6 January 2020

Changing uncertainty at the start of the new year in the US

Reduced trade tensions. Rising uncertainty relating to the elections. Resurgence of geopolitical risks. +2% GDP growth in 2020. Extreme equity valuations.

Key points

- Real GDP growth of approximately +2.2% in 2019 and +2% in 2020
- Risk of polarisation between the Democrats' and Republicans' political programmes
- Election year could prove turbulent for investors
- Growth in 2020 driven by favourable situation in interest-rate markets
- Trade conflict likely to abate
- US yield curve returns to "normal"
- Further liquidity injections in 2020
- Leading indicators more optimistic
- Full employment driving consumption
- Equity markets threatened by high valuations and growing geopolitical risks

Election year could prove turbulent for investors

In terms of the economy, 2019 was characterised by continued uncertainty relating to trade relations between China and the US. This risk factor has often been described as the main driver behind the widespread collapse of global manufacturing activity, leading to possible risks of contagion to other economic sectors and growing concerns regarding global economic growth.

Nevertheless, the US economy proved resilient until the end of the year, and the growth figures soon to be published for Q4 will confirm that real GDP growth exceeded +2.2% in 2019.

Recession risks, which had been regularly mentioned since September 2018, did not materialise and will likely fade further still in 2020 for various reasons, including reduced trade tensions primarily. Indeed, in a few days, the first phase of a trade agreement between China and the US is likely to be signed, a first step towards a more comprehensive deal subject to future negotiations. Nevertheless, in the present context of the US presidential election, this first phase is crucial for the US president and his administration, who will be able to claim they are the only ones to have faced down China. They will undoubtedly seek to make the most of this argument and will not risk any further clashes, at least until November.

The main factor of uncertainty in 2019, which impacted economic prospects and financial markets, is thus unlikely to be a major risk factor in 2020. In economic terms, the situation still seems satisfactory at the start of the year in the US, and the main underlying trends will likely continue in 2020, with a GDP growth outlook of +2% for 2020.

However, this election year could prove turbulent for investors and risky for financial markets. The presidential campaign will only start in Q2 after the Democratic presidential nomination, but risks of a left turn in US politics may start to be factored in before then. In 2020, clashes between the Democrats' and the Republicans' political programmes may well be more polarised than in the previous elections.

Within the Democratic party, the temptation to choose a candidate who is more favourable to the underprivileged and middle classes may well grow and focus on Senator Elizabeth Warren rather than a more "centrist" candidate such as Senator Joe Biden. Nevertheless, the latter is still the most likely to succeed against Donald Trump according to the latest polls in January 2020.

If Biden is nominated by the Democratic Party, the race for the White House is unlikely to be a major factor of uncertainty for financial markets. However, if Elizabeth Warren is nominated, risks of a major political change of course will have a direct impact on financial markets, and 2020 is likely to be much more volatile with the surprise nomination of Elizabeth Warren.

Growth in 2020 driven by the favourable situation in interest rate markets

We mentioned it several times in 2019: the key rate cuts, the Fed's liquidity injections and the only slight rise in long-term rates have served as extremely positive economic drivers that will have even more impact in 2020. For several quarters, financing costs for all economic agents, individuals, SMEs, multinationals, public entities and governments have thus been more attractive, which will likely support both consumption and investment in an ultimately much more favourable economic context than expected by the consensus forecast in 2019. Beyond the decline of nominal rates, real rates will likely also indirectly contribute to the economy, thus strengthening economic growth and the real estate market especially in the next few months.

Real interest rates, usually positive, became negative in the US following the drop in long-term rates (10 years) from 3% to 1.5% (August 2019). They remain negative at the start of 2020 despite the upswing in ten-year yields to 1.9% and an inflation rate excluding food and energy of 2.3% (overall inflation at 2.1%), both slightly above the Fed's objective. Excessive and unfounded pessimism in 2019 thus led to adjustments in nominal and real interest rates that will help boost the economy in the next few quarters.

Trade conflict should abate

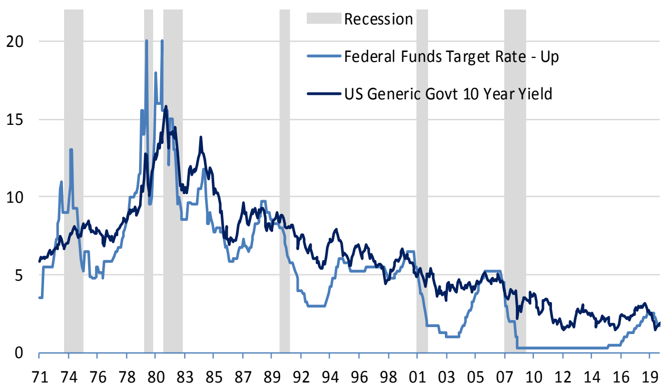
The expected signature on 15 January of part 1 of the trade agreement between China and the US will undoubtedly mark the beginnings of a welcome truce with regard to this complicated issue that marked 2019. It is indeed very likely that Donald Trump will be satisfied with this first success, which is probably sufficient to enable him to position himself as the defender of the interests of the American people against the economic threat of China, and to make the most of it during the presidential campaign. Fears of a recession fuelled or triggered by a possible trade war between China and the US have thus been discarded, although they remain a possible factor of a resurgence of risks in 2020. However, we believe that this factor will take a back seat because of the interests and objectives of the presidential campaign.

