BCA Research

BEARISH CASES FOR TODAY'S MACROECONOMIC OUTLOOK

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This paper outlines the cyclical (six to 12 months) bearish outlook for assets within BCA Research's team. The group foresees a further deterioration in activity or a delayed recovery, additional downside in stocks and risk assets, outperformance of defensives relative to cyclicals, low safe-haven yields, and a generally stronger US dollar.

The presenters outlined their arguments for the bearish camp in the roundtable discussion reproduced in this paper.

The panel comprised:

- Anastasios Avgeriou, U.S. equity strategist, BCA Research.
- Arthur Budaghyan, chief emerging market strategist, BCA Research.
- Dhaval Joshi, chief European investment strategist, BCA Research.

The conversation was moderated by Mathieu Savary, BCA Research's bank credit analyst strategist. [Information current as at July 2019.]

BCA roundtable findings

Mathieu Savary: *Yield curve inversions have often been harbingers of recessions. Anastasios, you are amongst those investors troubled by this inversion. Do you not worry that this episode might prove similar to 1998, when the curve only inverted temporarily and did not foreshadow a recession? Moreover, how do you account for the highly variable time lags between the inversion of the yield curve and the occurrence of the actual recession?*

Anastasios Avgeriou: The yield curve inverts at or near the peak of the business cycle and it eventually forewarns of upcoming recessions. This past December, parts of the yield curve inverted and I believe investors should heed the signal from this simple indicator, especially given that the SPX [S&P 500 Index] has subsequently made all-time highs as our research predicted.

[At the time of original publication, 25 July 2019, we wrote that] the yield curve inversion forecasts a Fed rate cut, and it has never been wrong on that front. It served well investors that heeded the message in June of 1998 as the market soon thereafter fell 20% in a heartbeat.

If investors got out at the 1998 peak near 1,200 and forwent about 350 points of gains until the March 2000 SPX cycle peak, they still benefited if they held tight as the market ultimately troughed near 777 in October 2002 [Figure 1].

With regard to timing the previous seven recessions, using the yield curve, if we accept that mid-1998 is the starting point of the inversion, it took 33 months before the recession commenced. Last cycle, the recession began 24 months after the inversion. Consequently, December 2020 is the earliest possible onset of recession and September 2021, the latest.

Our forecast calls for SPX EPS [earnings per share] to fall 20% in 2021 to [USD] $140, with the multiple dropping between 13.5 times and 16.5 times for an SPX end-2020 target range of 1,890–2,310. In other words, we are not willing to play a 100–200 point advance for a potential 1,000 point drawdown. The risk-reward trade-off is to the downside, and we choose to sit this one out.

Mathieu Savary: *The level of policy accommodation will most likely determine whether Anastasios or the bullish camp is proven right. Dhaval, why do you think global rates are not accommodative?*

Dhaval Joshi: Actually, I think that global rates are accommodative, but that the global bond yield can rise by just 70 bps before conditions become perilously un-accommodative. My disagreement with the bullish view is this: the danger doesn't come from economics. It comes from the *mathematics of ultra-low bond yields*.

The unprecedented and experimental panacea of our era has been 'universal QE' — which has led to ultra-low bond yields everywhere. But what is not understood is that when bond yields reach and remain close to their lower bound, weird things happen to financial markets.

In some of our research, I've shown that the proximity of the lower bound to yields increases the risk of owning supposedly 'safe' bonds to the risk of owning so-called 'risk-assets'. The result is that the valuation of risk-assets rises exponentially because when the riskiness of the asset-classes converges, investors price risk-assets to deliver the same ultra-low nominal return as bonds.

Comparisons with previous economic cycles miss the current danger. The post-2000 policy easing distorted the global economy by engineering a credit boom — so the subsequent danger emanated from the most credit-sensitive sectors in the economy such as mortgage lending. In contrast, the post-2008 universal QE has severely distorted the valuation relationship between bonds and global risk-assets — so this is where the current danger lies. Higher bond yields can suddenly undermine the valuation support of global risk-assets whose [USD] $400 trillion worth dwarfs the global economy by five to one.

