Morgan Stanley

INVESTMENT MANAGEMENT

Global Multi-Asset Viewpoint

Cyclical Assets Have Room to Outperform as Global Growth Recovers

SOLUTIONS & MULTI-ASSET | GLOBAL MULTI-ASSET TEAM | MACRO INSIGHT | MARCH 2019

Despite the strong recovery in many risky assets since Christmas, the market's mood remains sober. Even as global equities have risen almost 17% over this period, the majority of investors have continued to be skeptical of the rally and lightly positioned.[1] Investor survey data in March showed that fund manager positioning in global equities is at levels last seen in the prior mid-cycle slowdown of 2016.[2]

The dovish policy turn, most notably by the Federal Reserve (the Fed) but also the European Central Bank (ECB), was a major force that lifted risky assets and led to a pronounced global rates rally. Yet both the central banks' dovishness and the lower rates themselves appear to have exacerbated growth concerns. The inversion of the U.S. yield curve (albeit brief and partial) and the lowering of official growth and inflation forecasts by the Fed and the ECB seemed to support the perceived inevitability of a continued slowdown. Intriguingly, many areas of the market still appear to be pricing in a severe slowdown or recession (e.g. U.S. banks, short-end bonds, many cyclical stocks, and certain areas of the Eurozone and Japanese equity market).

Global growth data have been mixed during the first quarter of this year, but appear to have begun to show reacceleration. We see accumulating evidence of resilience in what have been, until recently, perceived as the global economy's weak links. China's stimulus efforts have become more pronounced, and as supportive measures and policies have been introduced, credit growth has begun to accelerate. And growth in the Eurozone appears poised to stabilize in response to fiscal support and the reversal of one-off headwinds. We expect that

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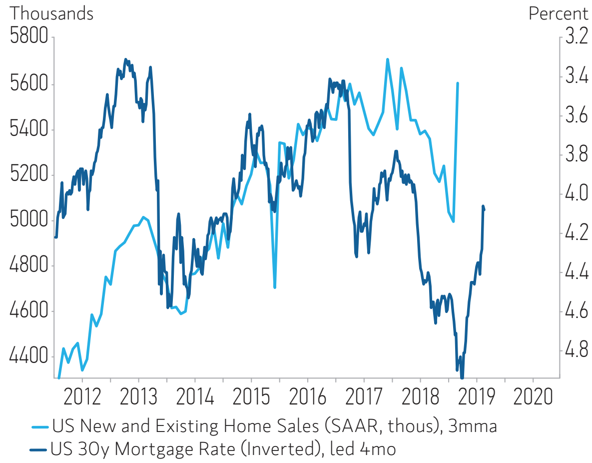
Display 1: **Sharp Recovery in Home Sales Benefitting from Lower Interest Rates**
U.S. Home Sales vs. 30-Year Mortgage Rate



Source: MSIM Global Multi-Asset Team Analysis, Bloomberg, Haver, Census Bureau, National Association of Realtors. Data as of March 31, 2019.
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a cyclical upturn and the perception of the global economy being in better structural shape than feared will likely drive outperformance of growth-sensitive assets. While the delayed effects of Fed tightening during the past two years and elevated fragility of China's credit system make this cyclical upswing potentially limited and tenuous, we believe that the probability of a soft landing rather than a recession in 2020 is now 60% (up from 40% previously).[3] As a result, we have added positions that could potentially stand to benefit from improving global growth but are still priced for a more bearish outcome.

The Fed's dovish pivot over the past six months has been a major change in global policy, and is likely to be appreciably supportive of growth conditions in the U.S. and globally. The Fed's overly-hawkish stance in the third quarter of 2018 that scared the markets has been largely walked back. In addition to pausing rate hikes, the Federal Open Market Committee (FOMC) has reduced its long-run neutral policy rate back to 2.8%—from 3% at the peak of optimism in the third quarter—and indicated it would hike rates only once in 2020, down from their expectation in November of last year of three hikes in 2019 and one in 2020.[4] The market has gone even further and is now pricing in 21 basis points of rate cuts by the end of 2019 (down from three hikes as of November 2018).[5] Further, the Fed has begun to reassess its framework, considering the possibility of adopting an average inflation target, rather than an upper limit. While it is not clear what the specific policy implications of this change would be, the probability that the Fed will allow inflation to accelerate above 2% while refraining from rate hikes has risen. With the latest inflation data below 2% and missing expectations (core PCE decelerated to a 1.8% annual pace in January 2019 from 2.0% prior and vs. the consensus expectation of 1.9%), the Fed appears to have additional room to remain dovish.[6]

