BCA Research

BULLISH CASES FOR TODAY'S MACROECONOMIC OUTLOOK

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BCA Research has been the market's leading source for independent global macro research for 70 year. Occasionally, this independence has resulted in strongly diverging views. Today, two views on the cyclical (six to 12 months) outlook for assets have emerged: bullish and bearish.

This paper outlines the arguments from the bullish camp, which expects global growth to rebound in the second half of the year. Along with accelerating growth, it anticipates stock prices and risk assets to remain firm, cyclical equities to outperform defensive ones, safe-haven yields to move up, and the US dollar to weaken.

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

The panel comprised:

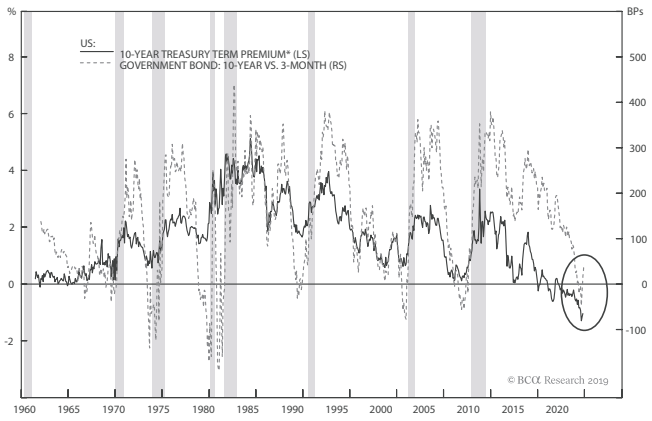
- Peter Berezin, chief global investment strategist, BCA Research.
- Doug Peta, chief U.S investment strategist, BCA Research.
- Rob Robis, chief global fixed income strategist, BCA Research. The conversation was moderated by Mathieu Savary, BCA Research's bank credit analyst strategist. [Information current as at July 2019.]

BCA roundtable findings

Mathieu Savary: *Yield curve inversions, as we're currently experiencing, have often been harbingers of recessions. Yet, Rob, you take a much more sanguine view of the current curve inversion. Why?*

Rob Robis: While the four most dangerous words in investing are 'this time is different', this time really does appear to be different. Never before have negative term premia on longer-term Treasury yields and a curve inversion coexisted [Figure 1].

Figure 1. Negative term premium distorting the economic message of an inverted yield curve



Source: New York Fed; Tobias Adrian, Richard Crump & Emanuel Moench.
Note: Shaded areas denote NBER-designated recessions.

Longer-term treasury yields have therefore been pushed down to extremely low levels by factors beyond just expectations of a lower fed funds rate. The negative treasury term premium is distorting the economic message of the US yield curve inversion.

Term premia are depressed everywhere, as seen in German, Japanese and other yields, reflecting the intense demand for safe assets like government bonds during a period of heightened uncertainty. Global bond markets may also be discounting a higher probability of the European Central Bank (ECB) restarting its Asset Purchase Program, as term premia typically fall sharply when central banks embark on quantitative easing. This has global spillovers.

Prior to previous recessions, US Treasury curve inversions occurred when the Fed was running an unequivocally tight monetary policy. [At the time of original publication, 25 July 2019, we wrote] that is not the case today. The real fed funds rate still is not above the Fed's estimate of the neutral real rate, aka 'r-star', which was the necessary ingredient for all previous treasury curve inversions since 1960.

Mathieu Savary: *The level of policy accommodation will most likely determine whether Rob or the bearish camp is proven right. Peter, you have been steadfastly arguing that policy, in the US at least, remains easy. Can you elaborate why?*

Peter Berezin: Remember that the neutral rate of interest is the rate that equalises the level of aggregate demand with the economy's supply-side potential. Loose fiscal policy and fading deleveraging headwinds are boosting demand in the United States. So [too] is rising wage growth, especially at the bottom of the income distribution.

Given that the US does not currently suffer from any major imbalances, our guess is that the economy can tolerate higher rates without significant ill-effects. In other words, monetary policy is currently quite easy.

Of course, we cannot observe the neutral rate directly. Like a black hole, one can only detect it based on the effect that it has on its surroundings.