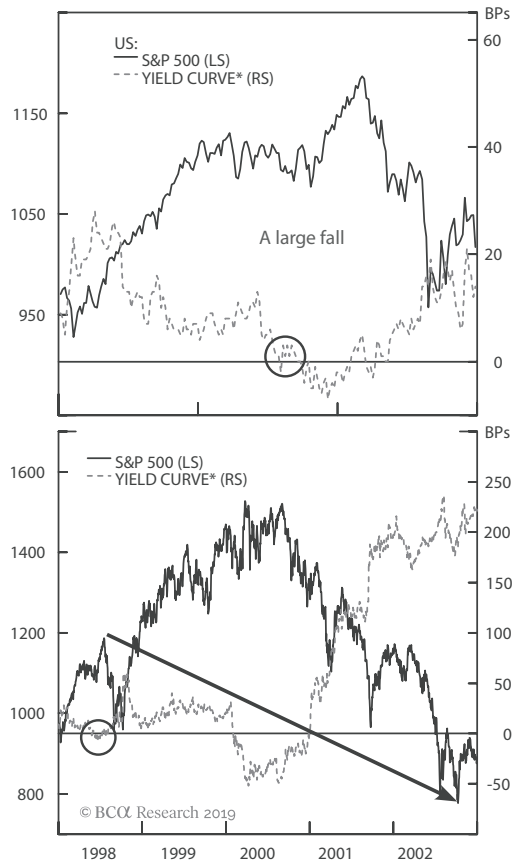
Where is this tipping point? It is when the global 10-year yield — defined as the average of the US, euro area (France is a good proxy for the euro area), and China — approaches 2.5%. Through the past five years, the inability of this yield to remain above 2.5% confirms the hyper-sensitivity of financial conditions to this tipping point [Figure 2].

Right now, I agree that bond yields are accommodative but the scope for yields to move higher is quite limited.

Mathieu Savary: *Monetary policy is important to the outlook, but so is the global manufacturing cycle. The global growth slowdown has been concentrated in the manufacturing sector; tradeable goods in particular. Across advanced economies, the service and consumer sector have been surprisingly resilient, but this will not last if the industrial sector decelerates further. Arthur, you still do not anticipate any major improvement in global trade and industrial production. Can you elaborate why?*

Arthur Budaghyan: To properly assess the economic outlook going forward, one needs to understand what has caused the ongoing global trade/manufacturing downturn. One thing we know for certain — it originated in China, not the US.

Figure 1. The 1998 episode revisited



* 10-YEAR TREASURY YIELD MINUS 2-YEAR TREASURY YIELD.

Source: BCA Research

Figure 2. Since 2015, the global long bond yield has struggled to surpass 2.5%

Source: BCA Research

The quote

The unprecedented and experimental panacea of our era has been 'universal QE' — which has led to ultra-low bond yields everywhere.

The chart below [Figure 3] illustrates that Korean, Japanese, Taiwanese and Singaporean exports to China have been shrinking at an annual rate of 10%, while their shipments to the US have been growing. China's aggregate imports have also been contracting. This entails that from the perspective of the rest of the world, China has been and remains in recession.

US manufacturing is the least exposed to China, which is the main reason why it has been the last shoe to drop. Hence, the US has lagged in this downturn, and one should not be looking to the US for clues about a potential global recovery.

