UOB Investment Insights

Monthly Market Views

September 2019

Getting ready for recession: what are the signs saying?

1-minute digest

- Although the traditional recessionary alarm of an inverted yield curve has sounded, its predictive power has been brought into question thanks to the unprecedented levels of monetary easing.
- Various other signals that analysts, economists and commentators use to assess market direction are not necessarily suggesting a prolonged downturn at this current juncture.
- However, the unquestionably challenging economic and geopolitical conditions offer a timely opportunity to revisit investment portfolios and (re)apply the tried-and-tested principles of asset allocation, rather than shorter term tactical or reactive moves.
- We believe a well-positioned portfolio in such volatile times is one that remains invested but with a more defensive tilt.

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What does an inverted yield curve mean?

A yield curve is "inverted" when short-term US Treasury bonds pay a higher yield than a longer-term US Treasury bond. Getting more interest for a short-term than a long-term investment appears to make zero economic sense. This is the market's version of near-term economic pessimism.

As a result, the spread between the 2-year and 10-year US Treasury bonds has broadly been considered by market analysts to be an early-warning sign of a recession. The US Federal Reserve (Fed), by contrast, only predicts this probability by using the spread between the 3-month and 10-year US Treasury bonds – which inverted in March 2019.

Although the gap has been narrowing for some time, 14 August 2019 saw the yield for the 2-year Treasury note rise above that of the benchmark 10-year note. Everyone is watching whether this yield curve dynamic is here to stay. The immediate response from many global investors has been a flight-to-quality.

A "normal" yield curve

Yield curves typically slope upwards because investors demand more compensation (yield) to hold a note or bond for longer. This is due to the risk of inflation and other uncertainties that might impact the price of the bond over time.

It is worth noting that while an inverted yield curve has proceeded every US recession since 1950, a recession **does not always** follow an inverted yield curve.

In particular, with the Fed's easing of monetary conditions, the jury is still out on the predictive power of this latest inversion.

Will there really be a recession?

It was perhaps inevitable that quantitative easing (QE) would shift the signalling pattern of the yield curve and potentially reduce its reliability in predicting a recession. After all, keeping the yields on long-term bonds artificially lower was an objective of monetary easing.

To help gauge the impact of QE globally, investors can consider what is known as "term premia" – the excess yield that investors are required to commit to holding a long-term bond instead of a series of shorter-term bonds.

It is possible that the curve could remain flat even if lower interest rates help stimulate the real economy. However, there could also be a causal link between a flat yield curve and an economic slowdown if the shape the yield curve results in commercial banks being less willing to lend money to businesses and consumers.

Another reason for the inversion might be a response by investors who are worried about future economic growth – excessively boosting allocations to safer, long-term Treasury bonds, in turn driving yields down.

Table 1: Other warning signs of a recession

Indicator	What it shows us	Current situation
Credit spreads	The wider the spread – ie, the extra yield that corporate bonds offer over Treasuries – arguably indicates market conditions are getting worse.	With spreads tight at the moment (as they typically are late in a cycle), this does not suggest market distress. Investors should nonetheless be choosy about which bonds to buy given current volatility.
Equity quality	These are used to judge whether corporate balance sheets are overextended.	Although corporate cash holdings have declined and net debt has risen, the driver is (largely) share buybacks, which return cash to shareholders, and fewer instances where companies issue new shares (a positive sign for investors).

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3 ways to tackle fears of a recession

Different signals give us different messages, but we can still heed these early warnings and start preparing our portfolios today.

Although the current cycle is unique due to QE and other reasons already discussed, we can draw on some experience from investing in two recent recessions:

- In the 2008 global financial crisis – government bonds and high-grade corporate bonds made positive returns through the downturn. Even in a severe crisis, equities came back faster than expected.

- In a milder recession like 1990 – the equity downturn was very short; there is strong evidence that the next recession might also be mild.

