Q2 2019 | Capital Markets Outlook

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Rally losing steam, but risk signals remain muted

We devoted the bulk of the first-quarter outlook to discussing why we think the slope of the yield curve matters to the real economy. It is important, then, to express our thoughts regarding the inversion of the "10-year note – 3-month bill" part of the yield curve in the waning days of the first quarter. Three months ago, we argued why the yield curve is an important signal, but also that it is just one of a handful of signals that we use in the overall mosaic informing our outlook. Also, among the various yield curve measures available, we prefer to track the shape of 10-year notes versus 2-year notes (10–2 spread). As of this writing, this spread was not inverted. Nevertheless, taken together with a small tightening in credit conditions from the Fed's January Senior Loan Officer Survey, the evidence of recession risk is getting harder to ignore.

Treasury yield normalization notably absent

Even so, we are still not quite convinced of the case to sell everything that is not nailed down, as one probably should if a recession could clearly be seen before the market turned bearish. Before we return to this point, we'll provide a brief review of the first quarter of 2019. The S&P 500, following an approximate 20% peak-to-trough decline in equity prices in the fourth quarter of 2018, retraced about 90% of that decline by March 21. The index stood within a few percentage points of making new all-time

Asset allocations

Shading in the table indicates the change from the previous quarter

	Underweight	Neutral	Overweight
EQUITY		●	
U.S. large cap			●
U.S. small cap			●
U.S. value			●
U.S. growth			●
Europe		●	
Japan			●
Emerging markets		●	
FIXED INCOME	●		
U.S. government	●		
U.S. investment-grade corporates	●		
U.S. mortgage-backed			●
U.S. floating-rate bank loans		●	
U.S. high yield		○	●
Non-U.S. developed country		●	
Emerging markets		●	
COMMODITIES		●	○
CASH		●	

Currency strategy

U.S. dollar versus	Favor other	Neutral	Favor dollar
€ **Euro**		●	
£ **Pound**	●		
¥ **Yen**		●	

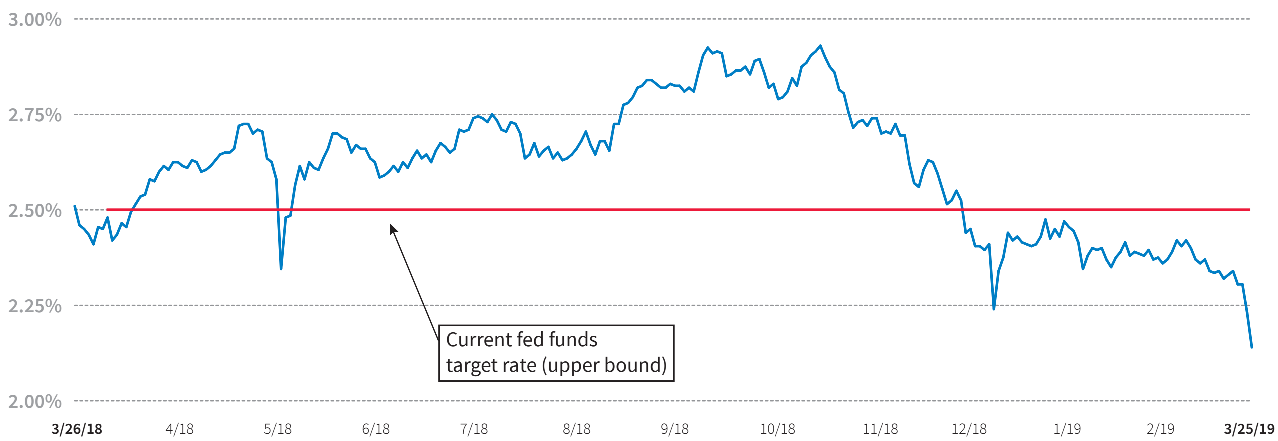
highs. Other risk assets fared similarly, if not quite as well as stocks. For example, high-yield spreads retraced 70% of their widening and oil prices retraced 50% of their decline. Notably absent, though, was an equivalent move in 10-year Treasury yields back toward the levels that prevailed prior to the sell-off in risky assets.

The proximate cause for that sudden year-end bear market is hard to pin down exactly. We believe it was likely driven by some combination of (1) a Fed viewed by the market as about to make a policy mistake, (2) worries about a breakdown in U.S.–China trade negotiations and 3) an actual slowdown in economic activity around the world. The rebound in equities to start 2019 has coincided very nicely with the Fed's complete U-turn on rate normalization and balance sheet runoff. Indeed, the federal funds futures market has priced out fully three 25-basis-point hikes since mid-November (see the following chart).

After its March meeting, the FOMC (Federal Open Market Committee) also officially announced an end to balance sheet contraction this year. It will use the proceeds of maturing mortgage-backed securities to buy Treasuries.

Since November, the futures market has bid down rate expectations by three quarters of a point

Rate-equivalent pricing of CME Dec-2019 fed fund future contract



Sources: Putnam, Bloomberg.

