Q3 2019 | Capital Markets Outlook

Robert J. Schoen
Chief Investment Officer,
Global Asset Allocation

James A. Fetch
Co-Head of
Global Asset Allocation

Jason R. Vaillancourt, CFA
Co-Head of
Global Asset Allocation

Caution with a chance of bearishness

The second half of 2019 begins with the S&P 500 having recently made all-time highs in a turbulent second quarter, which included an almost 7% sell-off in May before a swift rebound in June. Both moves were triggered by global macro developments. The drop was a consequence of President Trump's threat to "weaponize" tariffs on Mexico to advance his immigration agenda. The rally followed signals from the world's major central banks that they stand ready to embark on a new easing cycle to fend off an apparent slowdown in global growth.

While we had been relatively bullish for most of the first half of the year, we find ourselves with a much more conservative tactical asset allocation posture at the start of the third quarter. Our current view on equity, credit, and commodities is for average risk-adjusted returns at best. Also, we are actively evaluating incoming data for evidence of a skew toward more negative outcomes, which may cause us to adopt a more defensive posture. While an "earnings recession" similar to that experienced in 2015–2016 is not currently our base case, the odds of that outcome have certainly risen. We will devote the remainder of this note to describe why our view has changed and the specific clues we are looking for to tilt us toward an outright bearish stance.

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

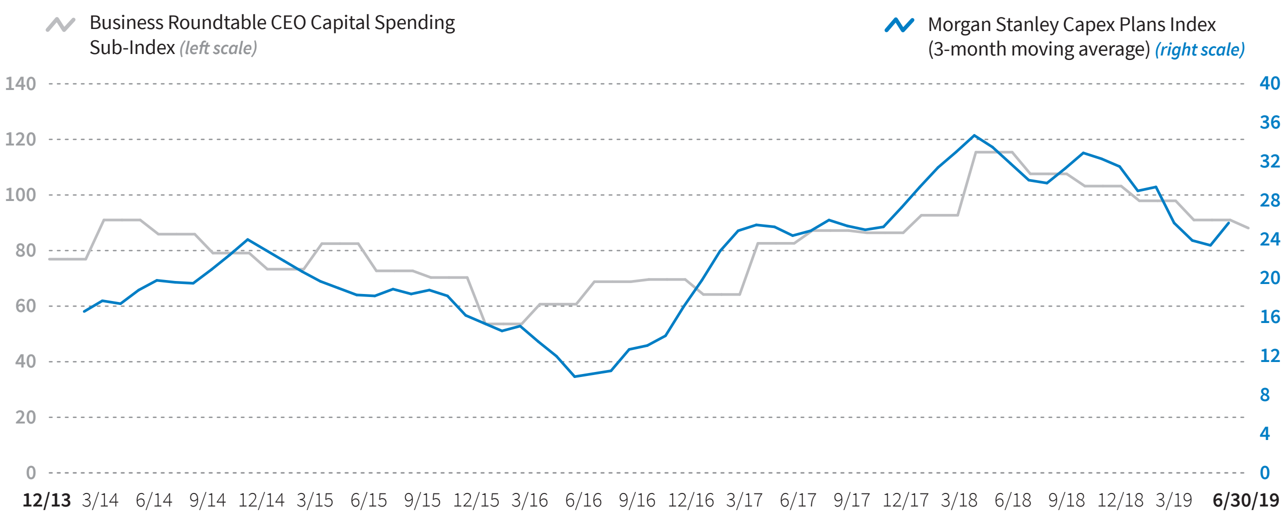
U.S. dollar versus	Favor other	Neutral	Favor dollar
€ Euro		○	●
£ Pound	○		●
¥ Yen	●	○	

Fading confidence and diminished globalization

A year ago, we described how the second-order effects of a prolonged trade war were much more dangerous than the simple dollar value of the overall tariffs themselves. This year, trade talks with China collapsed in early May, when it appeared a deal was imminent, making those dangers a reality. The consequences are beginning to show up in the data via the transmission mechanism of corporate animal spirits. CEO and CFO confidence is the fuel that drives hiring decisions and plans for capital expenditures (CapEx). For example, after the 2015–2016 profit recession (which had resulted from the retrenchment in energy and commodity-related sectors caused by a 75% collapse in oil prices, as well as fears of capital flight in China's capital account after an unexpected currency revaluation), a surge in CapEx lifted the U.S. manufacturing sector, starting in the second half of 2016 and lasting into early 2018. As can be seen in the various measures of corporate confidence in Figure 1, it is clear that after Trump's election, the combination of expected deregulation and corporate tax reform was a potent elixir for stimulating CapEx. The opportunity to deduct the full expense of capital equipment and a repatriation tax holiday on profits held overseas also pulled activity forward, driving 20% growth in CapEx by S&P 500 companies in 2017.

