The View From The Outer

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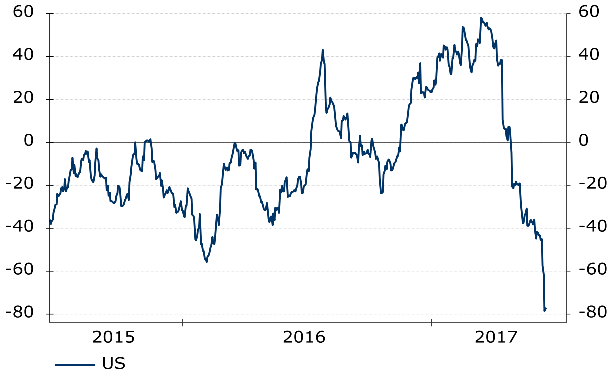
Peak recovery and sector rotation

The recent strong performance by equity markets has meant that much of the gain in shares that we expected in 2017 have already been achieved. The charts below show that Emerging Markets have returned nearly 20% this year and more than 10% since March.

Source: Thomson Reuters Datastream, Evans & Partners

At the same time there are the early signs that the global recovery may soon lose some momentum. Until recently, global data had been unambiguously strong and the global recovery had been steadily broadening from China to the US and Europe. However, over the past month a noticeable change has been that economic data has begun to miss expectations. This trend is captured by economic surprise indices that compare incoming economic data with economists' forecasts. A change is clear in the US where, over the past month, a net 80% of data has missed expectations.



Source: Thomson Reuters Datastream, Evans & Partners

Part of the reason for this might be that expectations have been raised too much. Economists that have been observing the recovery may have become carried away and raised forecasts too high. Some of the data that has disappointed included:

- All consumer data missed expectations in May including retail sales, auto sales and consumer confidence. The decline has not been large but it nevertheless might suggest a point of inflection. The jump in confidence that occurred around the Trump election is being unwound.
- Housing starts, permits and construction have fallen for the past couple of months. This may be due to tightening credit towards the construction sector.
- Industrial production and business surveys have been a little softer. Within production, the oil sector has been lifting output but there is now the prospect of a sharp fall in auto production.

While none of these data have deteriorated significantly, the breadth of the forecast misses suggest the US economy may be at a point of inflection in its recovery and that GDP growth may ease back modestly over the next year.

- This does not cause us to change our core view that this economic cycle has some years to run. There have been a number of structural improvements in the global economy over the past couple of years that will provide broad support to the economy.
- Government finances have improved, particularly in Europe, and this is allowing governments to spend again.
- The financial sector has recapitalised and is in a better position to lend to corporates and will be more robust to future macro shocks.
- Some of the industrial overcapacity that became apparent in the financial crisis has been worked through particularly in China.
- Finally, several emerging markets that were in recession during 2015-16 such as Russia and Brazil are now on recovery paths.

Nevertheless the turn in the data combined with elevated valuations has caused us to rethink some of our asset allocation recommendations earlier than we expected to.

More uncertainty on Chinese policy

A subtle change appears to have occurred in Chinese policy and politics. Most observers were expecting a quiet period out of China until the announcement of the new Politburo standing committee in August or September but instead there have been some notable developments recently. It is possible the new committee has been finalised early and is already operating behind the scenes. The two changes are:

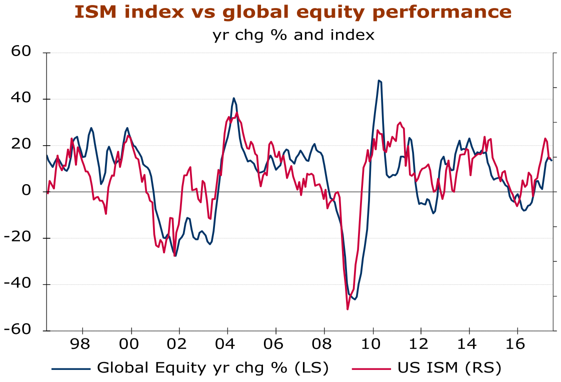
- The anti-corruption crusade may now be returning, this time focussed on the financial sector. Some local observers consider that the arrest of the chief of Anbang Insurance on 27 April signalled the start of a new anti-corruption drive focussing on bribery, stock market manipulation and frauds used to skirt capital controls in the financial sector. This apparently followed a special meeting of the Politburo on April 25 on the issue.