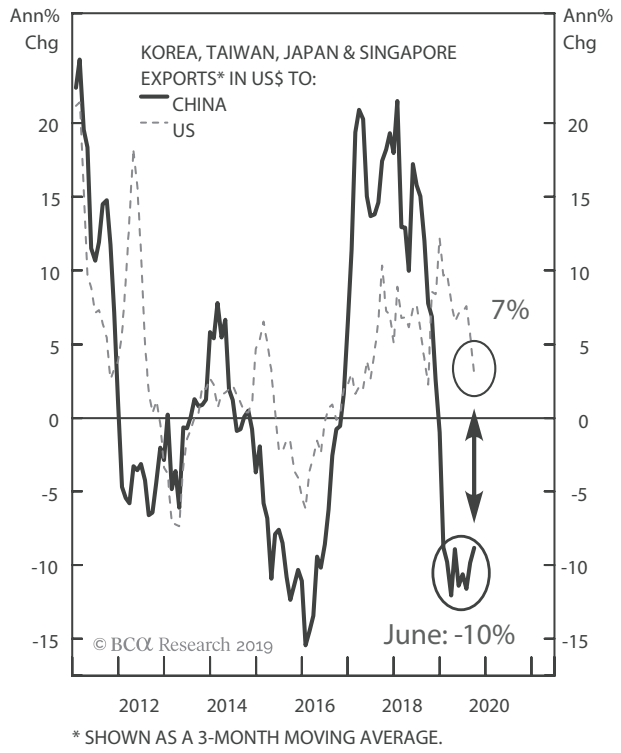
We need to gauge what will turn Chinese demand around. In this regard, the rising credit and fiscal spending impulse is positive, but it has so far failed to kick-start a recovery [Figure 4].

The key reason has been a declining marginal propensity to spend among households and companies. Notably, the marginal propensity to spend of mainland companies leads industrial metals prices by a few months, and it currently continues to point south [Figure 4, bottom panel].

The lack of willingness among Chinese consumers and enterprises to spend is due to several factors:

1. The US-China [trade] confrontation.
2. High levels of indebtedness among both enterprises and households.
3. Ongoing regulatory scrutiny over banks and shadow banking as well as local government debt.
4. A lack of outright government subsidies for purchases of autos and housing.

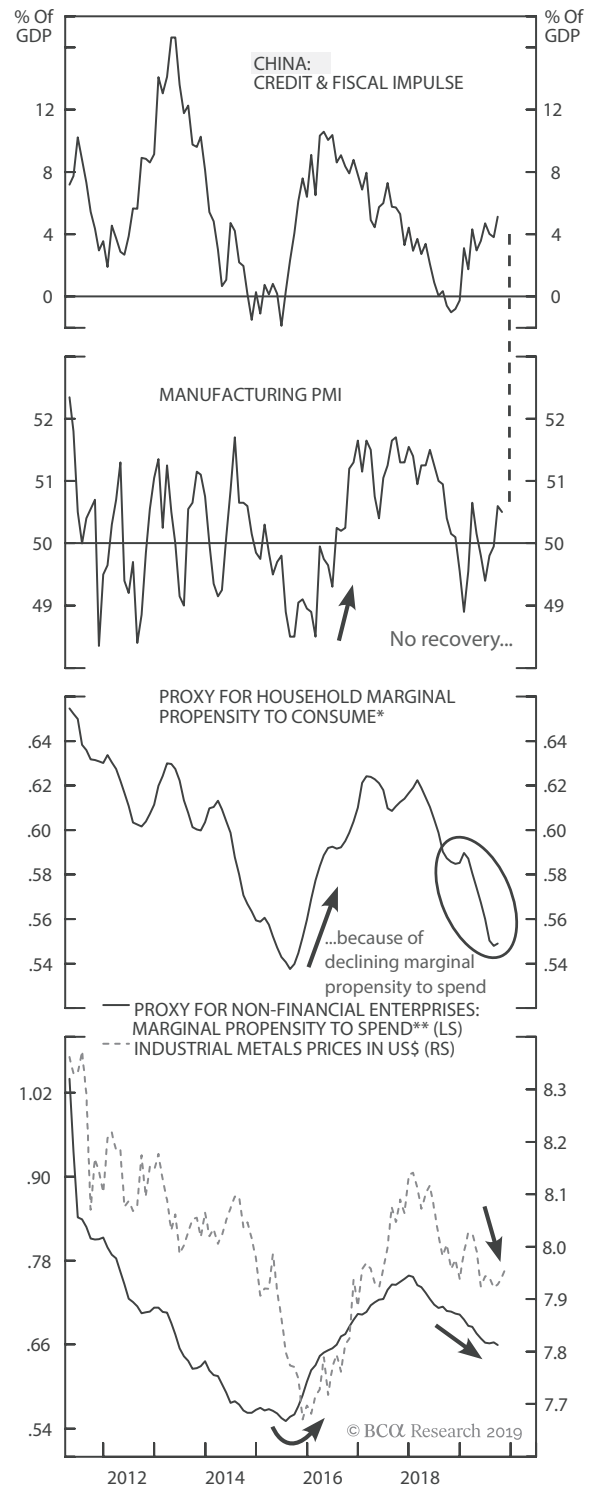
Figure 3. Global trade is down due to China, not the US



