

FEBRUARY 2019

NAVIGATING THROUGH TURBULENT MARKETS

MERCER GLOBAL DYNAMIC ASSET ALLOCATION UPDATE

The good news is that valuations on global equities are much more reasonable, particularly relative to defensive assets.

Global equity markets tumbled nearly 14% on an AUD hedged basis and 11% on an AUD unhedged basis in the fourth quarter of 2018. Concerns over Fed tightening, Trade Wars, Brexit and slowing Chinese growth contributed to the first leg of the sell-off in October. A deteriorating global growth and earnings outlook seemed to drive the second leg that began in December. Thin liquidity around the holidays likely exacerbated the losses. Emerging market assets showed some resilience and fell by 5% on an AUD unhedged basis as they had already underperformed during previous quarters. Investment-grade and high yield credit suffered relative to US Treasury bonds during the quarter as credit spread spiked, consistent with an increase in volatility in the VIX.

In our view, the magnitude of the sell-off was not justified by changes in fundamentals. As we have noted, downside risks to the global growth outlook have grown over the past several months, but we continue to believe that a global recession is unlikely in 2019. The good news is that valuations on global equities are much more reasonable (figure 1), particularly relative to defensive assets. As such, we suggest clients use this as an opportunity to rebalance portfolios.

Figure 1: MSCI World Shiller P/E Ratio



Source: Datastream, MSCI, Mercer

Our dynamic asset allocation (DAA) recommendations for the fourth quarter of 2018 suggested a modestly defensive stance through an underweight to growth fixed income and an overweight to cash, which provided some protection during the quarter as credit spreads widened. We now suggest removing the defensive positioning by returning to neutral on growth fixed income. We also have a marginally more positive view on equities. We continue to prefer emerging market assets relative to developed, both in fixed income and equities, due to relatively attractive valuations.

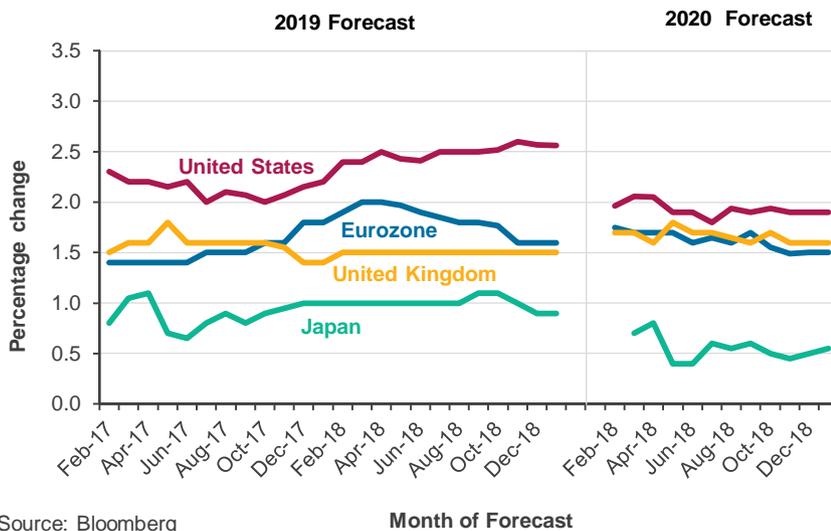
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GLOBAL GROWTH OUTLOOK

As discussed in our annual economic and market outlook released late last year, we expect global economic growth to weaken from 2018 levels. Nevertheless, the downbeat assessment implied by markets during December appears overdone.

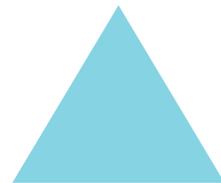
The US was the driver of the global expansion in 2018. Growth in the US will certainly slow from the unsustainable 2018 pace, but should remain above the 2% trend in 2019 (figure 2). Growth in US business investment has flagged, partially due to falling energy prices and trade uncertainties. However, US household finances remain solid. Household income is growing as a result of the strong jobs market and wage gains, which should keep consumer spending strong. There is a risk of a more significant slowdown in 2020 due to fading fiscal stimulus and labor supply constraints. Nevertheless, even if there is a recession in 2020, it should be mild as there are no obvious excesses in the US economy at this point.

Figure 2: Revisions to Consensus Growth Forecasts



Source: Bloomberg

The growth picture outside the US is more uncertain, and China in particular presents downside risk. The direction of trade tensions between the US and China is a key uncertainty. A further escalation could lead to a material slowdown in global economic growth, especially if it lowers business confidence. The recent re-opening of negotiations between the US and China is encouraging. A silver lining of the equity market rout is that it should provide President Trump more incentive to complete a deal.



