Butterfield

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July 2019

Global strategy

The longest expansion ever

As we pass the halfway point of the year, we also pass another important milestone—as, based on the data available today—this is now the longest US economic expansion in history. This period of economic growth has now entered its 121st month, which means that it has surpassed the previous record, set during the 1990s. It is therefore unsurprising that the most recent Merrill Lynch Fund Manager Survey suggests that close to 90% of managers believe that we are now in the latter stages of the current economic cycle. It is also unsurprising that this belief has prompted economists to review the question “do economic cycles die of old age?”

Our strong belief is that cycles end due to economic or financial market imbalances, exogenous shocks or because monetary policy becomes too restrictive (interest rates are raised too high). There are some who believe that the Federal Reserve always brings economic cycles to an end by overtightening policy; this is frankly a silly accusation, because it suggests that it is possible for cycles to continue forever, which is incompatible with historical precedent. What is less controversial is that the longer an economic cycle is, the more opportunity there is for economic or financial imbalances to build up in the system.

While it has been the longest economic expansion, it has also been one of the shallowest. This is largely a function of the depth of the previous recession and the pain experienced during the recession and its aftermath. Furthermore, it is no coincidence that two of the weakest sectors in the crisis—the consumer and the banking system—are in significantly better shape now than they were then. On aggregate, consumers have been reluctant to borrow and banks are considerably less leveraged than they were last cycle. Healthy consumer and banking sectors are important pillars for economic growth, so this helps to explain why the last recession was so deep. That these sectors are fundamentally healthier means that they are highly unlikely to cause the cycle to end anytime soon.

Global strategy

The longest expansion ever

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There are, however, new areas of risk, and towards the end of the cycle it is particularly important to try and understand where these might be. While the consumer and banking sectors are in much better shape, we have seen notable rises in both government and corporate debt. The capacity of the government to borrow is a subject of much debate and new theories like "modern monetary theory" are challenging the conventional thinking. The more likely vulnerability is in the corporate debt market, so this is an area where we have been spending time recently, but broadly speaking our exposure is in very high quality bonds relative to the overall public and private universe. The most likely exogenous shock appears to be trade policy, however the latest signs here are more encouraging, with the US and China appearing to reach a truce, for now, at the latest G-20 meeting in Japan. So overall, it is now 121 months and counting.

Fixed income

Insurance cuts?

The second quarter was another very strong one for fixed income markets, with sovereign yields falling across the maturity spectrum and credit markets also performing well. In the first half of this year, the broad-based US aggregate bond index produced the best six month return (6.1%) since 2011, when yields fell as the market embraced the "new normal" idea that bond yields would be structurally lower than the past. The cause this time around is similar, in the sense that markets have rapidly re-priced the expected path of future interest rates.

We began the year with the Federal Reserve walking back their December rate rise, with a marked shift in language focusing on "patience", "downside risks" and "listening very carefully" to signals from financial markets. As we progressed through the second quarter, the market went further and aggressively priced in a series of rate cuts in the second half of this year, to the point where the market is now pricing in four rate cuts over the next twelve months. This has put the Fed in a difficult position; either acquiesce to the market and deliver the rate cuts while running the risk of asset bubbles, or don't deliver the rate cuts and run the risk of tightening financial conditions and ending the economic cycle. With the Fed under increasing political pressure, it is unsurprising that they seem to have chosen the former, with Fed Chair Jerome Powell recently stating that the Fed will "act as appropriate to sustain the expansion".

One of the key questions at this point is whether this is the start of a new rate cutting cycle or whether rate cuts would be more like "insurance" cuts, which would help boost growth and prolong the expansion, before potentially leading to rate hikes re-commencing next year. It is useful to draw on historical comparisons, as there are examples of both in the past, with very different outcomes for bond and equity markets. In both 1995 and 1998, the Federal Reserve cut interest rates by 0.75%, essentially easing policy before there was clear evidence of material economic deterioration. The 1998 comparison is probably

Fixed income

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the most appropriate, as weakness in the rest of the world, particularly in Emerging Markets, threatened to feed back to US growth through weaker financial markets. Ultimately this halted the dollar's rise, allowed growth to stabilise and risk assets then went on to make significant new highs.