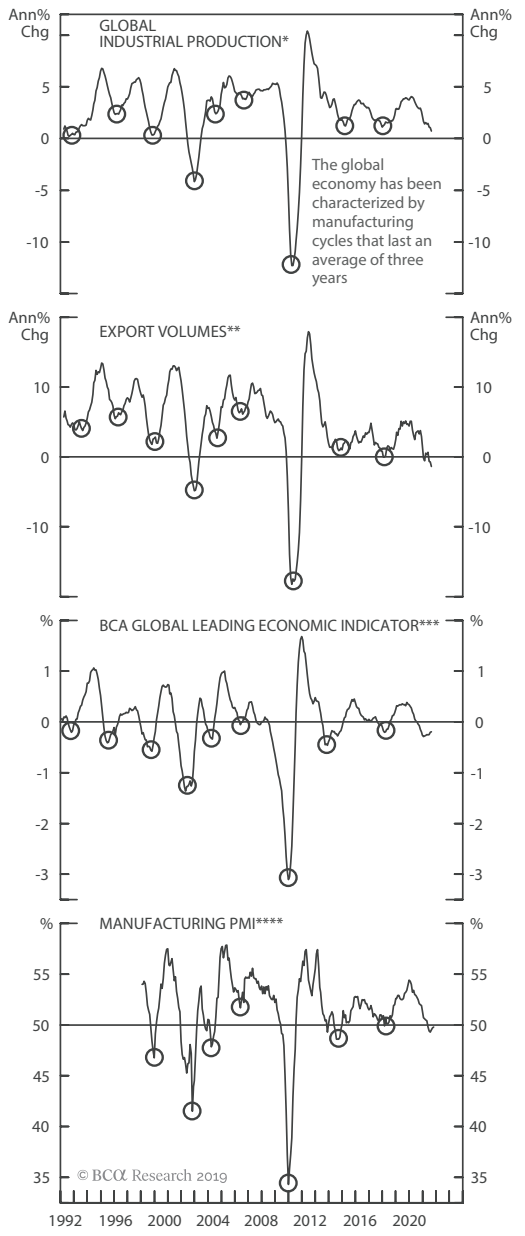
Housing is by far the most interest-rate-sensitive sector of the economy. If history is any guide, the recent decline in mortgage rates will boost housing activity in the second half of the year. If that relationship breaks down, as it did during the Great Recession, it would suggest that the neutral rate is quite low.

Given that mortgage origination standards have been quite strong and the homeowner vacancy is presently very low, our guess is that housing will hold up well. We should know better in the next few months.

Mathieu Savary: *Monetary policy is important to the outlook, but so is the global manufacturing cycle. Even though we are in a global growth slowdown, you have a much more optimistic stance. What is driving your optimism?*

Peter Berezin: China's deleveraging campaign began more than a year before global manufacturing peaked. I have no doubt that slower Chinese credit growth weighed on global capex, but we should not lose sight of the fact there are natural ebbs and flows at work.

Figure 2. The global manufacturing cycle has likely reached a bottom



*Industrial production volume excluding construction.
Shown as a 3-month moving average;
Source: Netherlands Bureau for Economic Policy Analysis.
**Shown as a 3-month moving average;
Source: Netherlands Bureau for Economic Policy Analysis.
***Based on 23 countries, BCA calculations.
Source: Markit/J.P. Morgan.

The quote

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Most manufactured goods retain some value for a while after they are purchased. If spending on, say, consumer durable goods or business equipment rises to a high level for an extended period time, a glut will form, requiring a period of lower production.

These demand cycles typically last about three years; roughly 18 months on the way up, 18 months on the way down [Figure 2].

The last down-leg in the global manufacturing cycle began in early 2018, so if history is any guide, we are nearing a trough. The fact that US manufacturing output rose in both May and June, followed by this week's sharp rebound in the July Philly Fed manufacturing survey, supports this view.

Of course, extraneous forces could complicate matters. If trade tensions ratchet higher, this would weaken my bullish thesis. Nevertheless, with China stimulating its economy again, it would probably take a severe trade war to push the global economy into recession.