We expect the Fed to tighten policy in 2019 as the economic expansion continues.

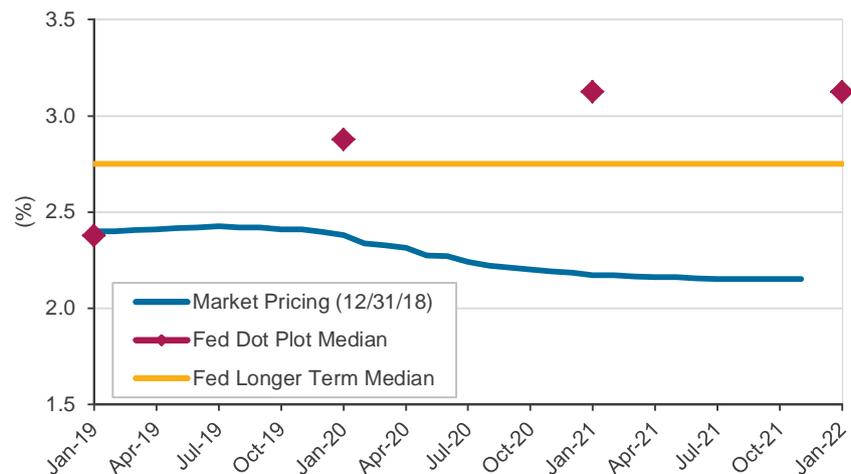
Elsewhere, data out of the Eurozone has been particularly disappointing of late, partially due to temporary factors. Going forward, Eurozone data should stabilize as a result of resilient consumer spending. Brexit uncertainty still looms, but we believe an uncoordinated “no deal” break is unlikely.

An earnings slowdown could weigh on markets as profit growth will likely decelerate sharply in 2019. In the US, corporate tax cuts will not directly contribute to 2019 earnings growth as they did in 2018. Decelerating GDP growth and wage pressures resulting from the tight labor market are further headwinds. This is evident in downward revisions in analyst 2019 earnings projections, which probably have further to go. Decelerating economic growth outside the US will mean similar pressures for non-US equities, although with more labor market slack outside the US, wage pressures should be less intense. The good news is that the sharp decline in valuations during the fourth quarter suggests that this may have already been priced-in.

MONETARY POLICY AND FINANCIAL CONDITIONS

Recent market turbulence has reduced the risk of a hawkish surprise from the Fed, which we saw as a key risk for equities in 2019. As expected, the Fed lifted its policy rate by a quarter-point at its December meeting to a range of 2.25% to 2.5%. However, the number of rate hikes implied by the “dot plot” median for 2019 fell from three to two. The market has gone much further. It now prices no rate hikes by the Fed in 2019 and the potential for a rate cut in late-2019 or early-2020 (figure 3), which implies a very downbeat view on economic growth. A dovish statement made by Fed Chairman Powell in late January seems to be consistent with the view that short-dated rates in the US might increase at a much slower pace this year than expected only a few weeks ago. We expect the Fed to tighten policy in 2019 as the economic expansion continues, which suggests downside for duration. However, it does appear the Fed is approaching the end of this tightening cycle.

Figure 3: Fed Funds Rate Expectations



Source: Bloomberg

Another event that might have contributed to volatility was the end of ECB bond purchases in December. Combined with balance sheet reduction from the Fed, global central banks will likely be net sellers of assets in 2019, which will drain liquidity from the system. However, investors have known this for months, so we are skeptical that it has had a major role in the recent sell-off.

Financial conditions are a feedback mechanism from capital markets to the economy. A material tightening in financial conditions increases the odds of a recession because it makes it more costly for business and consumers to borrow. The recent widening in credit spreads combined with earlier Fed rate hikes has led to tighter financial conditions, although the decline in longer-term bond yields has offset this to some extent. While financial conditions have tightened (figure 4), a further deterioration would be required to cause a recession.

Figure 4: GS Financial Conditions Index



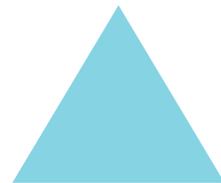
Source: Bloomberg

CONCLUSIONS

We expect markets will continue to exhibit bouts of volatility in 2019 as economic growth moderates, trade developments make headlines, and with lingering uncertainties around the pace of monetary policy normalization. Nevertheless, we think the sell-off during the fourth quarter has removed much of the frothiness in equity valuations. While we do not think global equity valuations are sufficiently attractive for a significant overweight in light of the downside risks, we have become more constructive on the outlook, especially relative to defensive assets. As 2019 progresses, we will keep clients informed of opportunities and risks as they develop.

For more information, please visit our [website](#).

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