BCT Market Outlook

May 2019

Investment Markets	BCT's Investment Views
Equities	**Neutral**
US	Neutral
Europe	Neutral
Japan	Neutral
Asia ex. Japan	Overweight
China & HK	Overweight
Global Bonds	**Neutral**
Government Bonds	Neutral
Credit	Neutral

Scales of weighting: Underweight, Neutral & Overweight.

US Equities

U.S. equities continued their strong 2019 performance through the month of April, as the NASDAQ and S&P 500 finished with returns of +4.8% and +4.0%, respectively. This goldilocks environment, with the earnings season so far being taken positively, trade headlines by and large incrementally more positive, and a continued lack of volatility all contributed to the favorable backdrop for risk assets. The March labor market report helped to calm near-term recession fears. The 196,000 payroll gain exceeded consensus and was much better than the 33,000 gain reported in February. The unemployment rate stayed at 3.8%, which confirms the view that the 10-year economic expansion is losing momentum but not faltering. The Russell 2000, an index of mid- and small-caps, underperformed large-cap indices, with a monthly return of +3.4%. At sector-level(1), Financials (+9.0%) were among the best-performing sectors during the month, after relatively muted performance in March. Healthcare stocks (-2.6%), meanwhile, faced headwinds from ongoing concerns over changes to drug pricing legislation. The VIX Index, a measure of risk aversion, decreased from 13.9 at end-March to 13.1 at end-April.

We expect some volatility in the market in the coming weeks. April's favorable movement has been due to good news from central banks, which stimulated risk appetite. The market focus is on companies' forward earnings guidance. A stronger outlook on top-line growth, along with still-manageable wage inflation, would suggest that the trajectory of profit margins is not likely to reverse quickly. Still-dynamic labor demand and wage growth, coupled with contained inflationary pressures, support resiliency in personal consumption, which is expected to be the main driver of domestic demand. Business confidence has moderated appreciably compared to last year among small and larger businesses, and this reflects a moderation in capex intentions and investments, which anyhow remain in line with our outlook. Moderate domestic and external inflationary pressures are keeping both core and headline CPI in check and somewhat subdued, composing a benign inflation outlook. The US Federal Reserve (Fed) is not expected to deliver further rate hikes this year, will end Quantitative Tightening and remain alert to any changes in financial conditions, economic outlook and inflation dynamics. **Some early signals of the earnings season seem positive, showing that revisions are starting to improve again. Further confirmation is needed to see a continuation of the bull market. We therefore keep a neutral stance on U.S. Equities.**

European Equities

In Europe, the Euro Stoxx 600 rose +3.9% despite concerns on economic growth. Notable markets were the German DAX (+7.1%) and the Italian FTSE MIB (+3.3%). Manufacturing continues to be the weak spot, with the Manufacturing PMI only improving slightly to 47.8 in April. More positively, the employment component stayed above 50, at 50.8: an indication that poor activity data has not yet had a negative impact on the labor market. The unemployment rate fell slightly to 7.7% in the March labor market report. This is consistent with relatively stable data from the service sector and the consumer. The Services Purchasing Managers Index improved to 52.5 and consumer confidence fell to -7.9, which is lower than in the previous month (-7.2) but still far above the long term average of -11.7. The European Central Bank expects rates to remain at their present levels at least through the end of 2019, since the slower growth momentum is expected to extend further into this year. The Eurozone bank lending survey for Q1 2019 suggests that overall bank lending conditions remained favorable. At sector level(1), digging into the April moves, the top spot went to European Banks, which returned +8.4%, while Healthcare (-2%) and Real Estate (-1%) underperformed.

In Europe, valuations have reset after the rally and are now in line with historical averages. Yet, positioning is very light, and could improve in case of further earnings delivery and/or the resolution of political risks. After a highly disappointing 2018, figures have so far been mixed in 2019. However, while most of the difficulties involve export-intensive (manufacturing) sectors, the job market is holding up well and is likely to support consumption and services. We expect a gradual improvement during the rest of 2019. The risk of a no-deal Brexit has become less imminent, but there is still threat of U.S. trade measures against Europe. Moreover, there are still some considerable political uncertainties, particularly the upcoming European elections and the situation in Italy.

Stabilization of economic indicators in Europe and also China and Asia, could provide a catalyst for further upside in the coming months. Our neutral outlook to European equities is unchanged, as earnings delivery and/or the resolution of political risks is needed for further upside.