A lower 'discount rate' is generally supportive for risky assets. The 10-year Treasury yield fell below 2.4% in March, briefly falling below the fed funds rate. Lower rates have clearly lifted many risky assets already—particularly rate-sensitive assets such as U.S. REITs and gold—yet their full effect remains to be fully felt. For example, even after the recent equity rally, the U.S. equity risk premium of 3.9% is excessive, and on our analysis is consistent with 2.6% global GDP growth for the remainder of this year. If global growth accelerates to 3%, in line with our forecast, this would suggest a 3.6% equity risk premium, or an 11% upside for stocks (assuming static bond yields).[7]

The 'discount rate' argument aside, cheaper financing is supportive for growth. Housing activity in the U.S.—the more rate-sensitive segment of the economy and the classic 'transmission mechanism' of monetary policy—appears to be rebounding after having decelerated in the second half of 2018. With the 30-year fixed mortgage rate having fallen ~80 basis points, from 4.8% to 4.0%, new home sales have spiked back to 5.6 million units (new and existing combined) in February from a low of 5.0 million in January, reversing the entire decline of last year *(Display 1)*. While the latest data point may overstate the rebound due to the volatility of the data, housing transactions appear to have bottomed even on a smoothed, three-month moving average, basis. Likewise, recent rebounds in the U.S. Mortgage Bankers Association (MBA) Purchase Index and the National Association of Home Builders (NAHB) Index also indicate that housing market activity has turned up. The housing recovery has been prolonged during this expansion but relatively shallow, such that activity levels are at approximately mid-cycle conditions. With household formation having recovered from under 650,000 new households per year in the first several years of this cycle to 1.5 million new households in 2018—the highest level in the last 30 years outside of 2005—it appears that structural, pent-up demand is there to support additional expansion of the housing sector, especially the more economically-impactful single-family housing sector. With close to a third of 18 to 34 year olds still living at home, there is potential for demand growth from these three million-plus additional house buyers. Interestingly, the homeownership rate among people under 35 has begun to grow over the past three years, but at 36% remains well below its peak of 44% fifteen years ago.[8]

The Fed's dovish turn also serves to alleviate corporate leverage risk, at least in the near term. Elevated leverage in the U.S. high yield corporate sector, at 4.2x EBITDA, has been widely identified as an area of potential risk. While the corporate high yield sector's interest coverage ratio remains fairly high, at 3.8x, meaningfully higher rates would, in theory, weaken interest coverage. U.S. corporate health remains extremely strong, with 2018 EBITDA margins of over 15% for high yield and nearly 30% for investment grade, and strong cashflow generation.[9] The corporate sector is unlikely to be the economy's Achilles heel, while rates remain low.

From a structural point of view, we are open to the possibility of positive supply side developments that would extend the cycle. Recent deregulation measures notwithstanding, we note that it is rare for productivity growth to recover in later stages of the cycle (the late 1990's is an exception). However, it appears that the labour force has room to maintain a high growth rate (currently close to 1.25% on a three-month smoothed basis). This is because the labour force participation rate of the core 25 to 54 year old segment of the population is 82.5%, with room to continue to recover to the pre-crisis level of over 83%, and perhaps to catch up to the advanced economy average of over 85%.[10]

While we still expect a continued slowdown of the U.S. economy from the strong 3.5% GDP growth pace during the middle of 2018, we currently think growth can stabilize closer to (but likely below) a 2% pace by the end of this year, above the 1.5% pace we envisioned six months ago.[11]

