

Q4 outlook: Gathering clouds

We turn cautious on global equities on a tactical and medium-term view, as US stocks flirt with record highs even though risks to the world economy are mounting.



Emiel van den Heiligenberg joined LGIM in August 2013 as Head of Asset Allocation with responsibility for asset allocation, strategy and multi-asset macro research.

In our last quarterly note, we pointed out that investors faced a murky macroeconomic outlook, with a number of risks on the horizon. The outlook is now somewhat clearer – in that the risks have grown in scale.

The risks facing the global economy are tilted to the downside: our economists see a 30% chance of a global recession in the next 12 months. This is the highest probability since the start of the cycle in 2009. And yet US equities are within spitting distance of their record highs.

We are, in fact, increasingly convinced that investors are now in a ‘late cycle’ period, when the buy-on-dip strategy we have deployed over the past few years might prove less effective. As a result, we have reduced our equity stance to a slight underweight or negative position from neutral, on both a tactical and medium-term view.

WEAK EARNINGS

A darkening economic outlook translates into expectations for corporate earnings, which are disproportionately impacted by developments in the industrial sector. And manufacturing growth, dissected by James below, is weak globally – leading us to anticipate US earnings will contract slightly next year.



At the same time, we believe the current perceived “deal” in the US-China trade war might represent a temporary peak in optimism. Tensions will probably remain for the coming years – as we are in a [Thucydides](#) trap, where US leadership is challenged by the rising power of China.

In the run up to the US presidential election next year, negative rhetoric on the world’s second largest economy might increase from both challengers within the Democrats and the incumbent, making it harder for a long-term agreement with China to be reached. That election could result in a sharp swing to the left, with momentum towards the impeachment of Donald Trump a positive for Democratic candidate Elizabeth Warren, whose plans are seen as negative for Wall Street.

Elsewhere, as Lars discusses below, the Brexit drama rumbles on, posing a material risk to the euro-area economy, even if and when we get a deal. Moreover, a regime shift in economic policy-making in China means we can no longer rely on the country to prop up global growth, a significant development analysed by Erik.

FED SUPPORT

The US Federal Reserve does remain willing to support markets, in the event of a tightening of credit conditions. But contrary to December 2018, quite a bit of accommodation is already factored in by investors – and we believe the central bank could do less than is priced.

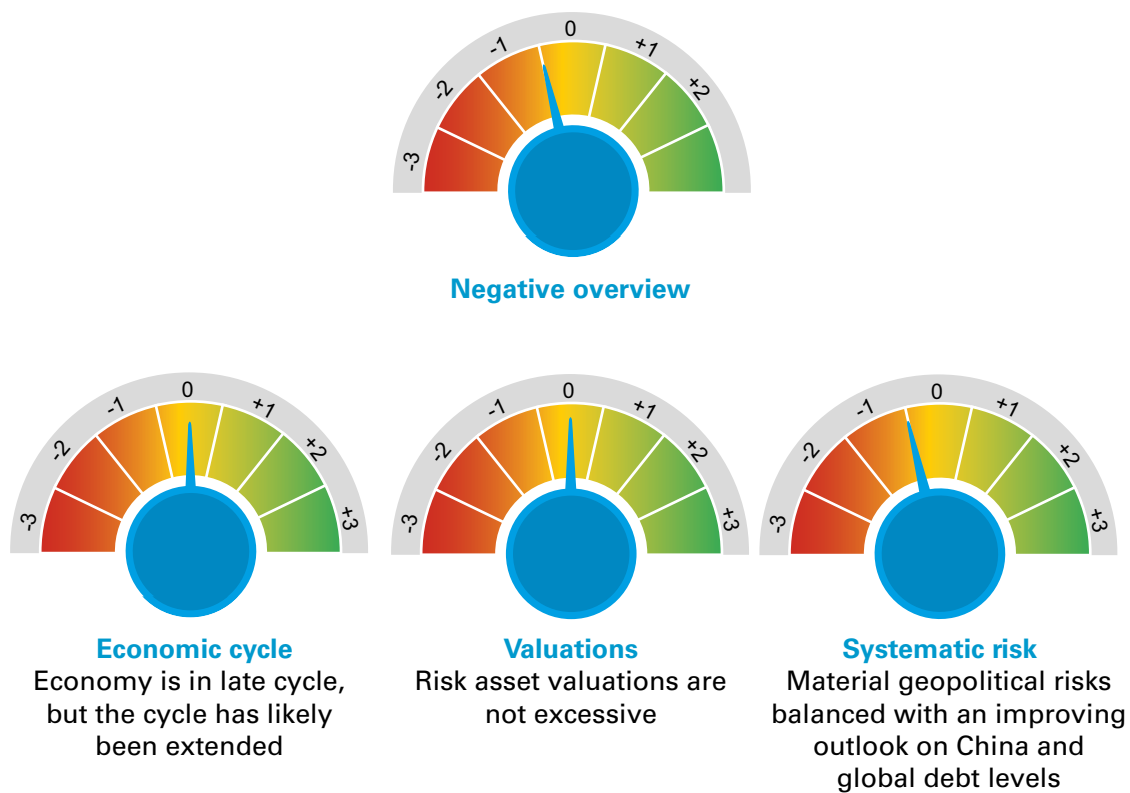
Taken together, these factors create substantial vulnerability for equities, hence our cautious positioning.