Mathieu Savary: *A positive and a negative view of the world logically result in bifurcated outlooks for interest rates and the [US] dollar. Rob, how do you see US, German, and Japanese yields evolving over the coming 12 months?*

Rob Robis: If global growth rebounds, US Treasury yields will have far more upside than Bund or Japanese Government Bond (JGB) yields. Inflation expectations should recover faster in the US, with the Fed taking inflationary risks by cutting rates with a 3.7% unemployment rate and core CPI inflation at 2.1%. [At the time of original publication, 25 July 2019, we wrote that] the Fed is also likely to disappoint by delivering fewer rate cuts than are currently discounted by markets (90 bps over the next 12 months). Treasury yields can therefore increase more than German and Japanese yields, with the ECB and BoJ [Bank of Japan] more likely to deliver the modest rate cuts currently discounted in their yield curves.

Japanese yields will remain mired at or below zero over the next six to 12 months, as wage growth and core inflation remain too anaemic for the Bank of Japan to alter its 0% target on 10-year JGB yields. German yields have a bit more potential to rise if European growth begins to recover, but will lag any move higher in Treasury yields. That means that the Treasury-Bund and Treasury-JGB spreads will move higher over the next year.

Negative German and Japanese yields may look completely unappetising compared to plus-2% US Treasury yields, but this handicap vanishes when all three yields are expressed in US dollar terms. Hedging a 10-year German Bund or JGB into higher-yielding US dollars creates yields that are 50–60 bps higher than a 10-year US Treasury.

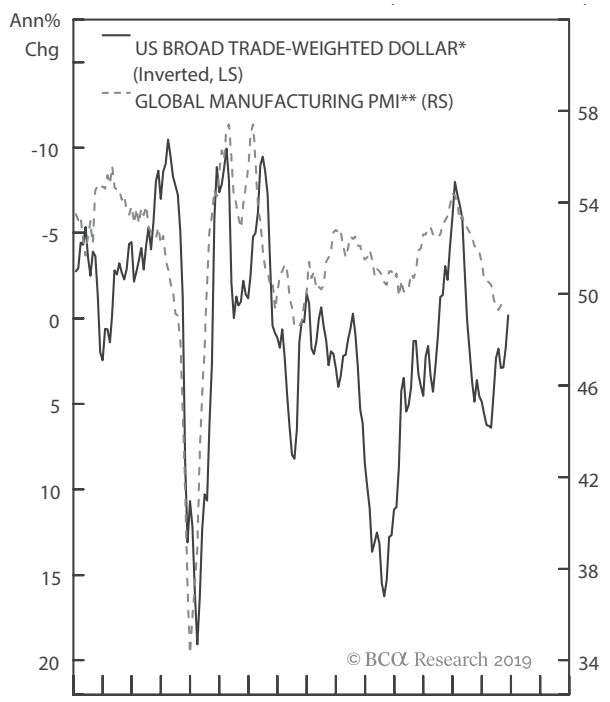
It is abundantly clear that German and Japanese bonds will outperform treasuries over the next year if global growth recovers.

Mathieu Savary: *Peter, your positive view on global growth means that the Fed will cut rates less than what is currently priced into the overnight index swaps [OIS] curve. So why do you expect the [US] dollar to weaken in the second half of 2019?*

Peter Berezin: What the Fed does affects interest rate differentials, but just as important is what other central banks do.

The ECB is not going to raise rates over the next 12 months. However, if euro area growth surprises on the upside later this year, investors will begin to question the need for the ECB to keep policy rates in negative territory until mid-2024. The market's expectation of where policy rates will be five years out tends to correlate well with today's exchange rate. By that measure, there is scope for interest rate differentials to narrow against the US dollar.

Figure 3. The US dollar is a countercyclical currency



*Source: Federal Reserve.
**Source: Markit/J.P. Morgan.

Keep in mind that the US dollar is a countercyclical currency, meaning that it moves in the opposite direction of global growth [Figure 3].

This countercyclicality stems from the fact that the US economy is more geared towards services than manufacturing compared with the rest of the world.

