Macro Strategy

Rally Looking More Sustainable

14 February 2019

The Federal Reserve met in late January and made a significant change in monetary policy. Having had the world accustomed to its gradual pace of rate hikes, Fed chair Jerome Powell signalled that the Fed would be on pause as it acknowledges the current weakness in the global economy and financial markets. Investors cheered and sent global equities into a V-shaped recovery. Many have called this a bear market rally. Investors will be well rewarded to dig deeper to see if the current rally is sustainable.

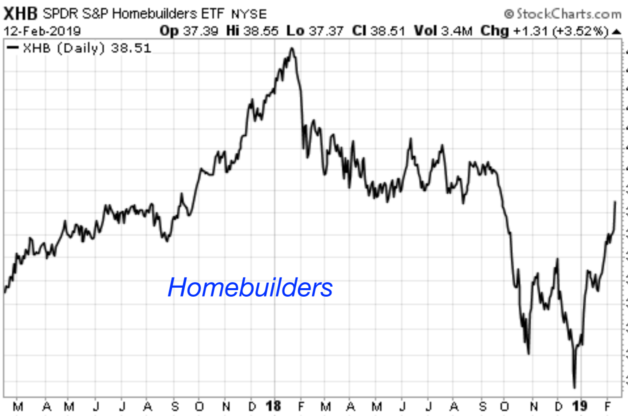
Recession check - Manufacturing Slowing

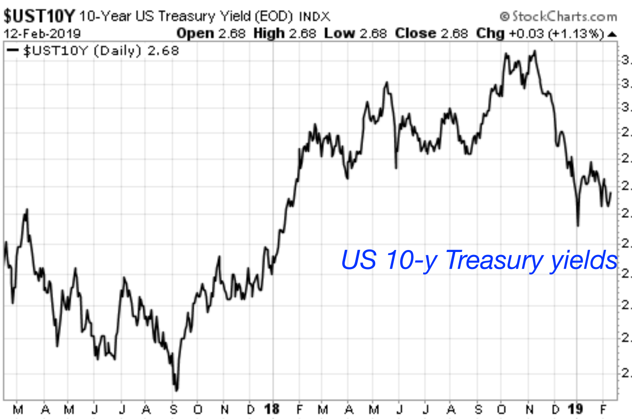
The economic slowdown outside of the US continues, judging by the PMI data. Markit's manufacturing PMI saw a continuation of softness in Europe and Japan, while East Asian powerhouses like China, South Korea and Taiwan experienced a contraction in manufacturing. The slowdown in business activity has prompted the International Monetary Fund to issue a call for central banks to be more flexible. Looking at fundamental data suggests that the odds of a recession is rising.

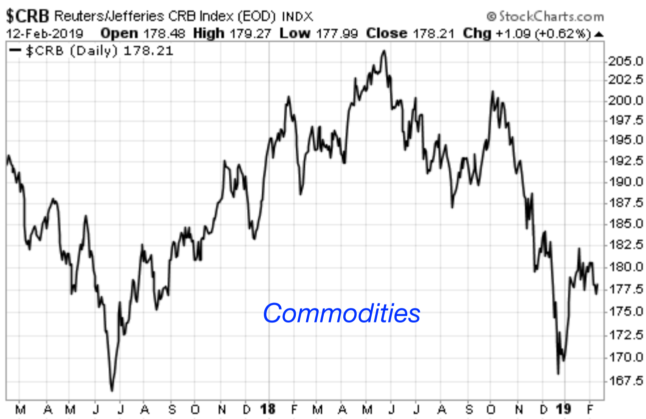
Markit Manufacturing PMI	Dec 2018	Jan 2019
US	53.8	54.9
EU	51.4	50.5
China	49.7	48.3
Japan	52.6	50.3
South Korea	49.8	48.3
Taiwan	47.7	47.5

Market Check - Recession Odds Falling

While many had expected the rally to peter out after the late January Fed meeting, investors were encouraged by positive news coming out of the US-China trade talks and more stimulus from the Chinese government. So even though the global economic numbers continue to be weak, equities are still rallying, led by sectors that are sensitive to the economy. Below are six charts that give us a clue on the odds of a US recession. Both banks and homebuilding stocks have made sharp recoveries, erasing much of the Q4 losses. Junk bonds and retailers are also rallying while the yields on the 10-year bond is holding steady, neither falling (on recession fears) or spiking (on inflation fears). A continuation of this trend is important for the sustainability of the current rally.





