termed gains were much closer to our USD-termed return targets.

One might think that with weaker than consensus economic growth and decelerating earnings growth, coupled with major increases in geopolitical risks, we would be very bearish; however, equity investors have proven “time and again” to remain constructive on risk during a period of low interest rates, with the view that the economy and profits will not dip too far and will recover before long. This view could easily be dashed if U.S. or global political risks accelerate massively, but until such is clear, equity investors don’t seem likely to flinch too much.

However, as a good amount of improvement in geopolitical affairs, especially the U.S.-China dispute, is priced into markets, our new scenario will disappoint consensus and, thus, we still cannot be very positive on global equities (as has been our view for virtually the entire period since the Global Financial Crisis until June). Further mild declines in interest rates will help soften any correction, but equity valuations will still likely decline moderately. Aggregating our national forecasts from our base date, we forecast that the MSCI World Total Return Index in USD terms will be relatively flat through year-end, rise 1.3% (unannualized) through March and by 2.9% through next September (relatively flat, -1.5% and -1.9% in Yen terms, respectively). Clearly, given all the risks present and the likely high volatility (poor risk-adjusted returns), this suggests mildly negatively stance for both USD termed and Yen-based investors.

In the U.S., the S&P 500 outperformed our target for September, but its PER on the CY19 EPS consensus estimate is now 18.7 times, which is expensive even given lower interest rates, especially as earnings estimates are likely to be downgraded further. A continued high level of share buybacks will help support the market, but given our increasingly problematic global macro and geopolitical risk forecasts, we expect the SPX to only rise mildly to 3044 (+2.7% total unannualized return from our base date) at end-March, and to 3094 next September (5.4% return), with Yen based returns being essentially flat.

European equities performed well in the 3Q and are now predicting that the U.S.-China trade conflicts will improve greatly, but it will likely be disappointed on that score. Meanwhile its GDP should be very near recession, so especially as higher Eurozone/BREXIT political risks become market impacting, we are quite negative on its equities. The PER (on a CY19 EPS that keeps falling and will likely continue to do so) is now quite high by historical standards, at 14.6. In sum, we expect both a PER de-rating and disappointing EPS, so the Euro Stoxx index should fall in the 4Q and continue down to 358 at end March, with FTSE down to 6970 then, which translates to returns of -3.8% (unannualized) for the MSCI Europe through March in USD terms (-6.5% in Yen terms). Returns through next September will even be worse, in our view.

Japanese equities rallied nicely in the 3Q, partly on the rotation towards laggards and value-plays. Moderately improved US-China trade relations sentiment also helped. Valuations remain very low, at 13.2 times a CY19 EPS consensus earnings number that has stabilized recently. The decline in the global semiconductor and smartphone cycles (which hit Japanese semiconductor product equipment, electronic components and supplies very badly), soft global auto sales, weakening Chinese demand for capex goods and other factors have previously pushed down EPS estimates this year and next, and foreigners, thus, sold Japanese equities. They have started buying again, however, and most analysts expect the semiconductor cycle to improve from here. The TOPIX dividend yield of 2.4% is very attractive for domestic investors (and even more so for global investors if the Yen appreciates like we expect) and corporate governance continues to improve (despite a few hiccups) with share buybacks rising very sharply. However, some temporary caution about the effect of the VAT hike and the poor global backdrop means that we expect TOPIX to be quite flat in the 4Q with a mild decline to 1556 through March (due to the stronger Yen in the 1Q). This leads to total unannualized returns of +0.4% through March in USD terms (-2.4% in Yen terms). As mentioned earlier, there is some uncertainty about how economic sentiment will fare after the VAT hike in October 2019, as the last hike caused major disruption, but we expect the bumps should be quite mild this time.

Developed Pacific-ex Japan MSCI fell in the 3Q due to the problems in Hong Kong. The political unrest there is certainly a key factor looking forward as the population seems likely to continue a very strong stance vs. the authorities, but perhaps less disruptive than before, so we are not negative on this market now. Australia’s economy is fairly weak, but sentiment has somewhat stabilized, especially as the downturn in its property market has been reversed, but a weaker Chinese economy and worse than expected trade war progress will likely hurt equity investment quite a bit, so we expect declines in the ASX200 continuing through next September. In sum, we expect the region’s MSCI index in USD terms to be slightly negative in the 4Q, -0.9% through March and -3.2% through next September (and much lower in Yen terms).

Investment Strategy Concluding View

Most investors realize that geopolitical risks are increasingly significant and the global economy remains in a soft period, yet we are even somewhat more pessimistic than consensus, so the Global Investment Committee will continue its cautious and mildly negative outlook on global equities. We expect small USD-termed gains in Japan and U.S., but quite negative returns in Europe and Developed Pacific ex Japan. None of these economic or market downturns are of major size, so long term investors should not panic; rather a mild underweighting of global equities or at least increased caution is called for. Meanwhile, global bond yields should decline moderately, so we continue our moderately positive view on global bond returns, except for U.S. and major European bonds for Japanese investors.