As such, when global growth accelerates, capital tends to flow from the US to the rest of the world, translating into more demand for foreign currency and less demand for [US] dollars. If global growth picks up in the remainder of the year, as I expect, the [US] dollar will weaken.

Mathieu Savary: *Doug, you have expressed a positive outlook for US profits. What offsets do you foresee? Moreover, you are not concerned by the US corporate balance sheets. Can you share why?*

Doug Peta: As it relates to earnings, we foresee offsets from a revival in the rest of the world. Increasingly accommodative global monetary policy and reviving Chinese growth will give global ex-US economies a boost. That inflection may go largely unnoticed in US GDP, but it will help the S&P 500, as US-based multinationals' earnings benefit from increased overseas demand and a weaker [US] dollar.

When it comes to corporate balance sheets, shifting some of the funding burden to debt from equity when interest rates are at gen-

erational lows is a no-brainer. Even so, non-financial corporates have not added all that much leverage. Low interest rates, wide profit margins and conservative capex have left them with ample free cash flow to service their obligations.

Every single viable corporate entity with an effective federal tax rate above 21% became a better credit when the top marginal rate was cut from 35% to 21%. Every such corporation now has more net income with which to service debt, and will have that income unless the tax code is revised. You can't see it in earnings before interest tax, depreciation and amortisation [EBITDA] multiples, but it'll show up in reduced defaults.

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 six to 12 months?*

Doug Peta: The overriding question that guides all of BCA's research is, 'So what?' What is the practical investment application of this macro observation? At the same time, 'Why now?' is also a critical corollary for anyone allocating investment capital: Why is the imbalance you've observed about to become a problem?

As [American economist] Herbert Stein said, 'If something cannot go on forever, it will stop'. Imbalances matter, but [economist Rudi] Dornbusch's Law counsels patience in repositioning portfolios on their account, [stating that] 'Crises take longer to arrive than you can possibly imagine, but when they do come, they happen faster than you can possibly imagine.'

Look at Figure 4, which shows a vast white sky (bull markets) with intermittent clusters of light grey (recessions) and dark grey (bear markets) clouds. Market inflections are severe, but uncommon. When the default condition of an economy is to grow, and equity prices to rise, it is not enough for an investor to identify an imbalance. They also have to identify why it's on the cusp of reversing. Right now, as it relates to the US, there aren't meaningful imbalances in either markets or the real economy.

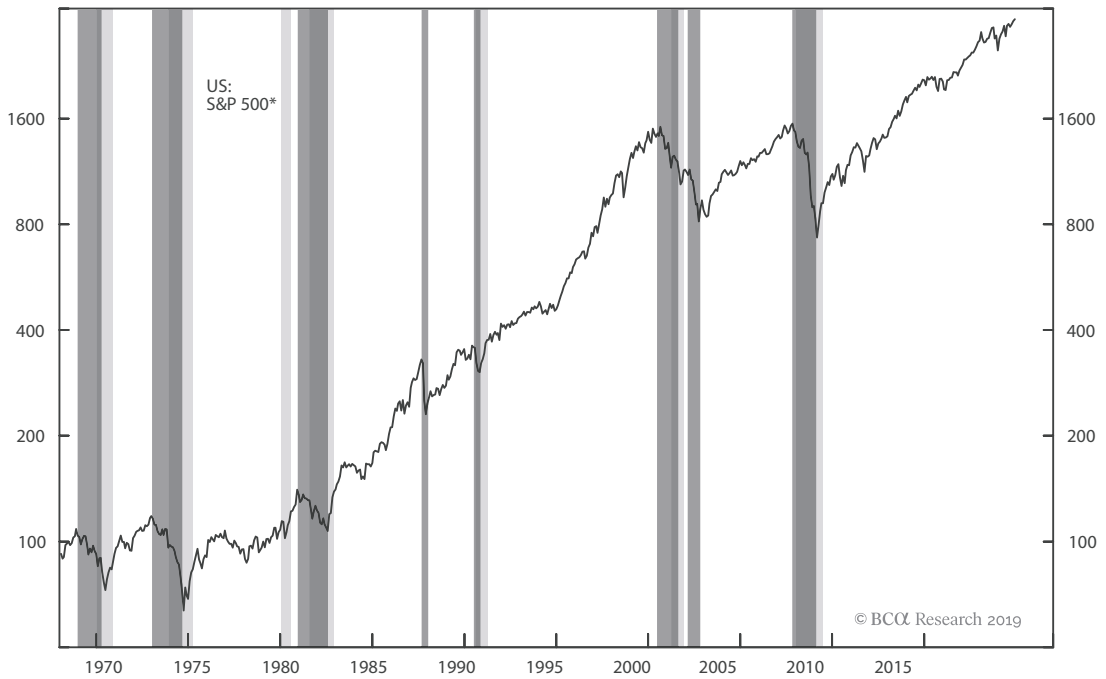
Even if we had perfect knowledge that a recession would arrive in 18 months, now would be way too early to sell. The S&P 500 has historically peaked an average of six months before the onset of a recession, and it has delivered juicy returns in the year preceding that peak. Bull markets tend to sprint to the finish line. If this one is like its predecessors, an investor risks significant relative underperformance if they fail to participate in its go-go latter stages.