* SHOWN AS A 3-MONTH MOVING AVERAGE.

Source: BCA Research

Figure 4. Stimulus versus marginal propensity to spend



* SHOWN AS 6-MONTH MOVING AVERAGE; CALCULATED AS A RATIO OF HOUSEHOLD DEMAND DEPOSITS TO TIME DEPOSITS.

** SHOWN AS A 6-MONTH MOVING AVERAGE; CALCULATED AS A RATIO OF CORPORATE DEMAND DEPOSITS TO TIME DEPOSITS.

Source: BCA Research

On the whole, the falling marginal propensity to spend will all but ensure that any recovery in mainland household and corporate spending is delayed.

Mathieu Savary: *Dhaval, you are not as negative as Arthur, but nonetheless expect a slowdown in the second half of the year. What is your rationale?*

Dhaval Joshi: To be clear, I am not forecasting a recession or major downturn — unless, as per my previous answer, the global 10-year bond yield approaches 2.5% and triggers a severe dislocation in global risk-assets. In fact, many people get the relationship between recession and financial market dislocation back-to-front. They think that the recession causes the financial market dislocation when, in most cases, the financial market dislocation causes the recession.

Nevertheless, I do believe that European and global growth is entering a regular down-oscillation based on the following compelling evidence:

1. From a low last summer, quarter-on-quarter GDP growth rates in the developed economies have already rebounded to the upper end of multi-year ranges.
2. Short-term credit impulses in Europe, the US, and China are entering down-oscillations.
3. The best current activity indicators, specifically the ZEW economic sentiment indicators, have rolled over.
4. The outperformance of industrials — the equity sector most exposed to global growth — has also rolled over.

Why expect a down-oscillation? Because it is the rate of decline in the bond yield that drove the rebound in growth after its low last summer. Furthermore, it is impossible for the rate of decline in the bond yield to keep increasing, or even stay where it is. Counterintuitively, if bond yields decline, but at a reduced pace, the effect is to slow economic growth.

Mathieu Savary: *Arthur, as you are significantly more negative on growth than your bullish colleagues at BCA Research, how do you see the [US] dollar and global yields evolving over the coming six to 12 months?*

Arthur Budaghyan: I am positive on the trade-weighted US dollar for the following reasons:

- The US dollar is a countercyclical currency — it exhibits a negative correlation with the global business cycle. Persistent weakness in the global economy emanating from China/EM [emerging markets] is positive for the dollar because the US economy is the major economic block least exposed to a China/EM slowdown.
- Meanwhile, the greenback is only loosely correlated with US interest rates. Thereby, the argument that lower US rates will drive the value of the US currency much lower is overemphasised. [At the time of original publication, 25 July 2019, we wrote that] the Federal Reserve will cut rates by more than what is currently priced into the market *only* in a scenario of a complete collapse in global growth. Yet this scenario would be dollar bullish. In this case, the dollar's strong inverse relationship with global growth will outweigh its weak positive relationship with interest rates.
- Contrary to consensus views, the US dollar is not very expensive. According to unit labour costs based on the real effective exchange rate — the best currency valuation measure — the greenback is only one standard deviation above its fair value. Often financial markets tend to overshoot to 1.5 or 2 standard deviations below or above their historical mean before reversing their trend.
- One of the oft-cited headwinds facing the dollar is positioning, yet there is a major discrepancy between positioning in DM [developed market] and EM currencies versus the US dollar. In aggregate, investors — asset managers and leveraged funds — have neutral exposure to DM currencies, but they are very long liquid EM exchange rates such as the BRL, MXN, ZAR and RUB versus the greenback.

