LATE CYCLE WORRIES

When writing our monthly newsletter we try as much as possible to stick to the events of the last calendar month. However, the first few days of October have delivered important macro data and market moves that cannot be ignored and it is therefore timely to include these in this document.

We have suggested for some time that we see a late cycle market environment and that a US recession in H2 2020 was a high probability. Whilst some commentators would disagree about a recession, we feel that the latest data supports our thesis. The messages from the bond markets have been at odds with equity prices for months. Whilst having a "glass half full" approach to life is to be recommended; when it comes to investing, we advocate thoughtful and pragmatic analysis of facts over emotion. We have positioned portfolios defensively and we continue to believe that this makes sense.

The ISM data released this week provides ample evidence of slowing economies in Europe and the US although the data from China was better. The ISM US non-manufacturing index for September was 52.6, its lowest level in three years, and down from 56.4 a month earlier. Respondents cited concerns over tariffs, labour resources, and the direction of the economy. The employment index fell from 47.4 to 46.3, and the manufacturing PMI dropped from 49.1 to 47,8, its lowest level since 2009. The IHS Markit US services PMI did hold steady in September at 50.9. As Oxford Economics (an independent global forecasting firm) points out, whilst manufacturing represents only 10% of the US economy the impact of weaker employment and eroding confidence can spill over into the rest of the economy. This firm expresses concern about the employment and new orders sub-indices and suggests that the protectionist backdrop makes the current slump worse than other periods.

The data from the Eurozone was worse. The September PMI Composite dropped to a six-year low registering 50.4 from 51.9 a month earlier. The manufacturing PMI was deep in contraction territory at 45.6, the lowest number since October 2012. The data are sufficiently weak enough to suggest that Germany will be in technical recession once the Q3 GDP numbers are released.

The macro data reversed what had been a generally positive month for equities. The Euro Stoxx 50 had rallied 4.16% to 3569 and the S&P 500 added 1.72% to 2976. The latter had been testing its all-time high of 3027 but by 3 October had traded as low as 2855, just above the 200-day moving average (DMA). A recovery during the trading day was based on hopes that the Fed would have to cut rates further.

Earlier in the month, much of the focus had been on central banks. Both the ECB and the Federal Reserve provided interest rate cuts which buoyed equity markets. The outgoing ECB President, Mario Draghi, announced a 10bps cut in the deposit rate together with Euro 20bn per month of bond purchases and an easing of the TLTRO facility for banks. In the US, the Fed cut the headline rate by 25bps to 1.75%-2%. Interestingly there was dissent from within the central banks on both continents. In Europe, Draghi was apparently keen to present a united front and asked that the ECB members not provide off the record leaks on the discussion. It was reported that one member retorted that this was not a problem as he would be very public about his opposition. In recent days we have seen multiple countries disagree with the ECB action. In the US, the St. Louis Fed President, James Bullard, called for more cuts to "provide insurance against further declines in inflation and a slowing economy". Bullard is rumoured to be a candidate for the Fed Chair should Trump get re-elected so perhaps his enthusiasm for rate cuts is less surprising. On the other hand, two Fed members voted against a rate cut.

During the month, there was a big surprise when overnight bank lending rates in the US jumped to c.8% prompting the Fed to step in to provide additional funding over multiple days. There were many explanations about this being a mere "plumbing" issue in the repo market, but it could also be another warning signal about trouble ahead.

Late Cycle Worries

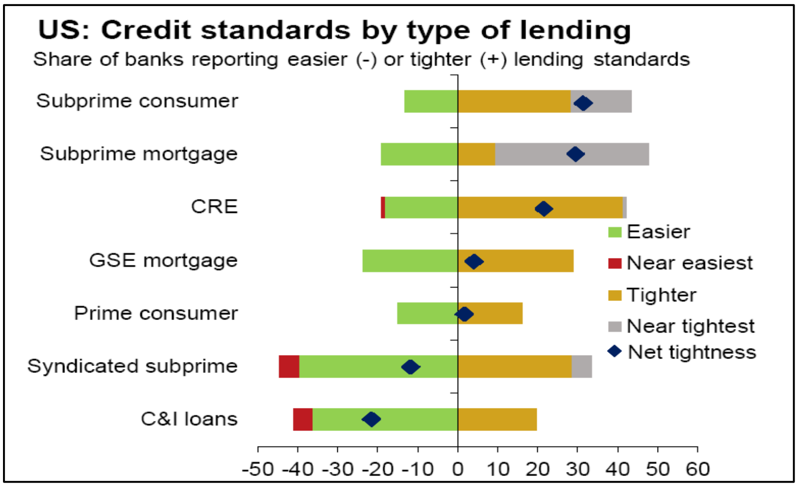
Given the data release this week, the market is currently showing a c.85% probability of another 25bps cut at the next Fed meeting later this month. This is a marked change from moves during September. The UST 10Y yield had jumped from 1.49% to 1.66% by month end as positive data had led to a fall in expectations for an October rate cut. Although the 2Y/10Y yields returned to a slight upward slope we remain concerned about the earlier yield curve inversion and it is one of the reasons why we expect a 2020 US recession.