Still, the picture is not completely bleak. The trade conflict could yet be resolved, especially since Trump requires

a positive economy in 2020 to boost his chances of re-election. And while absolute valuations for US stocks might be a cause for concern, relative valuations versus interest rates are positive.

Should the world economy enter a recession, we expect it to be **only a mild one**, justifying a market drawdown of about 20%. Any decline greater than this would probably turn us into dip-buyers again.

Figure 1: Summary of LGIM’s asset allocation core view



Economic Cycle	Valuations	Systemic Risk
Corporate profit margins are falling	Risk assets cheap versus government bonds	Trade war weighing on global economy
Historically low unemployment and low inflation	Equities mid range historically, cheap versus bonds	Debt levels high but decreasing
Low interest rates	EM credit attractive versus other credit	Unconventional monetary policy

Source: LGIM

OUR VIEWS AT A GLANCE:

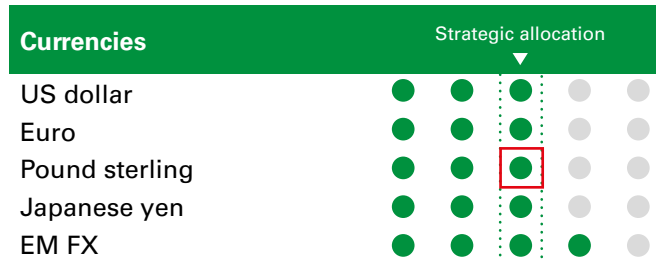
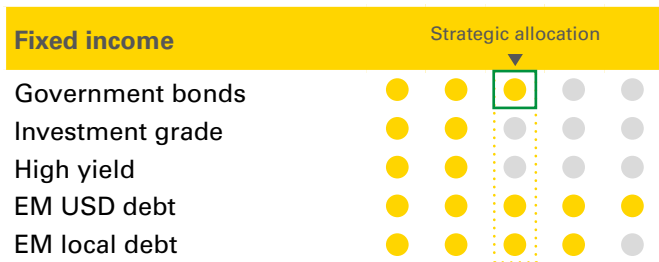
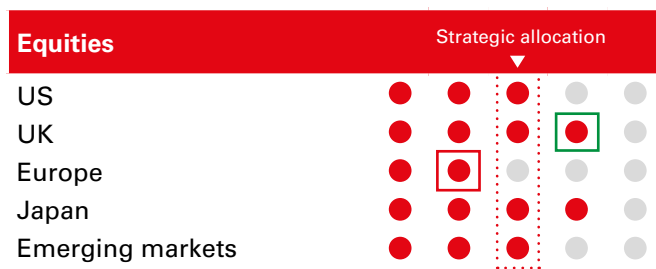
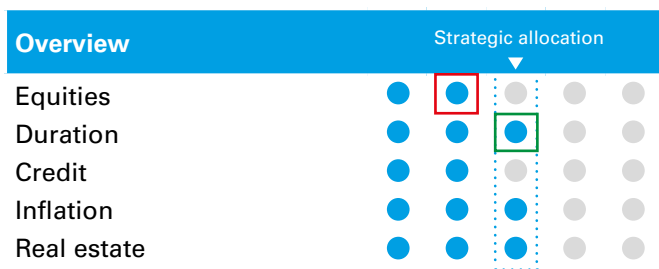
A slight negative view on equities – this has been downgraded since our last outlook, both tactically and over the medium-term, driven by the escalating US-China tensions weighing on the global economic outlook and our recession indicators having worsened. At a regional level, we still favour Japan relative to the US and have upgraded our view on the UK thanks to valuations and Brexit risk being fairly priced, in our view.

Remain positive on emerging-market debt – spreads remain relatively attractive and default risks stay low.

Neutral on developed-market government bonds – this has improved since last time as our fundamental view has changed, given central-bank actions and the economic environment.

Remain negative on credit – the asset class tends to underperform at this part of the cycle and valuations remain unattractive.

