

Leading the way?

Michael Clough

Unless the US slips into recession before the middle of the year, the country's current economic expansion will become the longest ever on record. We are nearly 10 years from the ending of the recession during the Global Financial Crisis. It is no great surprise to see investors debating when this elongated expansion will end. Whilst we would agree we are a long way into this cycle, we don't yet think we are at the end of it. Our tactical asset allocation process is valuation driven and we used recent growth concerns and the resultant market weakness to add to equity allocations in our portfolios.

While there is not, in our opinion, a risk of an imminent recession it is instructive to consider a selection of the leading indicators that investors often use to gauge when the next downturn might arrive. The most widely cited is probably the inversion of the sovereign bond yield curve. Typically, one would expect the yield curve to slope upwards to compensate investors for the uncertainties that come with a longer investment horizon. However, it is not always the case and throughout time the curve has inverted. Not all recessions have followed an inversion of the yield curve, but the last nine inversions have indeed been followed by one. At the time of writing the spread between the US 10 year and 2 year government bonds is less than 0.2%, meaning the curve is flat rather than inverted. At the start of 2014, it was 2.6%. Historically, it has been 12-18 months following an inversion for the economy to move into recession.

Another potential indicator is the unemployment rate relative to NAIRU (non-accelerating inflation rate of unemployment). Historically when the unemployment rate falls below NAIRU, a recession has often followed as tighter financial conditions usually follow to slow the inflation brought about by the tight labour market. Again, it doesn't always hold but history tells us it's a reasonable indicator to look at. Interestingly that occurred in the US in early 2017, though this indicator has historically required a longer lead before a recession.

Investors also look at the purchasing manager indices (PMI). PMIs are a compilation of surveys from various company executives as to whether business conditions are improving, contracting or unchanged from the previous month. They consider areas including new orders, supplier deliveries, inventories, production and employment within the manufacturing, services and construction industries. A PMI above 50 indicates expansion from the previous month, less than 50 indicates contraction and a PMI of 50 implies no change. Whilst data from the US has been positive of late with PMIs around 55, the picture is less bright elsewhere. UK PMIs have been trending down for the past few years with the current reading just marginally over 50, whilst since the start of 2018, PMIs in the Eurozone have fallen sharply to 51 today. Ultimately though, the readings in all regions are above 50 and indicate economic expansion, just not at levels seen in previous years.

Although we are certainly not tied to using these indicators as a basis for investment decision making, we do acknowledge them. Whilst the above is largely US focused, the implications worldwide of the US economy going into recession are significant. Expansions don't just die of old age and as a range of these indicators suggest, we don't believe we are on the verge of an immediate recession. However, we remain aware of the possibility and retain effective diversification in our portfolios to ensure we create robust portfolios for all seasons.

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Market Focus

- » A relatively flat week overall for equity markets
- » A \$16bn flight from passive ETFs took place in the January rally
- » Brent crude fell 1.0% to \$62.1 per barrel
- » Gold fell 0.2% to \$1315 per ounce

US

- » An impasse on the US-China trade dispute shows little signs of progress with President Trump and President Xi Jinping not expected to meet ahead of March 1st deadline. That day marks the end of a 90-day trade war truce agreed upon by both leaders at the G20 summit last December
- » President Trump announced during his annual State of the Union address that he plans to meet with North Korean leader Kim Jong Un in Vietnam beginning 27th February
- » The ISM non-manufacturing PMI index fell to 56.7 in January, down from a reading of 58 in December and below market expectations of 57.2. Respondents were concerned about the impact of the government shutdown
- » US equities ended the week flat while Treasuries rallied 0.4%

UK

- » The Bank of England voted unanimously to keep rates unchanged and cut its growth forecast for 2019 from 1.7% to 1.2%. The minutes struck a more dovish tone with risks surrounding the external and domestic environment elevated
- » UK Services PMI fell to 50.1 in January from 51.2 in the previous month and well below market expectations of 51.0. The latest reading was the lowest for two-and-a-half years. The Composite PMI fell to 50.3 versus a forecast of 51.5
- » UK equities rose 0.7% on the week while UK Gilts returned

Europe

- » The European Commission sharply cut its forecasts for eurozone economic growth this year and next, citing a high level of uncertainty and downside risks to outlook. The Eurozone growth forecast for 2019 was cut to 1.3% from 1.9%. Italy's growth forecasts for 2019 was cut to 0.2% from 1.2% and Germany's growth forecast for this year slashed to 1.1% from 1.8%
- » German industrial orders fell unexpectedly by 1.6% in December, missing market expectations of a 0.3% rise
- » The composite reading for the Euro Area PMI was confirmed at 51.0, down from December's 51.1, its lowest reading since July 2013
- » Continental European equities were down 0.8% on the week