- Policy tightening has broadened. There has been tightening in the property market for around a year which has resulted in a 16% fall in property sales but tightening has now broadened as evidenced by the ongoing squeeze in interbank liquidity. In China the availability of credit matters more than its price and rising interbank rates are evidence of a significant change in money availability. According to the PBOC, the intention is to reduce excesses in the shadow banking industry rather than materially lower growth but some impact on the overall economy is probably inevitable.

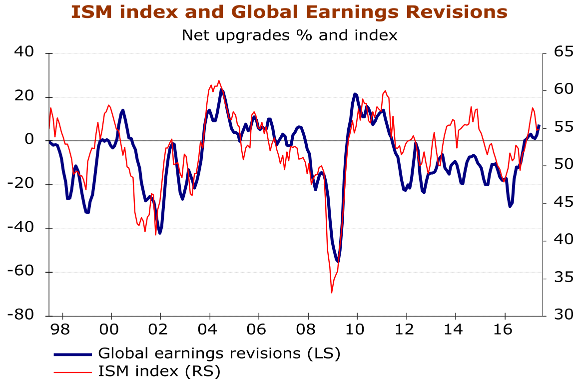
Time for some sector rotation

Growth slowdowns, even if they are modest, matter for markets. History shows that markets are strongest when economic growth is accelerating and weakest when it is decelerating. The US ISM Index has been consistently shown to be the best measure of the pace of acceleration in global growth; it is the single economic indicator that is most correlated with overall market performance and a key driver of relative sector performance.

The importance of the ISM can be seen in the two charts below. The first shows that there is a very tight correlation between global equity performance and the US ISM index. A fall in the index back towards 50, which is a typical low point in down cycles, is consistent with a flat equity market. The second shows the ISM index is closely correlated with earnings revisions. If global growth has peaked then earnings revisions have peaked. Downgrades will become more likely through the second half of the year.



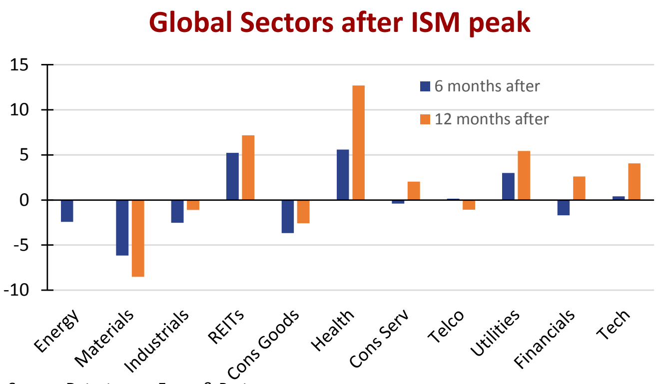
Source: Thomson Reuters Datastream, Evans & Partners



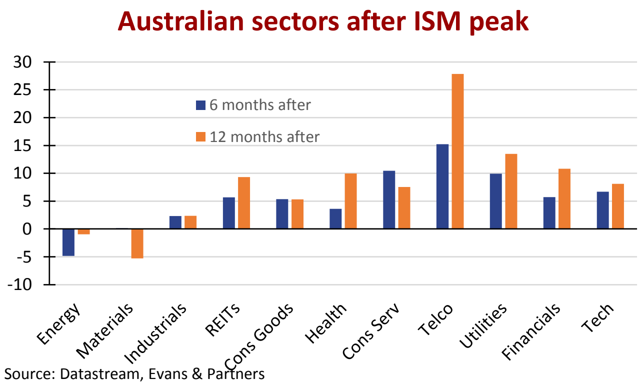
Source: Thomson Reuters Datastream, Evans & Partners

ISM peaks tend to signal major changes in sector performance. We looked at six similar periods in history where growth was slowing down and calculated the performance of sectors in the subsequent 6 and 12 month periods. The results are shown in the charts below at a global level and for Australia.

- Globally, the clear winners are healthcare and REITs with materials the major loser.
- The same defensives vs cyclicals switch occurs in Australia. In the past the major sector winners in Australia have been telcos, utilities, healthcare, banks and REITs.



Source: Datastream, Evans & Partners



Source: Datastream, Evans & Partners

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