GBP from slightly positive back to neutral – with the Brexit situation being so fluid and sterling having strengthened since the summer, we choose to be neutral at this point.



Source: LGIM

 Upgraded Downgraded

This schematic summarises the combined medium-term and tactical views of LGIM’s Asset Allocation team as of October 2019. The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point. Our core view on risk assets, as illustrated by the big dial, may move in either direction going forwards; and our certainty over the expected direction of travel and timeframe for this next move has decreased in reflection of the uncertain geopolitical environment.



Lars Kreckel
Global Equity Strategist

WHY ECB EASING ISN'T ENOUGH FOR EURO EQUITIES

The European Central bank (ECB) has recently unveiled its most meaningful package of stimulus in years – and yet **we are short or underweight Eurozone equities** across most portfolios.

While this position may appear counter-intuitive, the investment case is fairly straightforward: euro stocks have performed relatively well this year, outperforming in the first quarter and trading in line with global peers during the second and third quarters.

But over the same period, our macroeconomic views on the region have deteriorated significantly. This has left us facing the combination of higher prices for European equities and lower expectations for the region's macro backdrop – a poor mix.

The range of risks for stocks in Europe is pretty broad. We see the probability of a Eurozone recession over the next year at around 50%. The likelihood of a no-deal Brexit has also increased to around 45-50%; in most cases, this would also push the Eurozone into recession. The risks to our base-case forecasts for the region have, therefore, become heavily skewed to the downside.

We also have long held the view that the Eurozone would be one of the most vulnerable regions in the world to an economic downturn. This would reveal the structural issues that have worried markets in the past, such as the continent's lack of central-bank firepower and the institutional challenges it faces in responding quickly and decisively to crises.

INVESTOR SENTIMENT

All of the above would be bearable if the valuations of Eurozone equities were unusually low and/or sentiment was particularly bearish. Neither is the case today, though.

Valuations for European stocks, relative to other developed markets, are close to their historical averages. Sentiment surveys may suggest that Eurozone equities are far from everyone's favourite, but they are just as unpopular as UK and Japanese stocks, so do not stand out as offering an attractive discount.

The ECB presents one of the biggest potential risks for this position. A 'big bazooka' policy surprise, such as the expansion of quantitative easing (QE) to include stocks, could boost European equities as it did in early 2015. But Mario Draghi's penultimate press conference at the helm of the ECB did not suggest such a game changer is forthcoming.

What of the easing already announced? In the face of persistent inflation undershoot, a growth slowdown and further downside risks to the outlook, the central bank is deploying and re-deploying a range of policy tools.

There is, however, little that ECB action can do when uncertainty is so high. Can marginally lower rates (a meagre 10 basis point cut) really stimulate investment spending or help plug the gap in German exports to China?

So even though the stimulus package delivered in September was slightly larger than we expected, it has neither mitigated the recession risks facing the euro area – nor dimmed our view on its merits as an underweight position.



James Carrick
Global Economist

HOW LONG WILL THE GLOBAL MANUFACTURING SLUMP LAST?

The global manufacturing sector has been stagnant over the past year, with key gauges of activity falling to multi-year lows. This is similar to what occurred after the 2011 euro-area crisis and the 2014/15 commodity crunch.

What has caused the latest downturn? It is tempting to blame the US-China trade war. After all, that has created uncertainty, which in turn should depress capital expenditure. And global business equipment capex growth has fallen by around 5% since its peak compared with a 0.75% decline in global retail sales growth.

However, the capital goods sector is always more cyclical than the consumer goods sector (particularly for staple products like food).