Figure 1:

Corporate confidence rose in 2017 and has since fallen



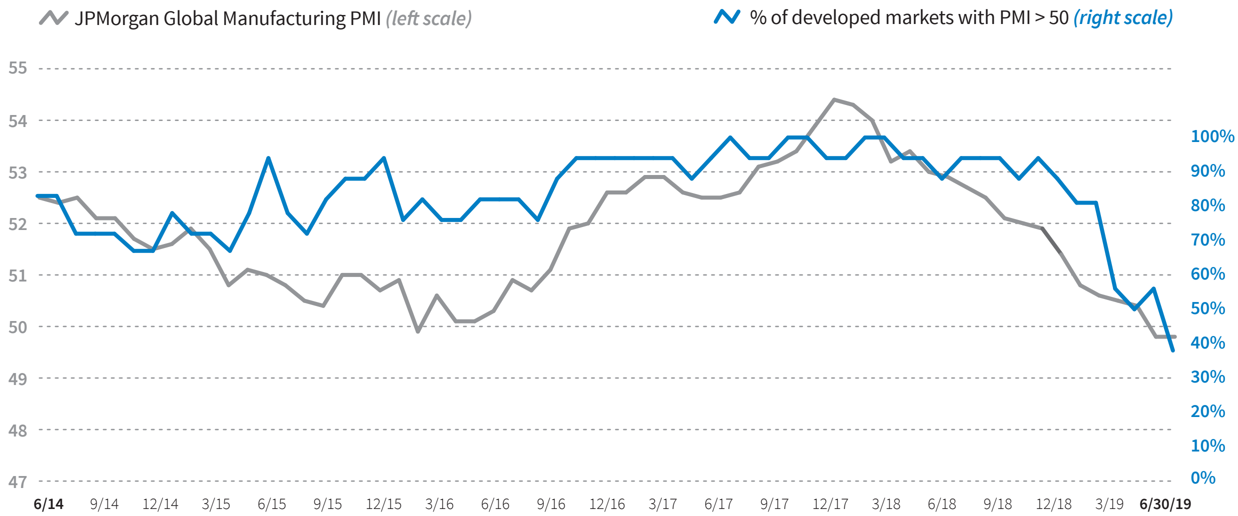
Source: Putnam.

We can clearly see in Figure 2 both the loss of corporate confidence and the effect on global manufacturing activity over the past eight months.

The effect on the real economy is compounded by the fact that year-on-year comparisons were already going to be difficult because the 2017 Tax Cuts and Jobs Act (TCJA), as mentioned, had pulled forward industrial demand. In addition, technology export restrictions imposed by the U.S. Department of Commerce have also caused companies to question the practicality of their global supply chains. These supply chains and systems of just-in-time inventory have taken the better part of two decades to implement and are not easily disentangled overnight. Further, Figure 3 shows that increased scrutiny of foreign buyers through the lens of the Committee on Foreign Investment in the United States (CFIUS) has had a chilling effect on cross-border M&A activity.

Figure 2:

Global manufacturing has entered a slump

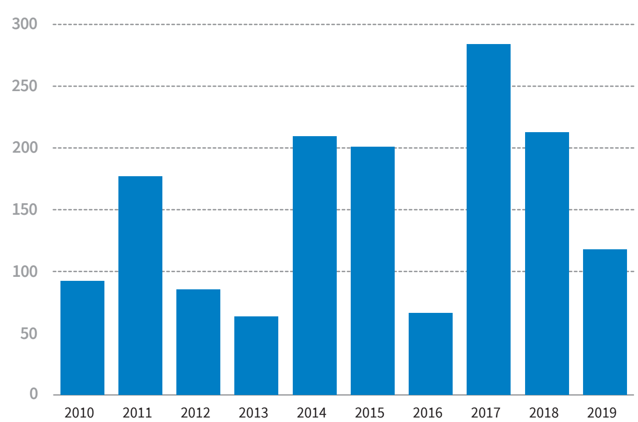


Source: Putnam.

Figure 3:

Cross-border M&A activity is down since 2017

Cross-border M&A YTD–May ($B)



Source: Putnam.

Economic damage translates directly to equity market damage. The technology sector contributes about a quarter of the total profits of the S&P 500, and sources more than half of its revenue from outside the United States. As such, thinking through the economic ramifications of these political actions is not merely an academic exercise.

Watching for lower earnings expectations

With the major global central banks now in full retreat after dovish turns by both the ECB (European Central Bank) and the Fed in late June, there was certainly a sign of a risk-on rally at the close of the second quarter. While we would not describe current equity markets as excessively frothy, consensus earnings estimates for the S&P 500 over the next year expect 12% EPS (earnings per share) growth and almost 5% revenue growth. These growth numbers seem to us to be lofty in the face of the deterioration of our global growth indicators.

We think that, with less than 40% of the world's developed market headline PMI (Purchasing Manager) indices in expansion mode and the JPMorgan Global Manufacturing PMI Index in contraction mode, it might be too late to avoid a mild earnings recession even with a U.S.–China trade truce. We will be carefully monitoring second-quarter earnings season reports for evidence that companies are cutting back on their CapEx plans. We would take that as a signal that enough damage has been done to confidence to reverse the benefits of corporate tax reform, and we would then expect to see substantial cuts to earnings estimates. This would likely be enough of a catalyst to tilt us into a more bearish tactical posture with respect to risky assets.

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