In contrast to the weak PMI data elsewhere, the Chinese Caixin manufacturing PMI rose to 51.4 in September from 50.4 in August. The PBoC has left the Medium Term Lending facility unchanged at 3.3%. Although slow and steady economic support measures have been taken by the Chinese authorities throughout this year it seems clear that there is no desire to provide stimulus to any new bout of excessive leverage. The Shanghai Composite ended the month at 2905 (+0.66%). In Hong Kong the Hang Seng Index added 1.43% but the continuing protest movement, which has seen one protestor shot, leaves much uncertainty over how a peaceful conclusion can be reached. In the meantime, the Hong Kong economy remains vulnerable.

This year has seen Chinese bond defaults picking up. The impact has been on the domestic bond market but the weakness of the RMB (it closed the month at 7.14 versus the USD) could spell trouble in 2020 when c.$8bn of foreign denominated bonds, with yields of at least 15%, will mature.

Globally corporate default rates have been low for quite some time which may lead to complacency amongst investors. S&P Global Ratings reported that it is forecasting the speculative grade default rate to rise to 3.4% by mid-2020 (from 3% currently) but that it may then spike to 10% by late 2020 through 2022. If such default rates were to materialise it would surely put significant pressure on the High Yield (Junk) bond markets. Oxford Economics reported that global bank credit standards and the credit impulse are pointing to weak global growth. In particular, Oxford Economics said that banks reported relatively loose standards for corporate lending even in high risk areas such as subprime syndicated loans (see chart). We see this as further confirmation of late cycle behavior and a signal for caution.

Chart 1. US corporate credit standards look loose, but risky categories tighter



Source: Oxford Economics/Federal Reserve ***Relative to midpoint since 2005**

Impeachments

Many Democrats have wanted to impeach Donald Trump almost as soon as he became US President. As the first two and a half years of the Trump presidency have passed, the calls for impeachment have risen. House Democrat Leader, Nancy Pelosi, had resisted these calls, fearing a public opinion backlash like that against the Republican Party when it moved to impeach Bill Clinton. Pelosi changed her mind when presented with whistleblower evidence that Trump had attempted to pressure Ukrainian President Zelensky to investigate Democrat US presidential candidate, Joe Biden. In announcing a formal impeachment investigation, Pelosi highlighted the “dishonourable facts of betrayal of his (Trump) oath of office”. For now, it is expected that Republican politicians will continue to behave as they have ever since Trump became president i.e. they will defend him no matter what he does. However, it is worth remembering that the Republican party supported Richard Nixon right up to the moment that they didn’t. Politics is a dirty business and if public opinion moves further to support the impeachment process, it would be no surprise that the same Republican supporters eventually run from Trump. Democrats may tactically prefer to run the investigation through the period up to the election rather than push for his immediate removal from office. The level of distaste for Trump is more likely to galvanise Democrats in the election than would for instance Mike Pence being installed as Republican candidate. It is too early to say how this saga will unfold but markets will be susceptible to erratic behavior by Trump and his administration.

Brexit

This saga continues. The UK Supreme Court unanimously ruled that PM Boris Johnson’s prorogation (suspension) of Parliament was “unlawful”. In reaching the decision the Court was not making any comment on Brexit directly but rather that the government was seeking to avoid scrutiny by parliament. Johnson continues to state that the UK will leave the EU on 31 October with or without a deal. He also states that the government will not break the law which seems incongruous with the so-called Benn Act which demands that the PM apply for an extension to the Brexit discussions if no deal is reached. At the time of writing, Johnson has made a deal proposal to the EU, but the Irish President, Leo Varadkar, said he was “unconvinced” by the proposal and European Commission President Jean Claude Juncker called them “problematic”. Notwithstanding the Benn Act, Johnson said that he would rather be “dead in a ditch” than delay Brexit. Sterling drifted on the risk of a no-deal exit and it closed the month at 1.2289 versus the dollar.