The dollar strength will occur mostly versus EM and commodities currencies. In other words, the euro, other European currencies and the yen will outperform EM exchange rates.

I have less conviction on global bond yields. While global growth will disappoint, yields have already fallen a lot and the US economy is currently not weak enough to justify around 90 basis points of rate cuts over the next 12 months.

Mathieu Savary: *Anastasios, you have done a lot of interesting work on the outlook for US profits. What is the message of your analysis?*

Anastasios Avgeriou: While markets cheered the trade truce following the recent G-20 meeting, no tariff rollback was agreed. Since the tariff rate on $200 billion of Chinese imports went up from 10% to 25% on May 10, odds are high that manufacturing will remain in the doldrums. This will likely continue to weigh on profits for the remainder of the year.

Profit growth should weaken further in the coming six months. Periods of falling manufacturing PMI result in larger negative earnings growth surprises as market forecasters rarely anticipate the full breadth and depth of slowdowns. Absent profit growth, equity markets lack the necessary 'oxygen' for a durable high-quality rally. Until global growth momentum turns, investors should fade rallies.

Our four-factor SPX EPS growth model is flirting with the contraction zone. In addition, our corporate pricing power proxy and Goldman Sachs' Current Activity Indicator both send a distress signal for SPX profits.

Already, more than half of the S&P 500 GICS [Global Industry Classification Standard] sectors' profits are forecast to contract in Q2, and three sectors could see declining revenues on a year-over-year basis, according to [Institutional Brokers' Estimate System] data. Q3 depicts an equally grim profit picture that will also spill over to Q4. Adding it all up, profits will underwhelm into year-end.

Mathieu Savary: *The last, and most important question. What are each of your main investment recommendations to capitalise on the economic trends you anticipate over the coming 6 to12 months?*

Arthur Budaghyan: First, the rally in global cyclicals and China plays since December [2019] has been premature and is at risk of unwinding as global growth and cyclical profits disappoint. Historical evidence suggests that global share prices have not led but have actually been coincident with the global manufacturing PMI. The recent divergence is unprecedented.

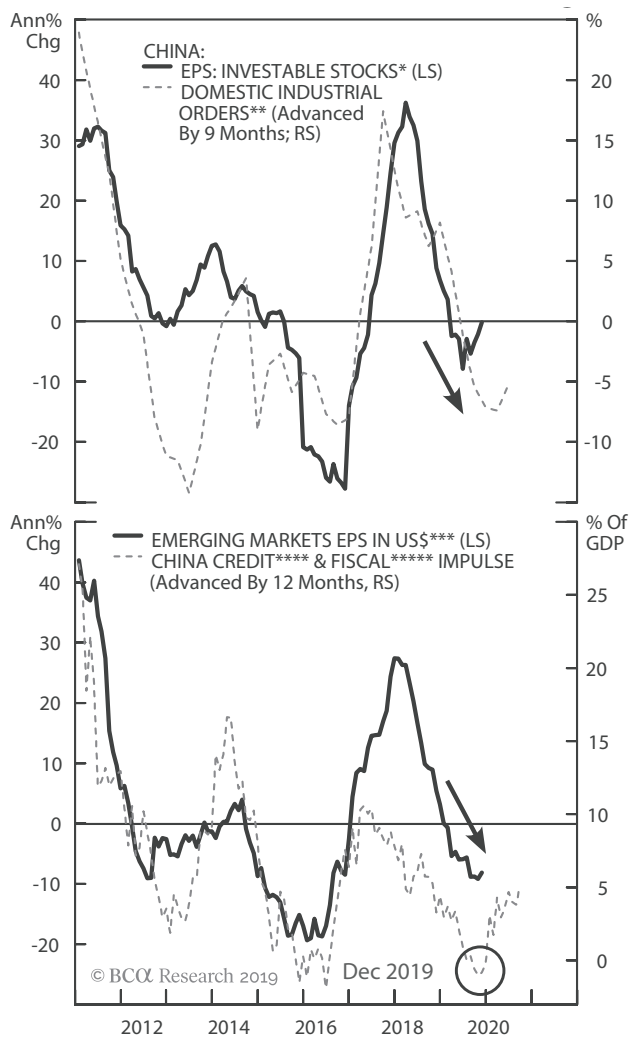
Second, EM risk assets and currencies remain vulnerable. EM and Chinese earnings per share are shrinking. The leading indicators signal that the rate of contraction will deepen through to at

