MAERKI BAUMANN & CO. AG

PRIVATBANK

Equities or bonds – which asset class is right this time?

Market Comment, June 2019

Despite a rise in volatility, equity markets remain much higher than at the beginning of 2019. On the other hand, bond yields have declined since the start of the year all around the world. As a general rule, these two economic indicators develop in parallel against a backdrop of an expanding economy. The fact that they are not doing so raises the question of which asset class is right – equities or bonds?

Anyone comparing equity and bond market developments since the start of 2019 will see that equities have risen sharply, while bond yields have exhibited a significant decline. The obvious question here is why such a discrepancy exists. In normal times, rising equity markets are an indicator of a stronger economy. But if this were the case, global bond yields also ought to be higher than they were at the beginning of January. When bond yields fall, this is traditionally an indicator of a struggling economy, which in most cases leads to weakness in equity markets sooner or later – either through falling equity market valuations or a slowdown in corporate earnings growth.

So which asset class is correct, equities or bonds? Only in-depth analysis of global economic momentum can provide an answer here. We have scrutinized more than a hundred indicators from all key economies, and have concluded that bonds are probably "right" in this instance – or will prove to be so. Why? Because it is rare for so many leading economic indicators from key countries to point to a weakening of the global economy at the same time.

This has initially led to a pause in the interest rate-raising intentions of key central banks, as can be discerned in the statements of these organizations since January. If the global economy continues to weaken and/or equity markets suffer a more pronounced correction, the central banks – particularly the US Fed – will have the required justification to cut interest rates. At a later stage, but probably only after a further correction, this could have the effect of stabilizing equity markets. The trade conflict could not only accelerate the economic slowdown through tariff increases but also exacerbate it by increasing uncertainty, which would weigh on industrial and investment activity. To some extent, a global manufacturing recession – i.e. a contraction of industrial activity – is already apparent in Europe and Japan, although not yet clearly in the US, which is why US equities are at historically higher levels.

The growing rivalry between the US and China is now moving on from the trade conflict to the next level, namely the battle for supremacy in key technologies: witness America's sanctions against the globally leading 5G network provider Huawei, for example. This technology battle could see the weakness in European and Japanese manufacturing activity increasingly spread to both China and the US. It is hardly a coincidence that industrial production and even retailing (as an indicator of consumer sentiment) clearly fell short of consensus expectations last month in both countries. It is therefore perfectly plausible to assume that bonds are probably a more accurate indicator than equities in their "anticipation function" right now. It would therefore be no surprise if equities were to experience a further correction and add their weight to the economic gloom.

> "The inversion of the US yield curve serves as a clear warning for the global economic cycle."
>
> Gérard Piasko, Chief Investment Officer

Inversion of yield curve

Global interest rates are first and foremost influenced by US interest rates – just as Wall Street sets the tone for the development of global equity markets. The inversion of the US yield curve already observable in March thus deserves special attention. The situation is unusual in that yields on long-term government bonds (10 years) have fallen below those on short-term bonds (3 months). The capital markets typically (and logically) demand a higher return for loans with longer terms than they do for shorter terms. A US yield curve inversion (10-year yields dipping below those of 3-month yields) has occurred in the run-up to every US economic recession over the last 50 years. It is therefore only reasonable to ask whether this phenomenon once again represents a clear warning to investors. The recent inversion in the US yield curve has a number of different causes. On the one hand, global demand for high-quality bonds that are not offering zero or even negative yields – US government bonds being a prime example – is currently high. Long-term US interest rates are therefore declining particularly strongly, even though short-term yields are falling too, as investors are expecting rate cuts from the Fed. As an additional factor, the historically unique demand of central banks for longer-dated government bonds has flattened yield curves all around the world. This expression of alternative monetary policy with its cumulative impact on demand for bonds complicates the analysis of yield curves, as it has been a source of additional downward pressure on long-term interest rates for more than 10 years.

Nonetheless, the economic "red flag" of an inverted US yield curve should be ignored by no one – and particularly not by central banks. How often has it been said in the past: "This time it's different". But rarely has this proven to be true.

The fact of the matter is that the difference between US 3-month yields and US 10-year yields frequently hovers around zero in the late phase of the US economic cycle. However, it is also a fact that an inverted yield curve has historically proved a solid indicator of recession. Our conclusion is as follows: If the inversion of the US yield curve (10-year and 3-month interest rates) were to become more pronounced and 10-year yields were to dip below 2-year yields, this indicator would become much more meaningful.

For the moment at any rate, the inversion of the yield curve serves as a warning to investors to structure their equity portfolios in a more defensive way – as we have been urging in our investment policy notes for some time now.

Gérard Piasko

Gérard Piasko is CIO and head of the investment committee of private bank Maerki Baumann & Co. AG. Before he was for many years CIO of Julius Baer, Sal. Oppenheim and Deutsche Bank.

Editorial deadline: 6 June

Maerki Baumann & Co. AG
Dreikönigstrasse 6, CH-8002 Zurich
T +41 44 286 25 25, info@maerki-baumann.ch
www.maerki-baumann.ch