In short, we propose that investors should think about positioning current portfolios to:

- Stay invested

- Continue following the good investment practice of being well-diversified

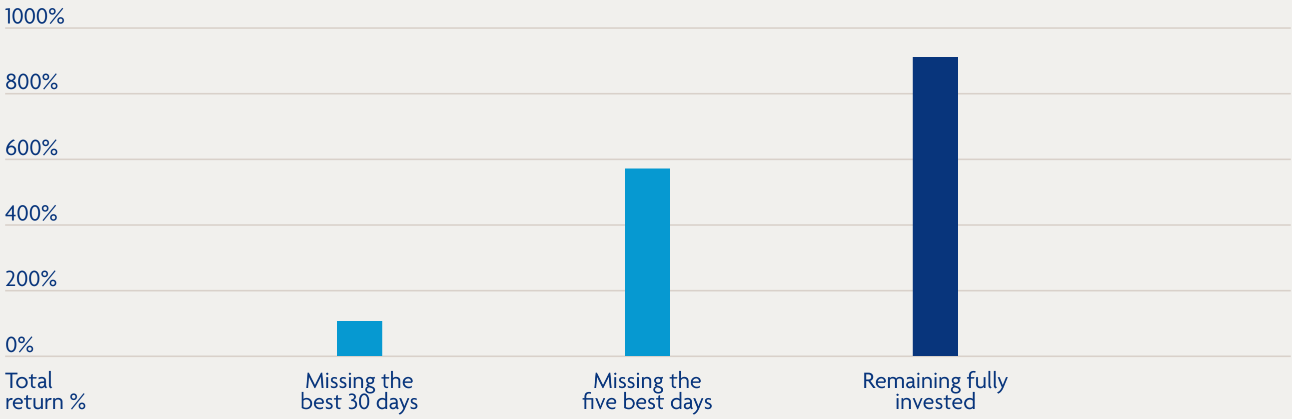
- Adopt a more defensive stance

Figure 1 makes it difficult to argue with the rationale of investors constructing a diversified portfolio and holding it through a volatile period. The data shows that the opportunity cost for missing the best 30 days in the S&P 500 over the past 25 years or so has been proven to be too high – the difference between 910% total returns if investors remained fully invested and only 107% if they missed out on the 30 best-performing days.

As Figure 2 shows, this pattern is consistent across multiple equity markets globally.

Figure 1

Total return and impact of missing the five and 30 best days in the S&P 500 (1992 - 2017), US$



Source: Datastream, Fidelity International, February 2018. S&P 500 total return data from 31/12/1992 - 30/12/2017

Figure 2

The impact of missing five or 30 of the best-performing days over the long term

31 December 1992 to 31 December 2017	Total return for the entire period	Total return minus five best-performing days	Total return minus 30 best-performing days
ASX 200	985%	730%	224%
CAC 40	524%	289%	-4%
DAX	736%	427%	25%
FTSE 100	552%	339%	47%
Hang Seng	1,177%	558%	23%
Nikkei 225	35%	-15%	-79%
S&P 500	910%	570%	107%

Source: Datastream, February 2018

Staying invested also makes sense when considering that a strategy to hold cash is increasingly less attractive in the face of low and declining interest rates. Central banks across the world are under pressure to further reduce interest rates..

Alongside this commitment, we believe investors should position their portfolios more defensively with a preference for assets that are better placed to withstand the challenges in today's investment environment.

A prudent approach to maintaining a diversified portfolio in this way is via Global Multi-Asset/Balanced strategies. These tend to mitigate downside risks better when markets are volatile. Investors can also speak to their advisor about the UOB Risk First Bento solution – diversified portfolios constructed based on our award-winning Risk First methodology.

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Economic Drivers and Risks

Economic drivers

Global growth

The IMF downgraded its forecast of global GDP growth to **3.2% in 2019[1] from its earlier 3.3% forecast**, citing ongoing trade tensions as an overhang. However, a recession is still not expected in 2019.