least the end of this year [Figure 5]. Asset allocators should continue underweighting EM versus DM equities.

Finally, my strongest-conviction; market-neutral trade is to short EM or Chinese banks and go long US banks. The latter are much healthier than EM/Chinese ones, as I've recently written about.

Anastasios Avgeriou: The [BCA Research] US Equity Strategy team is shifting away from a cyclical and toward a more defensive portfolio bent.

Figure 5. China and EM profits are contracting



* IN LOCAL CURRENCY; SOURCE: IBES.
** SHOWN AS A 4-QUARTER CHANGE; SOURCE: PBOC, 5000 INDUSTRIAL ENTERPRISES SURVEY.
*** SOURCE: IBES.
**** CUMULATIVE AGGREGATE FINANCING EXCLUDING EQUITY FINANCING, LGFV SWAP FROM 2015 TO 2018 AND LOCAL GOVERNMENT SPECIAL BONDS ISSUANCE.
***** GENERAL (CENTRAL AND LOCAL) GOVERNMENT, GOVERNMENT MANAGED FUNDS SPENDING AND SPECIAL INFRASTRUCTURE FUND FROM 2015 TO 2017.

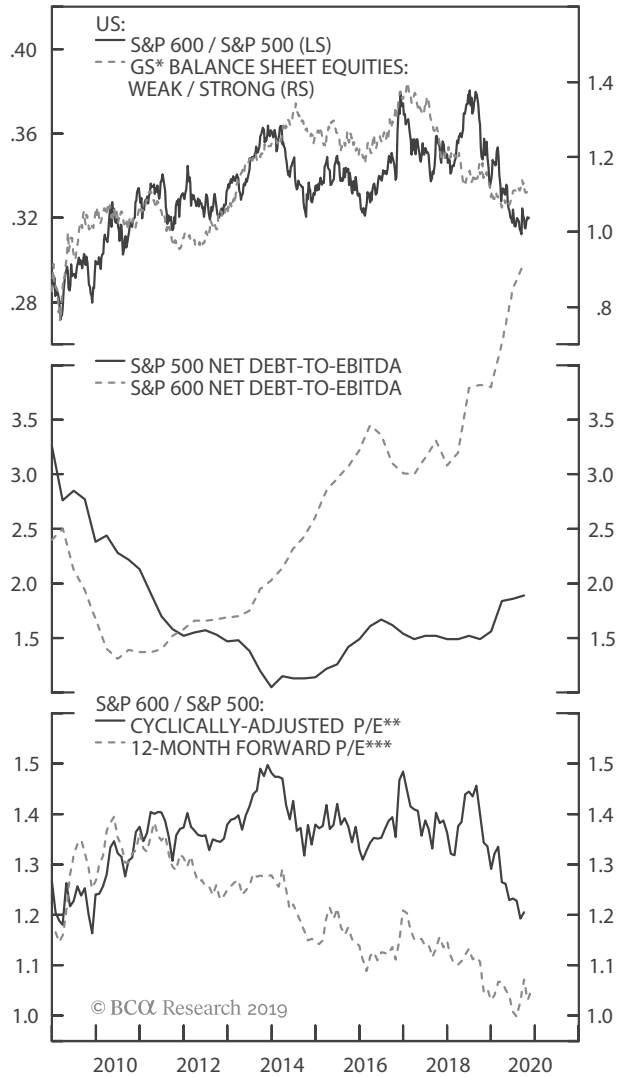
Source: BCA Research

Our highest-conviction view is to overweight mega caps versus small caps. Small caps are saddled with debt and are suffering a margin squeeze. Moreover, approximately 600 constituents of the Russell 2000 have no forward profits. Only one S&P 500 company has negative forward EPS. Given that both the S&P and the Russell omit these figures from the forward P/E calculation, this is masking the small-cap expensiveness. When adjusted for this discrepancy, small caps are trading at a hefty premium versus large caps [Figure 6].

We have also upgraded the S&P managed health care and the S&P hypermarkets groups. If the economic slowdown persists into early 2020, both of these defensive subgroups will fare well.

In mid-April, we lifted the S&P managed health care group to an above-benchmark allocation and posited that the selloff in this group

Figure 6. Continue to avoid small caps



* SOURCE: GOLDMAN SACHS, VIA BLOOMBERG.
** BASED ON A 10-YEAR MOVING AVERAGE OF EARNINGS.
*** SOURCE: THOMSON REUTERS / IBES.

Source: BCA Research

was overdone as the odds of 'Medicare for all' [US independent Senator Bernie Sanders' proposal to replace private health insurance with a government-run health insurance scheme] becoming law were slim. Moreover, a tight labour market along with melting medical cost inflation would boost the industry's margins and profits.

