ARVEST

April 2019 | Issue no. 113

Investor Info

Investment Commentary

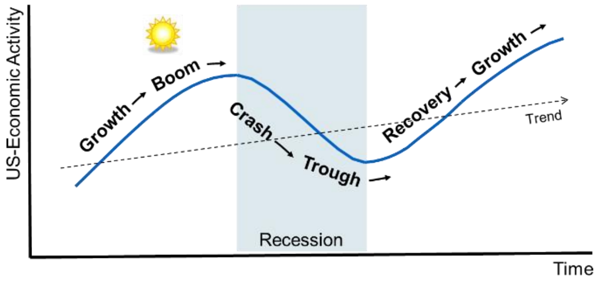
Briefing from the ARVEST Investment Committee

After the weak end of the last financial year, many investors were surprised by the sharp rise in equity and bond prices in the first quarter of 2019. Such significant gains in both major asset classes are indeed rare, as investors usually buy equities if they are optimistic about economic growth, but bonds if they are more pessimistic. How did this happen and what does it promise for the future?

Since last summer, global economic growth has slowed. The slowdown has spread from industrial manufacturing in China to suppliers in Europe, Japan and emerging Asian countries. The US was initially less affected due to its lower exports to China. However, the US economy is also becoming increasingly vulnerable to the worldwide decline in economic growth. In March 2019, the US Federal Reserve responded to the weakening US economic data and pulled back on previously expected interest rate hikes.

Following this Fed decision, international investors in particular started to buy long-term US government bonds. They strived to secure a positive yield in the global reserve currency before interest rates would fall again. These international buyers were certainly also concerned with avoiding the often negative bonds yields in their countries of origin. This demand for safe yields increased the prices of long-term government bonds. This led to a fall of long 10-year US government bond yields below the yields of 3-month Treasury bills. Economists refer to such a reversal of the usual conditions as an inverse yield curve or interest rate inversion. Every US recession since 1968 was preceded by an inverse yield curve. This rare condition became known as the most striking warning sign of a recession. However, not every interest rate inversion effectively led to a recession. And even when there was a recession after an interest rate inversion, it started with a lag between five months and sixteen months, making the exact timing unreliable.

Accordingly, the interest rate inversion is an early signal, but not a trigger or even a cause of a recession. Therefore, at ARVEST, we do not consider the actual inversion but rather the persistence of the inversion for a few months as the more reliable warning signal. It is also always necessary to analyze the concrete circumstances that led to an interest rate inversion. More and more individual indicators are confirming that the US economy is late in the economic cycle. At ARVEST, we refer to this phase as the boom phase, which usually lasts three to eight quarters. In our opinion, however, it is still too early to warn of an imminent slide of the US economy into a recession.



Future Prospects

The global economy is in “a delicate moment”, as International Monetary Fund chief Christine Lagarde rightly said on 2 April. The ARVEST Investment Committee may well note the first tentative signs of a soft economic landing, particularly in terms of demand from China. If a commercially reasonable solution can be found to the trade dispute between the US and China, China and its suppliers should be able to prevent a hard landing or a recession. Higher business investment and more stable global growth would be the result. The US could benefit as well and extend its economic cycle beyond the 2020 election year. Indeed, essential features that make up a boom for us are still missing in the US. In particular, credit conditions would have to be further tightened and, as a consequence, credit defaults would have to increase somewhat. Despite some considerable indebtedness of US companies, interest rates are apparently still too low for this yet to be visible. And as long as inflation is lower than expected, this could remain so for some time to come. Moreover, the mood among companies, consumers and investors is not yet as euphoric as it would be expected in a boom. We are paying particular attention to financial market psychology and valuation metrics. We certainly observe price excesses related to specific sectors or stocks. However, these seem to be brought about by institutional trading algorithms rather than by the herd instinct of small investors. The recent sharp price fluctuations in the financial markets are nevertheless very typical for a boom phase.

How does the ARVEST Investment Committee position itself in this situation? We continue to feel comfortable with an equity allocation in the middle of the strategic range that has been in place since the fourth quarter of 2017. This offers the most flexible starting position for possible developments. This also includes sufficient liquidity reserves to have the opportunity to buy shares even if the global economy should enter into a recession before we have been able to further reduce our equity exposure. Tactical bargain hunts are now just as inappropriate as panic reactions would have been at the beginning of the year. In today's market environment, we attach great importance to genuine diversification and continue to favour high-quality, international value stocks over high-flying US growth stocks, which have shaped media coverage in the current economic cycle and also dominate many stock market indices and passive ETFs. We maintain our fundamentally positive attitude towards equities.

5.4.2019
On behalf of the Investment Committee
Stefan Kimmel
Chief Investment Officer ARVEST Funds AG