We have given up a little performance from our short duration stance, but more than made up for this with our yield curve positioning, credit exposure and emerging market debt exposure. The dollar weakness seen in June was very positive for Emerging Markets, with local currency bonds having their best month since 2016. With markets pricing in a more aggressive path of rate cuts than we believe warranted by the fundamentals, we remain underweight duration. One of the risks to this view is that even with the move that we have seen in bond markets, speculative positioning has not become stretched. This could mean that yields move even lower if we get a risk-off episode in equity markets, but overall we feel that risk is better taken in selective parts of the credit market.

Equities

Steady returns, but earnings growth required

Global equity markets continued to march higher in the second quarter, despite a setback in May. The MSCI World index returned +4.0% for the second quarter of 2019, with all major sectors and regions posting positive returns except the energy sector. It is evident that the equity market is painting a much brighter picture than the bond market. It is also a common belief that bond markets have higher predictive ability relating to future economic activity. We believe, however, that both markets are sending valid signals, at least in the near term. There are risks on the horizon in equity markets, including slowing global growth and geopolitical noise. However, equity market fundamentals are solid and there is potential for cooling tensions on the trade front as we near an election cycle in the US. Furthermore, financial conditions in the majority of developed markets, including the US, remain accommodative, reinforcing our neutral stance towards the asset class.

Following a difficult period in May, equity markets rebounded solidly in June. European and US stocks both posted strong returns for the second quarter, +5.5% and +4.2%, respectively. The majority of the return experienced so far in 2019 has been driven by multiple expansion (investors willing to pay a higher multiple of current earnings for a stock) rather than earnings growth. The S&P 500 forward multiple had fallen to a low of 14.5 times earnings in December, but is currently around 17.5.

Corporate earnings clearly slowed relative to 2018, although the slowdown is not wholly unsurprising given that the Tax Cuts and Jobs Act of 2017 skewed 2018 earnings higher. First quarter 2019 earnings were expected to fall year over year, yet finished mildly positive, but estimates of second quarter earnings remain negative. A theme coming into 2019 was the divergent nature of the first half relative to the second half of the year; this is the case with earnings expectations, as all of the growth in S&P 500 earnings was expected to come from the second half of the year. Therefore, the continued strength in equity markets partly hinges on whether there is a re-acceleration of earnings growth—as the