This week [at the time of original publication, 25 July 2019, we wrote that], we upgraded the defensive S&P hypermarkets index to overweight arguing that the souring macro landscape coupled with a firming industry demand outlook will support relative share prices.

Dhaval Joshi: To be fair, I am not a pessimist. Provided the global bond yield stays well below 2.5%, the support to risk-asset valuations will prevent a major dislocation. But in a growth down-oscillation, the big game in town will be sector rotation into pro-defensive investment plays, especially into those defensives that have underperformed.
On this basis:

- overweight healthcare versus industrials
- overweight the Euro Stoxx 50 versus Shanghai Composite and Nikkei 225
- overweight US Treasury bonds versus German Bunds
- overweight the JPY in a portfolio of G10 currencies.

Summary of bearish views and recommendations

Arguments

- The yield curve has always been a reliable signal. It can be early but it is always prescient.
- It is prudent to risk a few points of underperformance in the short term in order to avoid a major decline in the medium term.
- Extraordinarily low rates have made risk assets very vulnerable to small backups in yields.
- Thus, monetary conditions may be accommodative today, but they will not be so if the global yield moves back above 2.5%.
- A down-oscillation in the business cycle is already underway.
- The global manufacturing slowdown started in China and will end in China.
- While Chinese credit and monetary policy is becoming more supportive, a falling marginal propensity to spend along with a continued regulatory tightening in the banking sector are undoing this positive.
- Yet, risk assets are pricing an imminent V-shaped rebound in global growth.
- This dichotomy will create downward pressures on risk assets over the coming six to 12 months.

Recommendations

- The countercyclical (US) dollar should strengthen, especially against EM currencies.
- Maintain a defensive slant in equity portfolios.
- Favour DM equities, the US in particular, over EMs.
- Short EM banks / long US banks.
- Overweight the Euro Stoxx 50 relative to both the Shanghai Composite and the Nikkei.
- In the US, favour large caps over small caps, overweight managed healthcare and hypermarkets.
- Globally, overweight healthcare stocks relative to industrials.
- Favor Treasurys over Bunds.
- Buy the yen. FS