Unicorns

Over the last few years there has been frequent admiration for so-called unicorns. These are privately held start-up companies that have valuations over USD 1bn. Often the companies are seen as disruptors which are changing the face of business. Doubts have surrounded whether it makes sense to put such high valuations on companies which have very substantial loss run rates. WeWork was just such a company and its planned IPO initially touted a possible $47bn valuation. In essence it is a real estate company offering shared work space and public market investors did not see how that warranted such a massive valuation. Now the IPO has been pulled; the CEO Adam Neumann has been forced to step down; and billionaire investor and co-founder of Oaktree Capital, Howard Marks, described the company as an overpriced sham. Marks also drew parallels with the 1999 “crazy valuations”. Perhaps this is another sign of a late cycle environment.

Markets

Name	30.09.2019	30.08.2019	MTD	YTD	Total Return MTD	Total Return YTD
Equities						
MSCI ACWI Index	520.65	510.88	1.91%	14.26%	2.14%	16.72%
S&P 500	2976.74	2926.46	1.72%	18.74%	1.88%	20.56%
DJIA	26916.83	26403.28	1.95%	15.39%	2.06%	17.51%
NASDAQ	7999.34	7962.88	0.46%	20.56%	0.55%	21.56%
RUSSELL 2000	1523.37	1494.84	1.91%	12.96%	2.09%	14.16%
Russell Top 200	710.17	699.60	1.51%	18.19%	1.65%	20.01%
STOXX 600	393.15	379.48	3.60%	16.44%	3.71%	20.32%
Euro Stoxx 50	3569.45	3426.76	4.16%	18.93%	4.29%	22.95%
FTSE 100	7408.21	7207.18	2.79%	10.11%	2.92%	14.15%
MSCI AXJ	617.77	609.01	1.44%	3.55%	1.65%	5.89%
Stock Exchange of Thailand	1637.22	1654.92	-1.07%	4.69%	-0.89%	7.54%
Jakarta Composite	6169.10	6328.47	-2.52%	-0.41%	-2.52%	1.80%
Philippines Stock Exchange	7779.07	7979.66	-2.51%	4.19%	-2.50%	5.75%
NIKKEI 225	21755.84	20704.37	5.08%	8.70%	5.74%	10.76%
KOSPI Index	2063.05	1967.79	4.84%	1.08%	4.85%	1.53%
Nifty 50	11474.45	11023.25	4.09%	5.63%	4.10%	6.81%
S&P BSE SENSEX 30	38667.33	37332.79	3.57%	7.21%	3.58%	8.29%
Straits Times Index	3119.99	3106.52	0.43%	1.67%	0.49%	5.30%
Hang Seng Index	26092.27	25724.73	1.43%	0.95%	1.87%	4.31%
Shanghai Comp	2905.19	2886.24	0.66%	16.49%	0.77%	19.33%
SHANGHAI A SHARE	3043.35	3023.71	0.65%	16.54%	0.77%	19.37%
S&P/ASX 200	6688.35	6604.22	1.27%	18.45%	2.03%	23.91%
MSCI AC ASEAN Index	771.71	778.79	-0.91%	1.62%	-0.73%	4.57%
MSCI EM Ex. Asia Index	1340.19	1321.11	1.44%	2.70%	1.73%	5.99%
MSCI EM Asia Index	504.71	495.88	1.78%	3.98%	1.97%	6.19%
MSCI EM Index	1001.00	984.33	1.69%	3.65%	1.91%	6.14%
Fixed Income					**MTD bps**	**YTD bps**
US10YT Yield	1.6646	1.4961	11.26%	-37.99%	16.85	-101.96
US2YT Yield	1.6217	1.5040	7.83%	-34.81%	11.77	-86.61
Bunds 10Y Yield	-0.5710	-0.7000	-	-	12.90	-81.30
Global Investment Grade	509.20	514.43	-1.02%	6.32%		
Global High Yield	1366.72	1360.27	0.47%	8.76%		
Forex						
EUR	1.0899	1.0982	-0.76%	-4.95%		
JPY	108.08	106.28	1.69%	-1.47%		
SGD	1.3819	1.3872	-0.38%	1.39%		
GBP	1.2289	1.2156	1.09%	-3.65%		
AUD	0.6750	0.6733	0.25%	-4.24%		
US Dollar Index	99.377	98.916	0.47%	3.33%		
China RMB Spot Currency	7.1483	7.1560	-0.11%	3.92%		
Offshore Deliverable CNY	7.1413	7.1623	-0.29%	3.94%		
Gold/Oil						
Brent Crude	60.78	60.43	0.58%	12.97%		
Generic 1st Crude Oil, WTI	54.07	55.10	-1.87%	19.07%		
Gold Spot Price	1472.49	1520.38	-3.15%	14.81%		