Equities

Steady returns, but earnings growth required

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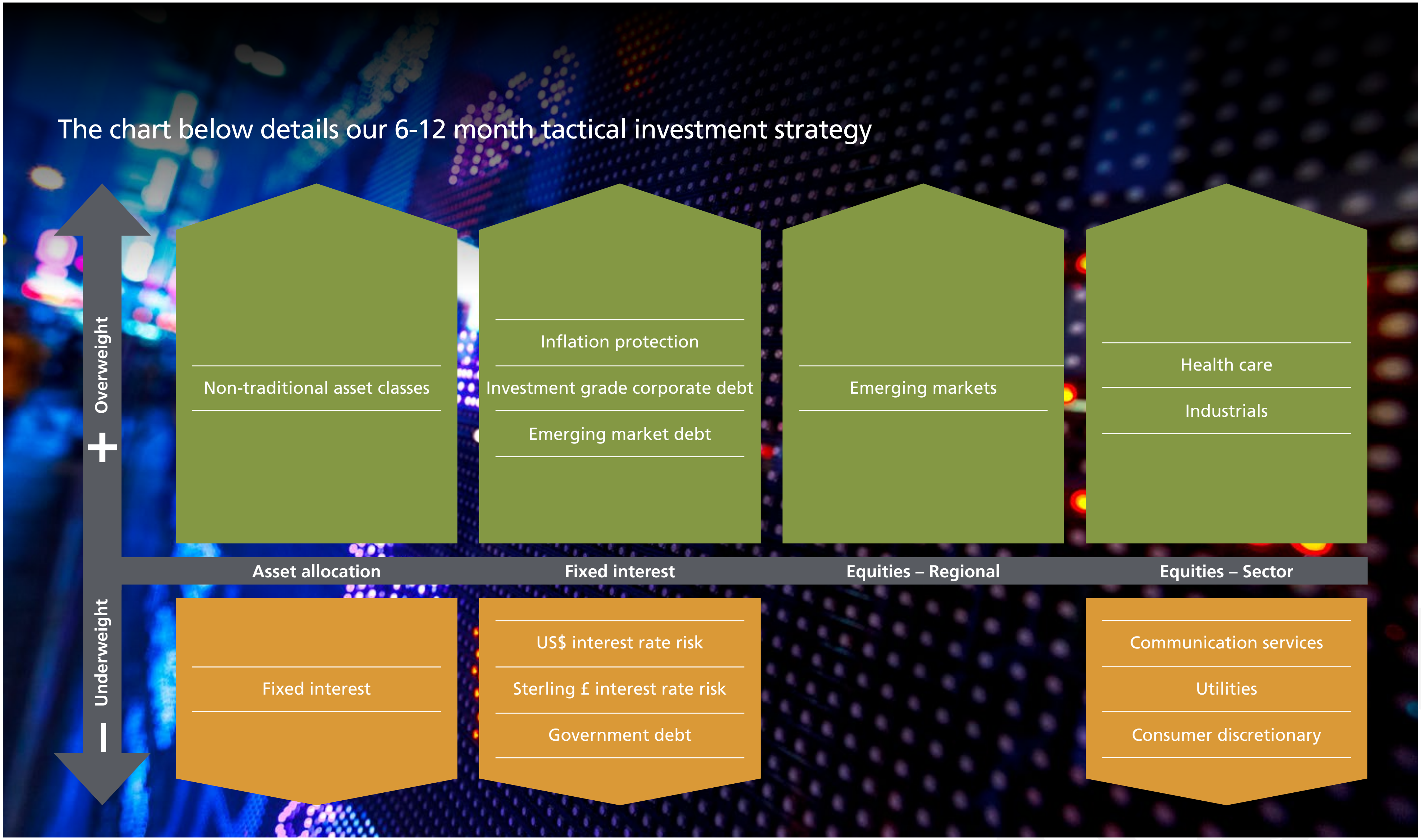
market is expecting—because there is limited room for the market to climb based on multiple expansion alone.

Counterintuitively, the best performing sector for the second quarter was financials, which returned 6.2%, despite falling interest rates and an inverted yield curve. The US Federal Reserve recently concluded another round of the annual stress test of 18 banks. All 18 passed, which puts each bank's financial picture through a scenario of increasing unemployment and a fall in US equity prices. Following the positive results, the Fed gave the banks the green light to distribute more funds to shareholders via increases to dividends and share repurchases. However, it should equally be recognised that the Financials sector covers a lot more than just banks, and the strong performance of the sector was driven largely by improvements in equity market-sensitive parts of the industry, such as capital markets businesses and insurance.

A topic that has been commanding a lot of airtime recently is the question of international equities relative to US domestic equities. There is a belief that an agreement on the trade front will have an outsized positive effect on European and Asian equity markets as those are the markets most exposed to trade related factors, and those markets have struggled to keep pace with the strength of US equities since the beginning of the trade war. We continue to monitor this closely, but before we were to consider implementing this within portfolios, we would like to see a pickup in global growth levels, a missing ingredient. Until such time, we continue to have a neutral stance towards the equity asset class, as well as to all major regions.

Global asset allocation



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