China's more aggressive stimulus efforts over the past several months have been another consequential shift in the global policy setting. Although Chinese authorities began to loosen policy during the second half of 2018, these measures were insufficient, constrained by concerns about adding further leverage and, perhaps most importantly, by the need to prevent a disorderly devaluation of the renminbi, which was depreciating (and fell by 8% vs. the U.S. dollar)[12] during that period. But with GDP growth having slowed to below 6% in the fourth quarter of 2018 and a hawkish Fed less of a threat to the currency, the authorities have begun to open the taps.[13] New credit surged by Rmb 4.9 trillion in January and February combined, or 5.4% of 2018 GDP. Liquidity conditions improved as cuts in China's Reserve Requirement Ratio since mid-2018 have released an additional Rmb 5 trillion.[14] Taxes are slated to be cut by 2% of GDP (though we expect their net impact to growth to be under 0.5%) and various administrative easing measures with respect to housing and local government financing have been announced. Anti-private business rhetoric has been walked back, and supportive statements and specific measures for small and medium-size business have likely helped business sentiment. As a result of these measures and announcements, we have seen improvement in both survey and hard activity data. Car sales, luxury-related consumption measures (e.g., watch sales) and housing activity appear to have bottomed over the past several months. Retail sales growth has rebounded in year-over-year terms. China's industrial production growth reaccelerated sequentially over the past five months and manufacturing PMIs (both NBS and Caixin) have turned up *(Display 2)*.[15]

Display 2: **China Activity Leads the Global Cycle**

China Manufacturing PMI vs. Global Manufacturing PMI

Source: MSIM Global Multi-Asset Team Analysis, Markit, Haver, National Bureau of Statistics (NBS). Data as of March 31, 2019.

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The apparent upturn in China's growth—and specifically in its industrial indicators—has profound implications not only for China, but also for the global industrial cycle. China's industrial activity has tended to lead global swings in the industrial cycle by one to three months since 2009 (with the exception of the European recession in 2012).[16] In the current environment, this signal is particularly significant because it helps tip the scales in the debate over the recent divergence between 1) the consumer and services sides of the global economy, which have remained largely resilient, and 2) the production and business side (as measured by industrial activity and capex), which have been weak. For example, global retail sales growth remained at a 3.4% pace in the first two months of this year, as compared to 3.5% during 2018. And the deceleration indicated by the fall in services PMI has been substantially less pronounced than the collapse in global manufacturing PMI, which, in our assessment, fell to levels consistent with 2.6% global GDP growth in the first quarter of this year.[17]

During the height of U.S./China trade-related tensions, we expected that tariffs would reduce global growth by 14 basis points over two years.[18] Our expectation was based on the best available estimates at the time, however, because the scale of these measures would have been unprecedented, our confidence in these assessments has been low. It is likely that markets priced in a much more dire economic outcome for the trade conflict. While the worst case scenario appears to have been averted for now, trade fluctuations did prompt growth concerns in the fourth quarter of 2018. Global exports fell nearly 3% sequentially (annualized), and were the weakest they have been during this expansion, except for the second quarter of 2015 during a significantly more pronounced global slowdown. Although the trade data were worrisome for the markets, we believe they overstated the underlying economic weakness. First, the weak fourth quarter came after strong 4.5% sequential annualized growth in the prior quarter. Second, trade weakness was substantially lower than other, generally closely-related indicators such as industrial production, would have suggested. And third, the trade slowdown was disproportionately more pronounced for China and the U.S. (which together accounted for almost half of the drop in exports) while representing about a quarter of global trade. Although the slowdown in China in the second half of last year likely played a role, it appears that the weakness was exacerbated by dispute-related shifts in the trade patterns during 2018.[19]

The Eurozone's growth weakened significantly in the second half of last year, and we believe it is poised to improve imminently. Eurozone GDP growth fell to 0.7% (annualized) in the second half of 2018, and industrial production collapsed by nearly 5% (annualized) in the second half. Exports growth also slowed sharply from 6.4% year-over-year in the fourth quarter of 2017 to a 1.5% pace in the fourth quarter of 2018.[20] However, as global growth rebounds, led by China, Europe's trade should also recover (albeit with the typical delay of approximately three months). In addition, several idiosyncratic factors detracted approximately 30 basis points from the Eurozone's growth in the second half of last year which we expect to reverse this year. These include the emissions-related slowdown in car production and the disruption of transport traffic on the Rhine River, which we estimate reduced Eurozone growth by 5 and 7 basis points, respectively, in the second half of 2018.[21]

We now place a greater probability in a scenario where global growth remains resilient over the next two years, i.e. that it will slow, but remain above potential. Over the next two quarters it has the potential to accelerate from 2.3% in the first quarter of this year to 3.0% in the third quarter.[22] If global growth accelerates, growth-sensitive assets whose performance lagged this year will likely outperform. Some of dovish policy plays—such as government bonds and rate-sensitive assets—may underperform as the monetary policy outlook is reassessed to be less dovish, especially in the U.S. We expect bond yields to rise, with the 10-year yield reaching 2.7%. Although higher rates may be an emerging headwind to stocks, we still expect stocks to outperform bonds over the next six months. A steeper yield curve and improving growth are likely to be supportive of many 'value' assets and we prefer U.S. financials and European equities such as banks, domestically-oriented stocks, German equities and auto manufacturing stocks. Many China-related assets such as A-shares and global metals and mining stocks also remain undervalued and we expect them to outperform as growth and liquidity in China improve.