Inflation and Central Banks

Central banks have adopted a **dovish tone**. **The Fed made a cut of 25 bps** in July, the first rate cut since 2008. **The ECB hinted at potential monetary stimulus measures** in September, while the BoJ will likely continue to stay accommodative.

Corporate earnings

In 2019, strong personal consumption supported by a healthy job market should continue to drive the **positive trend** in corporate profits. Global earnings growth is expected to rise around **8% in both 2019 and 2020**.

Risks

Rising US Protectionism

Both the **US and China imposed fresh tariffs** on each other, effective 1 September 2019. This further raised concerns of slowing global economic growth and an escalation in trade tensions. Our base case (65%) states that negotiations are likely to continue beyond 2H 2019 and into 1H 2020, with the probability of the worst-case scenario (all-out tariffs) increasing from 30% to 35%.

Political Uncertainty in Europe

UK Prime Minister Boris Johnson secured the Queen's consent to suspend Parliament from mid-Sept to mid-Oct, **increasing the risk of a no-deal Brexit**. Italy is likely to call for a general election following the breakdown of the coalition between its two largest parties.

Global Growth Slowdown

After 10 years of economic expansion, the global economy is entering a **late-stage expansion cycle**. With effects of **fiscal stimulus fading** in the US and **trade tensions rising**, global economic growth may face a more drastic slowdown.

[1] World Economic Outlook, IMF, July 2019

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Asset Class Views

Asset Class	Subclass	View	VTAR framework	Rationales/Drivers
Equities	US	N	V T A R	Valuations are slightly expensive, prolonged trade negotiations could hurt consumer and business sentiments due to the ongoing uncertainties.
	Europe	–	V T A R	Valuations and trends are attractive relative to the US. However, growth is slowing and volatility is expected to remain high due to EU political instability.
	Japan	N	V T A R	Attractively valued, although global trade tensions are weighing on business sentiment. The consumption tax hike scheduled in October 2019 remains a risk.
	Asia (ex-Japan)	+	V T A R	Earnings are expected to trend lower, but P/E is relatively cheaper than DM. Chinese fiscal stimulus is expected to provide relief to an escalation of US-China tensions.
	EM (ex-Asia)	+	V T A R	Valuations are attractive relative to DM peers. Expectations of Fed rate cuts and stable oil prices will sustain equity returns in 2019.
Fixed Income	DM government bonds	+	V T A R	Fed, ECB and BoJ are all expected to remain dovish with further monetary easing in H2 2019. US Treasuries offer better value than other DM government bonds.
	DM investment-grade bonds	N	V T A R	IG yield spreads have narrowed year-to-date. Supply-demand dynamics remain supportive, but credit fundamentals in the BBB space have started to deteriorate.
	DM high-yield bonds	–	V T A R	HY offers some income buffer but default rates are projected to climb higher as the economy enters late-cycle expansion amid an uncertain economic climate.
	EM US dollar debt	N	V T A R	Spreads have narrowed after the YTD rally. Easing in global central banks provides support to EMD USD. Prefer Asian investment-grade bonds.
	EM local-currency debt	N	V T A R	EM sentiment is likely to improve if the Fed starts cutting rates. However, EM currencies, led by CNY, could weaken against the USD.
Commodities	Gold	+		The Fed's potential rate cuts are positive for Gold. China's reallocation of reserves into Gold will provide a support level. Target USD 1,650/oz by Q2 2020.
	Oil	N		Tensions in the Middle East could support oil prices in the short term. However, the upside is capped by concerns over slower global growth.
Currencies	The US dollar	N		The USD is expected to hold up in the near term, but could face headwinds if the Fed begins to cut rates. SGD is expected to depreciate against USD.