We are bullish on the outlook for the next six to 12 months, and recommend overweighting equities and spread product in balanced US portfolios while significantly underweighting Treasuries.

Peter Berezin: I agree with Doug. Equity bear markets seldom occur outside of recessions, and recessions rarely occur when monetary policy is accommodative. Policy is currently easy, and will get even more stimulative if the Fed and several other central banks cut rates.

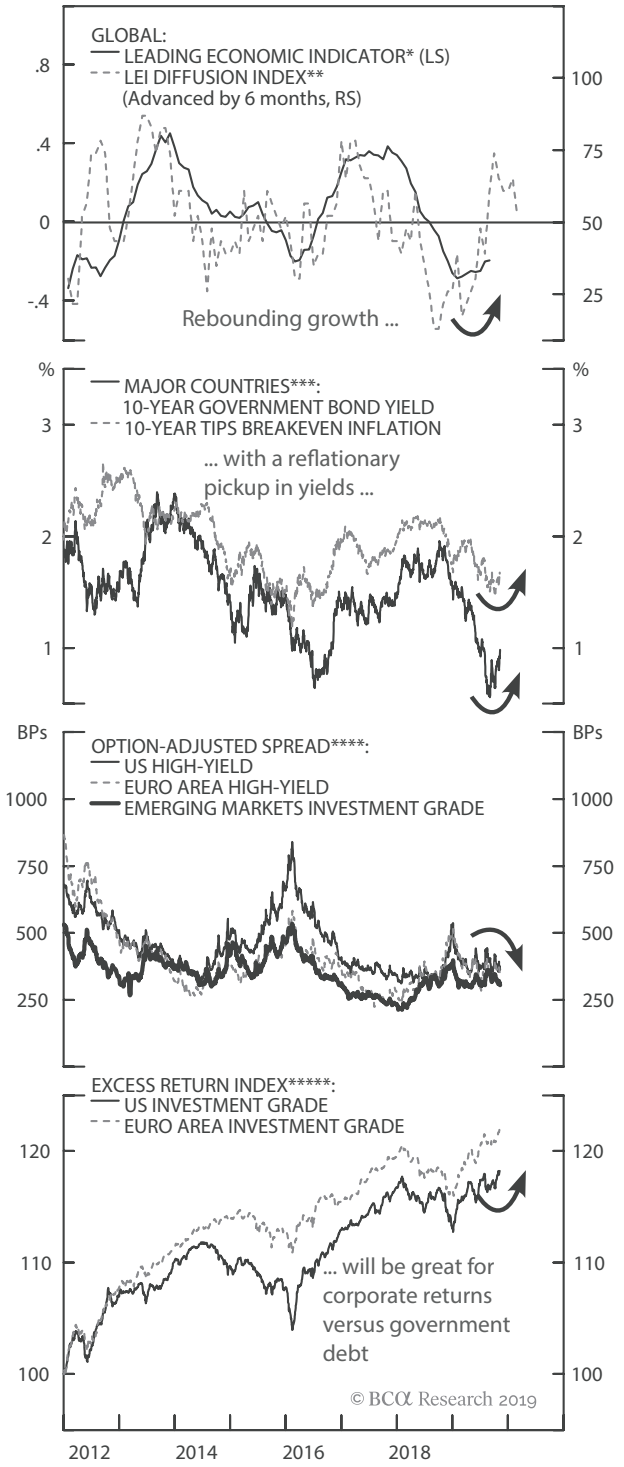
Global equites are not super-cheap, but they are not particularly expensive either. They currently trade at about 15-times forward earnings. Given the ultra-low level of global bond yields, this generates an equity risk premium [ERP] that is well above its historical av-