Rest of the World/Asia

- » Japan's service PMI rose to 51.6 in January, up from 51.0 in December following a pick-up in domestic demand
- » Japanese equities fell 1.6% on the week
- » In Brazil, the mining disaster continues to weigh on shares of iron ore mining company Vale, down 6.7% in the week
- » Brazilian equities fell 2.6% on the week

Currency returns					
Asset class/region	Currency	Week ending 08 February	Month to date	YTD 2019	12 months
Developed markets equities					
United States	USD	0.1%	0.2%	8.2%	6.4%
United Kingdom	GBP	0.7%	1.4%	5.2%	2.7%
Continental Europe	EUR	-0.8%	-0.5%	5.5%	-2.7%
Japan	JPY	-1.6%	-1.8%	3.0%	-10.9%
Asia Pacific (ex Japan)	USD	-0.1%	-0.1%	7.2%	-7.0%
Australia	AUD	3.6%	3.5%	7.5%	7.6%
Global	USD	-0.4%	-0.4%	7.4%	0.7%
Emerging markets equities					
Emerging Europe	USD	-2.0%	-2.1%	9.3%	-7.1%
Emerging Asia	USD	-0.7%	-0.5%	6.8%	-9.6%
Emerging Latin America	USD	-3.3%	-3.2%	11.2%	-1.5%
BRICs	USD	-1.1%	-0.7%	9.1%	-7.6%
MENA countries	USD	0.2%	0.2%	6.6%	10.2%
South Africa	USD	-4.3%	-5.7%	5.8%	-16.6%
India	USD	0.8%	0.7%	-1.3%	-5.0%
Global emerging markets	USD	-1.3%	-1.3%	7.3%	-8.7%
Bonds					
US Treasuries	USD	0.4%	0.2%	0.6%	3.7%
US Treasuries (inflation protected)	USD	0.0%	-0.2%	1.2%	1.8%
US Corporate (investment grade)	USD	0.5%	0.3%	2.7%	2.2%
US High Yield	USD	0.2%	0.3%	4.8%	3.2%
UK Gilts	GBP	1.0%	0.8%	1.9%	5.7%
UK Corporate (investment grade)	GBP	0.6%	0.5%	2.4%	2.3%
Euro Government Bonds	EUR	-0.2%	-0.5%	0.6%	2.0%
Euro Corporate (investment grade)	EUR	0.5%	0.5%	1.6%	0.9%
Euro High Yield	EUR	0.1%	0.1%	2.3%	-1.5%
Japanese Government	JPY	0.1%	0.4%	0.9%	2.3%
Australian Government	AUD	0.8%	1.0%	1.7%	7.9%
Global Government Bonds	USD	-0.3%	-0.6%	0.7%	-0.1%
Global Bonds	USD	-0.2%	-0.5%	0.9%	-0.3%
Global Convertible Bonds	USD	-0.1%	0.1%	4.2%	-1.0%
Emerging Market Bonds	USD	-0.4%	-0.3%	4.8%	1.8%

Source: Bloomberg. Past performance is not indicative of future returns.

Currency returns					
Asset class/region	Currency	Week ending 08 February	Month to date	YTD 2019	12 months
Property					
US Property Securities	USD	1.9%	1.1%	13.0%	22.1%
Australian Property Securities	AUD	3.7%	3.3%	9.7%	15.6%
Asia Property Securities	USD	-0.3%	-0.9%	8.4%	3.3%
Global Property Securities	USD	0.5%	-0.1%	10.5%	10.1%
Currencies					
Euro	USD	-1.2%	-1.0%	-1.1%	-7.5%
UK Pound Sterling	USD	-1.2%	-1.5%	1.4%	-7.0%
Japanese Yen	USD	-0.1%	-0.8%	-0.1%	-0.9%
Australian Dollar	USD	-2.3%	-2.4%	0.7%	-8.9%
South African Rand	USD	-2.2%	-2.2%	5.7%	-10.6%
Swiss Franc	USD	-0.5%	-0.6%	-1.7%	-6.3%
Chinese Yuan	USD	0.0%	-0.7%	2.0%	-6.2%
Commodities & Alternatives					
Commodities	USD	-1.5%	-0.6%	5.9%	-3.5%
Agricultural Commodities	USD	-0.8%	-0.7%	1.5%	-6.5%
Oil	USD	-1.0%	0.3%	15.4%	-4.2%
Gold	USD	-0.2%	-0.5%	2.6%	-0.4%
Hedge funds	USD	0.2%	0.2%	2.3%	-4.8%

Source: Bloomberg. Past performance is not indicative of future returns.

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