US yield curve returns to "normal"

We mentioned various yield curve inversion processes in previous weekly analyses, recalling that the yield curve inversion in the winter of 2018-2019, which was seen as a sign of an upcoming recession, had no basis in any traditional theoretical framework and had actually been triggered by a drop in long-term rates rather than an excessive and inappropriate tightening of monetary policy, which has indeed often driven the economy into recession in the past.

In these cases, the yield curve inversion resulted from a rise in short-term rates (the Fed's key rates) corresponding to the implementation of restrictive monetary policies meant to limit excessive inflation and slow down the economic cycle. Monetary policy thus led to a rebound in short-term rates, which then exceeded long-term rates to fend off inflation.

US recessions, long-term rates & Fed funds



Sources: Bloomberg, BearBull

A "classical" yield curve inversion thus follows the same logic, often exceeding the objective of slowing the economy and ultimately triggering a recession, usually short-lived. The Fed's change in monetary policy, by lowering short-term rates by 0.75% in H2, modified the yield curve by lowering its short end.

Reduced recession risks coupled with relatively robust economic statistics for the US economy have enabled long-term rates to tighten once again and to rise by approximately 40 basis points. Henceforth, the yield curve is once again "normal", although relatively flat since both the three-month and ten-year rates lie at 1.9%.

In 2020, although tensions on the labour market are likely to have an impact on business margins and prices, inflationary pressures will probably intensify somewhat and exceed the Fed's objective.

In this context, ten-year long-term rates will likely continue readjusting to economic conditions that are more robust than predicted by the consensus forecast in 2020 and rise beyond 2.5%.

Further liquidity injections in 2020

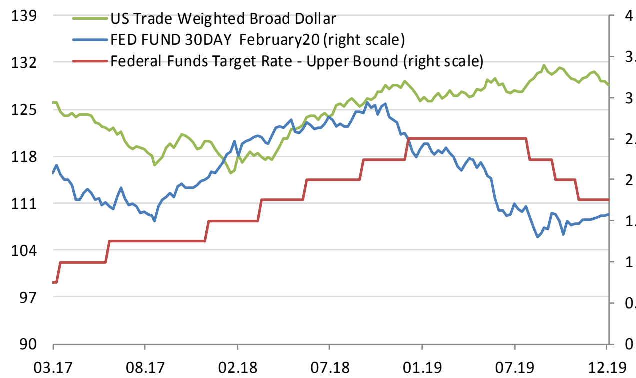
Since July, the Fed's monetary policy is once again accommodative. The central bank lowered its key rates by -0.25% three times in H2 starting in July, while boosting its asset purchase programme starting in September.

Over just a few weeks, the Fed's balance sheet surged by +11% from USD 3,759 billion in September to 4,165 billion in December, implying a liquidity injection of 406 billion in less than four months. By comparison, the Fed had needed close to twelve months to reduce its balance sheet by as much between September 2018 and September 2019.

Thus, the Bank decided to act, to counter the expectations of an economic slowdown, or even a recession, that had been widespread over the past year despite the consistently solid quarterly results posted by the US economy. The New York Fed's 12-month forward recession probability index has since dropped from 37% to only 24% currently.

In 2020, the Fed will likely maintain its low key rates policy, keeping it unchanged in the next few months, especially if an economic recovery is confirmed. Nevertheless, it seems to be aiming to maintain its liquidity injection policy by repurchasing assets at a sustained pace.

Fed funds, key rates & trade weighted dollar



Sources: Bloomberg, BearBull

Leading indicators more optimistic

The manufacturing PMI index published for the month of December is down slightly from 52.5 in November to 52.4, thus confirming the upward trend in sentiment observed in the industrial sector since September.

The recovery is now clear, attesting to the ongoing change in purchasing managers' outlook, which has been more optimistic in the last four months.

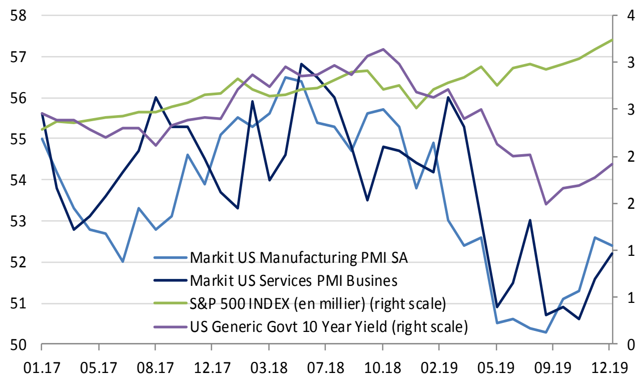
Unfortunately, the ISM (Institute for Supply Management) manufacturing index did not confirm this result, dropping further from 48.1 to 47.2 in December, i.e. its lowest level since 2009.