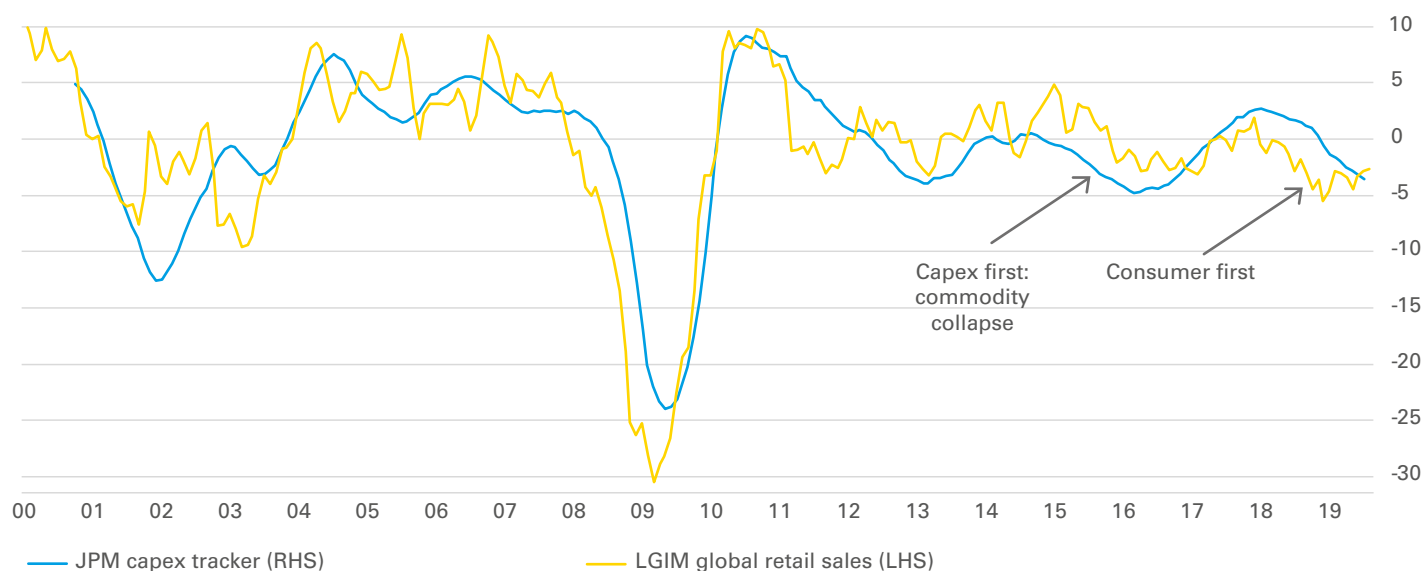
Indeed, the downturn in equipment capex seen so far looks consistent with a typical 'accelerator' effect from prior weakness in consumer spending. This is in contrast to 2015, when the collapse of the commodities complex depressed investment even though the global consumer remained resilient.

With the exception of the US, there was a broad-based slowdown in global consumer spending in 2018, equally split between advanced economies and China. Since then, we have seen a tentative recovery in advanced-economy retail sales. This is leading some analysts to anticipate a near-term recovery in industrial production. However, Chinese consumption remains depressed as the government stimulus has been relatively muted (see next section).

If the weakness in capex is mainly a reaction to prior consumer weakness, then we have yet to see the full effect of geopolitical concerns, such as the US-China trade war and Brexit.

So even if the global consumer holds steady, capital goods production could remain subdued for longer. This should hurt countries like Germany, Japan and Korea, whose manufacturing sectors are particularly exposed to capital goods.

Figure 2: Global retail sales and capex, % YOY, less median



Source: JP Morgan, Macrobond, LGIM as at 1 August 2019



Erik Lueth
Global Emerging Markets Economist

CHINA'S ECONOMIC POLICY CHANGE

For the past 10 years or so, bad news in China was usually good news: growth shocks triggered sizeable stimulus, leading to asset-price rebounds in the country, emerging markets and the world more broadly. This policy is now a thing of the past.

Take the trade war. Tariffs announced by the US potentially reduce Chinese growth by 1%, not counting second-round effects on confidence and financial conditions. And yet despite this large shock, Chinese stimulus announcements have been few and far between.

In addition, the leadership has explicitly ruled out using the property sector to stimulate the economy. The sector was part and parcel of every past stimulus package, as it accounts for 30% of activity when including upstream industries.

Most importantly, China's policy space has shrunk markedly after a decade of easy policies. Debt has surged by 112% of GDP over the past decade, the current account is moving towards deficit from a 10% surplus in 2007, and house prices look increasingly frothy.

The newfound tolerance for volatility is likely to be asymmetric. Were China to be hit by a positive shock, we believe the authorities would use much of the momentum to clean up balance sheets further and rebalance the economy towards consumption. Hence, average growth over the next five years should be lower than it would have been without the regime change in economic policymaking.

IMPLICATIONS FOR COMMODITIES

While the medium-term risks of a hard landing decrease as the leadership relies less on leverage to boost growth, short-term risks increase with its rising tolerance for volatility.

Given China's size – it now accounts for 30% of global growth – the regime change should be felt globally. World growth could become more volatile and weaker on average. In addition, commodity prices would likely suffer; emerging markets as major commodity producers would face headwinds and inflation could remain lower for even longer.

We also expect China's currency to become more of a shock absorber as the space for other policy action shrinks. For example, if the trade talks fail and additional tariffs are imposed later this year, the renminbi could take another leg down.

Deng Xiaoping, the former Chinese leader, once referred to his policy of reform as "crossing the river by feeling the stones." The regime change underway is likely to continue in a similarly gradual fashion, but continue nonetheless.

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