Figure 4. Recessions and bear markets travel together



Source: BCA Research.
**Shown in log scale.*
Note: Dark grey shading indicates bear markets; Light grey shading indicates NBER-designated recessions.

Figure 5. Best bond bets: overweight global corporates and inflation-linked bonds



*Source: OECD; standardised.
**Based on % of rising vs falling data series.
***GDP-weighted average of US, UK, euro area, Japan, Canada and Australia.
****Source: Bloomberg Barclays indices.
***** Source: Bloomberg Barclays indices; rebased to Jan. 2012 =100.

erage. One should favour stocks over bonds when the ERP is high.

The ERP is especially elevated outside the United States. This is partly because non-US stocks trade at a meagre 13-times forward earnings, but it also reflects the fact that bond yields are lower overseas.

As global growth accelerates, the [US] dollar will weaken. Equity sectors and regions with a more cyclical bent will benefit. We expect to upgrade EM [emerging market] and European stocks later this summer.

A softer [US] dollar will also benefit gold. Bullion will get a further boost early next decade when inflation begins to accelerate. We went long gold on 17 April 2019 and continue to believe in this trade.

Rob Robis: For fixed income investors, the most obvious way to play a combination of monetary easing and recovering global growth is to overweight corporate debt versus government bonds [Figure 5].

Within the US, corporate bond valuations look more attractive in high-yield over investment-grade. Assuming a benign outlook for default risk in a reaccelerating US economy, with the Fed easing, going for the carry in high-yield looks interesting. Emerging market credit should also do well if we see a bit of US dollar weakness and additional stimulus measures in China.

European corporates, however, may end up being the big winner if the ECB chooses to restart its Asset Purchase Program and ramps up its buying of European company debt. There are fewer restrictions for the ECB to buy corporates compared to the self-imposed limits on government bond purchases. The ECB would be entering a political minefield if it chose to buy more Italian debt and less German debt, but nobody would mind if the ECB helped finance European companies by buying their bonds.

If one expects reflation to be successful, a below-benchmark stance on portfolio duration also makes sense, given the current depressed level of government bond yields worldwide. Yields are more likely to grind upward than spike higher, and will be led first by increasing inflation expectations. Inflation-linked bonds should feature prominently in fixed income portfolios, especially in the US where TIPS [Treasury Inflation-Protected Securities] will outperform nominal yielding Treasuries.

Summary of bullish views and recommendations

Arguments

- The yield curve has less predictive power than in previous cycles because term premia are negative.
- There is little sign that monetary policy in advanced economies is tight, further invalidating the message from the yield curve.
- Easing already accommodative monetary conditions will only support growth further.
- Advanced economies have been negatively impacted by the slowdown in global manufacturing, but domestic demand remains robust.
- The world's manufacturing sector should pick up in the back half of 2019 in response to Chinese stimulus and the fall in global yields.
- The revival in growth should lift earnings, including in the US.
- The rise in corporate indebtedness is not yet worrisome, especially in light of the Trump tax cuts.

Recommendations

- This rebound in activity will allow global yields to grind higher.
- The [US] dollar is a countercyclical currency and will therefore depreciate.
- Stay overweight stocks versus bonds; equities need a recession to decline.
- Global equities should meaningfully outperform US stocks in the second half of the year.
- Maintain a below-benchmark duration; but US Treasury yields have the most upside.
- Inflation expectations should lead yields higher. Overweight inflation-linked bonds relative to nominal issues.
- US high-yield bonds still offer an attractive carry, and European corporates will be the biggest winner if the ECB resumes its QE program.
- From a long-term perspective, gold is attractive. **FS**