– – Negative – Slightly Negative N Neutral + Slightly Positive + + Positive

V=Value **T**=Trends **A** =Activity **R**=Risk

● Positive ● Neutral ● Negative

High-conviction strategies

Conviction	VTAR framework	Proposition	Risk
Global Quality Equities		Global quality equities tend to outperform broad equity markets over longer investment cycles.	Relatively expensive valuations could increase the probability of short-term corrections. However, good quality companies tend to better weather an economic slowdown, limiting the likelihood of large swings in quality stocks.
US Consumer Staples		US Consumer Staples is a sector that offers a more defensive positioning than many other US equity sectors, and thus is less likely to experience the same level of drawdowns in a risk-off scenario.	Certain sectors, such as Beverages and Tobacco, could face regulatory risk to reflect the change in social norms and acceptable practices. Technological disruption could cause companies that fail to keep up to fall behind the competition.
EM Equities		Broad EM equities are supported by stronger fundamentals and attractive valuations.	An unexpected surge in USD strength could cause a retreat from EM equities, as seen in the Turkey situation last year. A worsening of US-China trade tensions could also lead to higher market volatility. Another escalation, such as the recent increase in tariffs by both sides, can cause near-term pullbacks.
Unconstrained Bond Strategy		A dovish stance from major central banks will keep key global interest rates low. An unconstrained bond strategy tends to enhance the return over the broad fixed income market.	An inflation overshoot will send bond yields higher, which will be the major risk to fixed income in general. However, inflation-linked securities such as TIPS will be less affected in such an event.

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● Positive ● Neutral ● Negative ● NIL

Megatrends

Conviction	VTAR framework	Proposition	Risk
Global Healthcare		Healthcare is a structural growth story driven by long-term growth in an aging global population. In the medium-term, we expect drug approvals and an increase in M&A activity to be catalysts for a sector re-rating.	Policy uncertainty could weigh on sentiment for the sector. The Medicare-for-all scheme proposed by Democrat Presidential candidate Bernie Sanders could lead to volatility, but the probability for the programme to pass is low at present. This risk will likely be mitigated in the long-term as a growing silver segment should contribute to stronger increase in demand.
Chinese Equities		Chinese equities, to which many global investors are under-weight in their portfolios, provide good risk-reward and diversification benefits.	A US-China trade war remains a key risk in the near term and is likely to negatively impact China's economic growth. Financial deleveraging could continue to put pressure on growth and lead to higher risks of policy missteps.
AI & Innovation		Artificial Intelligence (AI) has the ability to drive multi-fold increases in productivity by utilising big data and powerful computing hardware to accurately and reliably solve real-world problems with little human input.	Policy and regulatory uncertainty is a key risk to watch for. As AI permeates more and more into people's daily lives, questions about safeguarding individual privacy and appropriate use of such tools will surface. Regulators may step-up efforts to curb the uses and applications, while differing standards from various countries can create barriers to universal adoption.

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Positive Neutral Negative NIL

Rates and FX Forecasts

Key Currencies					Key Rates (%)				
	4Q19F	1Q20F	2Q20F	3Q20F		4Q19F	1Q20F	2Q20F	3Q20F
USD/SGD	1.40	1.41	1.42	1.42	**USD**	1.50	1.50	1.50	1.50
EUR/SGD	1.54	1.55	1.59	1.62	**EUR**	0.00	0.00	0.00	0.00
GBP/SGD	1.68	1.69	1.72	1.73	**GBP**	0.75	0.75	0.75	0.75
AUD/SGD	0.97	0.97	0.99	1.01	**AUD**	1.00	1.00	1.00	1.00
JPY/SGD x 100	1.32	1.34	1.38	1.38	**JPY**	-0.10	-0.10	-0.10	-0.10
NZD/SGD	0.90	0.90	0.92	0.94	**NZD**	1.00	1.00	1.00	1.00
SGD/CNY	5.14	5.14	5.14	5.14	**CNY**	3.90	3.65	3.65	3.65
					SGD	1.80	1.70	1.70	1.70

Source: UOB Global Economics & Markets Research, 13 September 2019

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