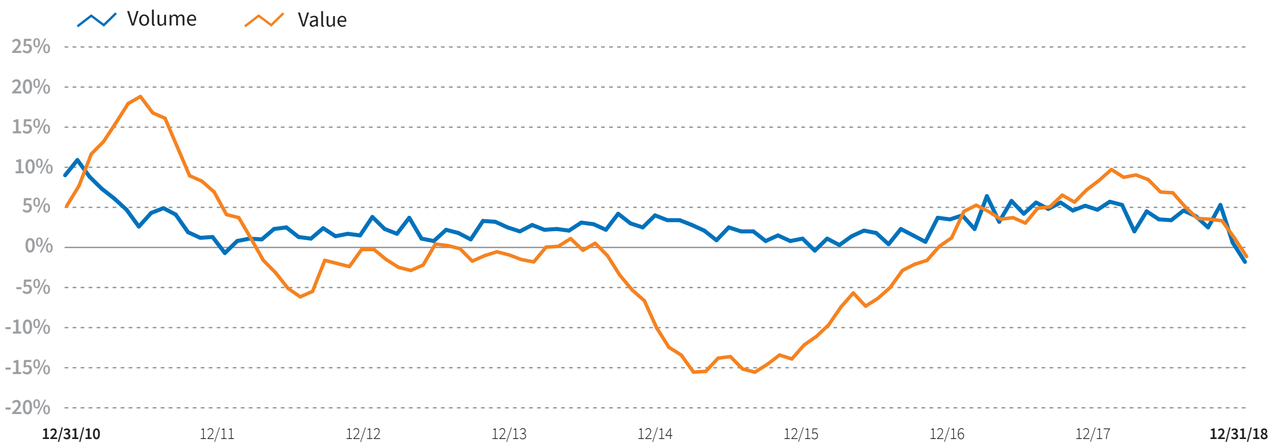
Trade worries are real but likely to ease

In our view, for risk assets to continue their recovery from here, we would need to make progress on our second and third concerns, namely growth and trade. Importantly, we see a close link because trade tensions have eroded corporate confidence, which in turn drives capital expenditures, hiring decisions, and merger and acquisition activity. This can be seen in how different in nature this current slowdown in real economic activity has been compared with the 2015/2016 mid-cycle slow-down. While the previous episode was about the price of "stuff" declining, the current slowdown has seen an actual contraction in the *volume* of global trade, which is quite unusual (see the following chart).

The pace of decline in global economic activity over the past several months has been sobering. With implied volatility in the equity market (as measured by the CBOE VIX Index) still well behaved in the mid-teens, we think the cost of waiting on the sidelines is relatively low.

The volume of world trade has sharply declined

World trade volume and price indexes (yoy change)



Sources: Putnam, Bloomberg, CPB Netherlands Bureau for Economic Policy Analysis. Year-on-year percentage change in CPB Merchandise: World Trade Volume Index SA and CPB Merchandise: World Trade Price per Unit Values in USD Index.

The signals are faint, not flashing

At this stage, we would still downplay recession risk despite the signals from lending conditions and the yield curve. The January Senior Loan Officer Survey would have been getting responses from participants in the teeth of the sell-off at year-end, timing that would have probably caused answers to be on the cautious side. As for the yield curve, the intermediate area has likely felt the confluence of technically driven buying: foreign investors looking for positive carry; financial institutions in need of "safe" duration free of capital charges under Basel III and Solvency II banking and insurance regulations; hedge funds getting short-squeezed (see the following chart); and now algorithm-driven buyers chasing momentum.

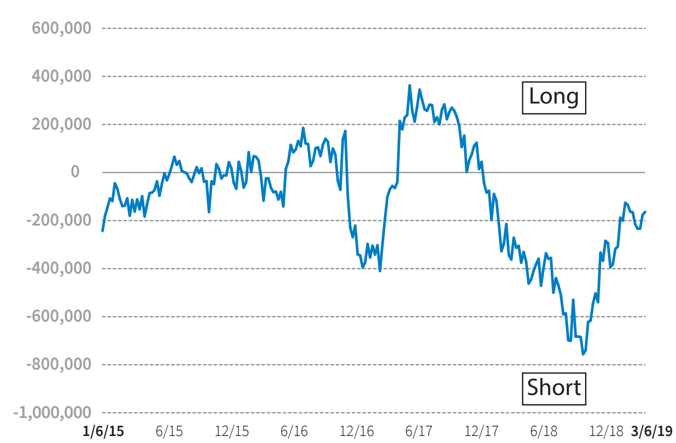
We are *not* saying this time is different. We are merely expressing a desire to wait on the sidelines — when the cost of doing so is quite small — while we fill in additional pieces of the mosaic after having participated in such a strong rebound.

A mostly neutral stance

To become more constructive on risk assets at this point, we would like to see additional evidence that growth is at least stabilizing. A signed U.S.–China trade pact would go a long way toward that end. We are cautiously optimistic that we will get one, but it remains to be seen how quickly corporate animal spirits will rebound. As a result, we have taken risk down in our tactical asset allocation posture, moving back to neutral in commodities and reducing our equity overweight, while still remaining slightly overweight high yield and underweight duration.

Hedge funds rushed to cover short positions in 10-year Treasury futures in Q1

CFTC net non-commercial future positions



Sources: Putnam, Bloomberg. CFTC net non-commercial futures positions reflect the buying of futures contracts by hedge funds.

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