Nevertheless, industrial production also rebounded by +1.1% in November, thus offsetting the weakness of the previous month. The services PMI index also strengthened in December, rising by 0.6 points to 52.2, a result that remains at the lower end of its range over the last few years but which enables the composite index to post a better result in December too.

Recovery in the manufacturing sector many not be significant yet but signs of bottoming out are more apparent. On the consumer side, confidence remains high even though it weakened very slightly in December from 126.8 to 126.5 (Conference Board Index).

In parallel, Bloomberg's consumer comfort index is at a five-month high, confirming the University of Michigan's strong figures showing household sentiment at 99.3, close to its 10-year high. The drop in key rates, an unemployment level at a 50-year low, increasing household income and an agreement about to be signed between China and the US have certainly all been factors driving high levels of household confidence, which will likely persist at the start of 2020.

Long-term interest rates, PMIs and S&P500



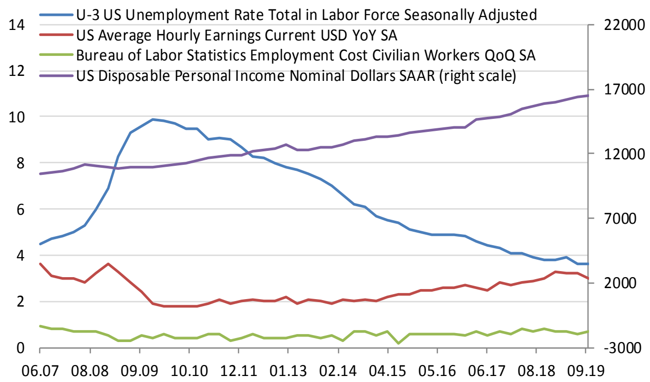
Sources: Bloomberg, BearBull

Full employment drives consumption

The employment market is showing increasing signs of vigour, while the economy has posted its longest period of expansion. Jobs are being created at a sustained pace of around 180,000 to 200,000 new jobs per month, i.e. almost twice the growth rate of workers entering the market.

In this context, the unemployment rate is likely to drop further to below 3.3% in 2020. Wage pressures have increased (hourly wage increase of +3.1% in November), and with rising disposable income, consumption is likely to remain buoyant, pushing price indices up.

Unemployment, earnings, labour cost, income



Sources: Bloomberg, BearBull

A slowdown in the economic cycle in 2020 remains the favoured scenario, although the economy may well surprise on the upside thanks to robust domestic demand.

Equity markets threatened by high valuations and growing geopolitical risks

The last quarter of 2019 saw a sharp recovery in US equities, which reached new heights in a phase of acceleration essentially driven by the inflow of liquidity injected by the US Federal Reserve and the momentum observed on several tech stocks. The +8.5% rise of the S&P500 over the quarter, including +2.86% over the single month of December, brings 2019's performance to +28.9%, i.e. the second best performance since 1998.

The rise is surprising if you consider that, in 2019, US corporate earnings dropped by an estimated -5%. Thus, the rise of US equities is essentially due to PE ratio expansion resulting from the Fed's rate cuts and sustained liquidity injections at the end of the year.

Growth of the PE ratio from 14x to 19x in 2019 in this context is not really rational and should thus be concerning, even though it is true that in other PE expansion phases in the past, this ratio exceeded 20x for the S&P500 index before being followed by a correction of prices.

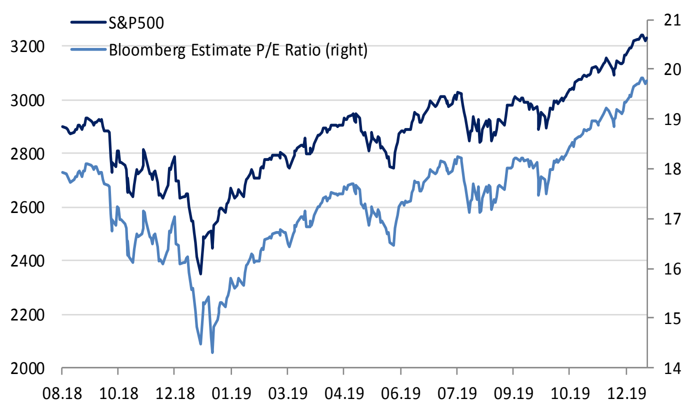
We are sticking to our analysis that, at the start of 2020, the emotional factor will irrationally drive equity prices to extreme heights, which usually heralds significant a stock market correction.

The Fear&Greed index is now at a rarely-reached level of 96/100, while indices have diverged by more than two standard deviations from their trend, which is also a sign of a high probability of the trend being interrupted. The last time the equity market reached current valuation levels of 2.4x sales (price to sales) was before the "dot.com" crash at the turn of the century.

Other measures such as enterprise value/EBITDA are also at their peak, suggesting that the current situation is a decoupling that could be historically devastating in the medium term.

Nevertheless, growth may still be bolstered by the continued action of the Fed, although the geopolitical risks that emerged brutally at the start of 2020 in the Middle East may well degenerate quickly into a new crisis with negative effects on oil prices and investors' mindset, which may trigger an adjustment of expectations and a significant market correction.

S&P 500 & P/E



Sources: Bloomberg, BearBull

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