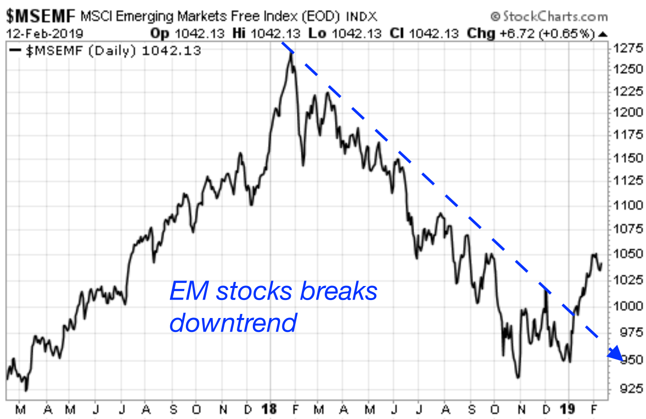


Market Internals - Healing In Progress

There are also indicators that the current recovery in equity markets is led by not just the major companies, but by a wide array of stocks. The US advance-decline index has made a sharp recovery and is on track to take out the previous high registered in September last year. Other measures of market internals, like new highs or bullish percent index are also improving, suggesting that investors continue to buy into the rally, rather than sell into strength. A sign that markets are discounting a turnaround in the current economic slow down.

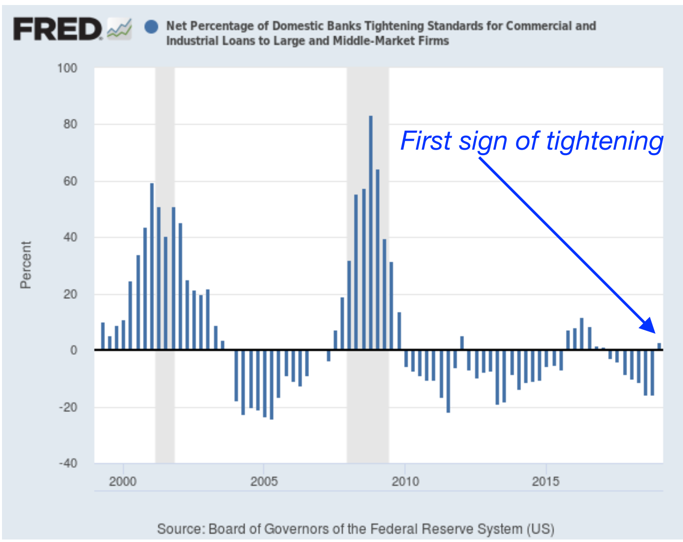
International Markets - Recovering In Tandem

Although economies outside the US are faring worse, their stock markets are also moving along in line with the recovery in US markets. Europe, plagued by Brexit uncertainties and a slowdown in the auto industry, has seen its stock markets making a sharp rally since the start of 2019. Emerging markets are also gaining traction, since making a bottom in Q4 last year. The positive news coming out of US-China trade talks currently outweighs the negative economic reports from China



Risk - Lending Concerns

One concern that we see is the senior loan officer survey where respondents indicated a tightening of lending standards in Q1 of 2019. It was a sharp reversal from the previous quarter where more bankers where not tightening lending standards. Typically a tightening of lending standards precedes an economic recession. How this develops bears watching, especially in conjunction with the performance of banking stocks and credit markets.



Conclusion: Investors are facing a barrage of negative views on a possible recession, frightening outcomes from Brexit and that the current surge in equities is just a bear market rally. While this may all be true, the current signals given by markets do not concur with such prognosis. Positive trends in economic sensitive sectors lower the odds of a recession, and as investors' confidence is prodded higher by a patient Fed, the sustainability of the current rally looks more credible by the day.

Simon Liew

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