There remain substantial risks to the near term growth acceleration scenario as well as a soft landing in 2020. First, although the Fed may have paused its hiking cycle just in time to avert a disaster, the come-down from the U.S. fiscal stimulus 'sugar high' is still likely to cause the U.S. economy to slow. We estimate that the fiscal impulse will detract -60 basis points from U.S. GDP growth in 2019 as compared to 2018, although the exact timing and magnitude of its impact are uncertain. Second, after three substantial credit-acceleration cycles, fragilities in China's financial system are a major concern. The ability of the Chinese economy to lever up for the fourth time since 2008 sufficiently to meaningfully affect growth may be limited. Lastly, while many one-off headwinds that depressed growth in the Eurozone last year are likely to wear off shortly, the persistently slow growth, below-target inflation and negative policy rate represent signs of malaise that may be becoming entrenched. With this in mind, our embrace of the near-term cyclical rebound is only partial and the cyclicality of our portfolios is modest. We watch for the above mentioned risks to reassert themselves in the near future.

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FOOTNOTES

[1] MSIM Global Multi-Asset Team analysis; Bloomberg, December 25, 2018 to March 31, 2019.

[2] MSIM Global Multi-Asset Team analysis; EPFR Global.

[3] MSIM Global Multi Asset Team estimates.

[4] MSIM Global Multi-Asset Team analysis; Board of Governors of the Federal Reserve System.

[5] MSIM Global Multi-Asset Team analysis; Bloomberg, as of March 31, 2019.

[6] MSIM Global Multi-Asset Team analysis; Bloomberg.

[7] MSIM Global Multi-Asset Team estimates.

[8] MSIM Global Multi-Asset Team analysis; Bloomberg; Haver; U.S. Census Bureau.

[9] MSIM Global Multi-Asset Team analysis; Deutche Bank Research; JP Morgan Research; as of 4Q18.

[10] MSIM Global Multi-Asset Team analysis and estimates; Bloomberg.

[11] MSIM Global Multi-Asset Team estimates.

[12] MSIM Global Multi-Asset Team analysis; Bloomberg; CNY vs. USD from May 31 – October 31, 2018.

[13] MSIM Global Multi-Asset Team analysis; National Bureau of Statistics of China; Haver Analytics.

[14] MSIM Global Multi-Asset Team analysis; National Bureau of Statistics of China; People's Bank of China; Haver Analytics.

[15] MSIM Global Multi-Asset Team analysis; National Bureau of Statistics of China; China Passenger Car Association; Markit Economics; Haver Analytics.

[16] MSIM Global Multi-Asset Team analysis; National Bureau of Statistics of China; Markit Economics; Haver Analytics.

[17] MSIM Global Multi-Asset Team analysis; Bloomberg; Haver Analytics.

[18] Assumed existing tariffs remained in place, with 80% probability that 10% tariffs on $200b in Chinese goods would rise to 25% (with partial retaliation from China), 50% probability that the U.S. imposed 25% tariffs on the remaining $267 in Chinese goods (with partial retaliation from China), and 10% probability that the US imposed 25% tariffs on non-USMCA autos and parts imports (with full dollar-for-dollar reciprocation).

[19] MSIM Global Multi-Asset Team analysis; Bloomberg; Haver Analytics.

[20] MSIM Global Multi-Asset Team analysis; Bloomberg; Haver Analytics.

[21] MSIM Global Multi-Asset Team estimates.

[22] MSIM Global Multi-Asset Team estimates; as of March 31, 2019. Note that the 1Q19 was particularly weak due to the U.S., where a government shutdown helped slow the pace of growth to 1.0%, and that the 2Q19 bounce-back may be exaggerated as a result. Excluding the impact of the first-quarter government shutdown in the U.S., global growth is accelerating from a 2.6% pace during 4Q18-1Q19 to 3.0% in 3Q19.

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