Global stocks rallied by more than 12% in local currency terms, the best start to a year since 1991. The risks to the outlook are real, and CIO recently reduced its equity exposure. But the case for optimism persists.

As the second quarter starts, investors are confronted with conflicting signals. Equity markets appear to be pricing in several possible positive events including a successful outcome to the US-China trade talks, a recovery in global economic growth, and the Federal Reserve remaining on hold for the rest of the year.

Bond markets, by contrast, are far less sanguine. The decline in 10-year US yields reflects pessimism over the growth and inflation outlook. For the first time since 2007, the yield on the 3-month Treasury bill rose above the 10-year yield in March. This phenomenon, known as a yield curve inversion, is generating a lot of headlines as a potential harbinger of recession. The risks highlighted by the bond market are real. But CIO believes there are grounds for confidence that the economic expansion and bull market can extend, rather than end.

Lower bond yields could prove supportive of equity flows. The decline in yields makes stocks look more attractive by comparison. Despite the first quarter rally, the equity risk premium has only narrowed by 0.1 percentage points since the start of 2019. It is now 5.7%, versus a 30-year average of 3.3%. CIO believes concern over the recent inversion of the 3-month/10-year portion of the US yield curve is overblown. Following the four such inversions since the 1970s the economic expansion lasted on average for a further 1.75 years, and stocks rose for another 1.6 years. Even more importantly, stocks rallied by 40.5% on average.

Economic growth should recover. While CIO wants to see more signs of recovery before they increase their portfolio risk, there are reasons to believe the slowdown will be short-lived. The consumer side of the global economy is in good health. The recent economic weakness has been triggered, instead, by lower capital spending by businesses, which has curbed global trade. CIO believes this trend will reverse, especially if US–China trade talks produce even a partial resolution.

Full-year US earnings growth should be positive. Investors have become accustomed to earnings expansion — with S&P 500 earnings per share growing by 23% in 2018 and by 12% annually on average over the past
decade. Consensus is now for a 2% decline in EPS growth in the first quarter and a modest 1% increase in the second quarter. But CIO does not regard this as the start of a lasting contraction in profits.

CIO expects earnings growth of around 4%. The slowdown in headline earnings is also exaggerated by a fading boost from US tax reform and idiosyncratic headwinds in a handful of sectors. The risks to the outlook are real, and CIO recently reduced our equity exposure. But the case for optimism persists, and so overall CIO remains modestly risk-on in our tactical asset allocation.

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For more, see: A strong quarter ends. Mixed signals ahead, 1 April 2019.

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