Japanese Equities

In Japan, the Nikkei 225 gained an impressive +5.0%, while small caps underperformed (Nikkei Mid & Small-Cap Index: +2.1%). In sector terms (1), Consumer Discretionary (+13.6%) and Information Technology (+9.0%) were the best performers, while Utilities (-7.4%) and Real Estate (-9.3%) underperformed. Although not in itself an economic event, the abdication of the Japanese Emperor at the end of April and the start of the new Reiwa era did lead to a rather subdued market environment. This seemed particularly prevalent among foreign investors who were reluctant to open new positions ahead of the extended Golden Week public holidays. Early results of the earnings season seem to have a slight skew towards negative surprises, but price reactions have been muted for the month. There was also no market reaction following the Bank of Japan's policy meeting, which produced no change in policy, as expected. The recent guidance from the central bank is clearly aimed at setting investor expectations towards an extended period of monetary accommodation. Domestic economic data released during the month was mixed at best, with industrial production falling more sharply than expected. The external environment, however, seemed slightly more benign as expectations grew for some kind of agreement on trade issues between the U.S. and China.

Global economic stagnancy has crippled manufacturers, with exports marking a Year-over-Year fall for four months. The Bank of Japan corporate survey points to decent capital spending plans for 2019. In fact, sluggish shipments are undermining investment. Machinery orders showed only a meagre gain in February after three months of contraction. However, non-manufacturers held up well on urban redevelopment, job placement and the coming 5G Telecom standard. Despite the weak export snapshot, shipments are likely to gather strength as the Chinese economy rebounds solidly. On the consumer front, settled pay raises are slightly higher than last year. Nonetheless, a 2% increase in disposable income is being partly offset by a higher savings rate, reflecting households' apprehension over corporate earnings and the upcoming VAT tax hike. They are also being discouraged by higher consumer staple prices. The earnings per share momentum is weak, although valuations are attractive. **In the last few weeks we have become more cautious on Japanese equities, and try to find some bottom-up opportunities.**

Asia ex Japan Equities

In Asia, the ongoing US Dollar strength caused equities to underperform this month, as the MSCI AC Asian ex-Japan index rose by 2.4% in April, while the MSCI World rose 3.6%. Sector-wise, Information Technology and Consumer Services (respectively +3.64% and +3.55%) were this month's outperformers, while Real Estate and Utilities underperformed, returning respectively -1.33% and -1.61% over the month. Singapore was the best performer, helped by a rally in the Banking sector, while the YTD rally continued in Taiwan (+4.0% in April), supported by the large cap tech names. Malaysian stocks remained one of the worst performers in ASEAN and the broader Asian region, due to a negative perception of the new government's tight fiscal stance amidst a growth slowdown. Indonesian shares underperformed as investors await the official result of the country's presidential election. Activities in the large Asian economies of Korea and Taiwan is still due to pick up. Manufacturing PMIs in Korea and Taiwan improved in March, but at 48.8 and 49.0 respectively, and are still signaling continued weakness in economic activity. In particular, the new export orders sub-component continues to be depressed.

Growth dynamics continued to be tepid. On the exports side, figures have been less negative since March (in South Korea, India and Indonesia).The region's inflation figures remained very benign. Oil and food prices pushed inflation to levels lower than expected. In India, inflation remains very benign (2.9% year-over-year), but March data showed some inversion towards higher food prices. Overall, CBs in the region are in a wait-and-see mode before shifting towards a more dovish stance, thanks to a more favorable global financial environment. India cut its policy rates by a further 0.25%. Final elections results in Thailand leave the country divided and signal the military's grip on power, while the region is holding new electoral campaigns (in India and Indonesia). On the trade front, increased tariffs will inevitably have a significant impact considering both its high correlation with global trade and the economic role of China in the area. On a sectoral basis, the Automotive industry is in the weakest position, along with the rest of the Industrial sector. Our base case remains that a deal between the US and China will eventually be reached. **We continue to see some encouraging signals coming from both parties, even if the path to a final deal could be tougher and longer than was once expected. Besides, Asia should benefit from Chinese stimulus. This justifies, in our view, a cautiously positive stance on Asia ex-Japan Equities.**

China & Hong Kong Equities

Chinese equities lost some momentum in April after a strong rally in Q1, in part on worries the government might begin dialing back stimulus in light of improved growth. Although this is a fair assessment, it should also be noted that Chinese policymakers remain vigilant and will provide support if the economic data softens again. The Manufacturing PMI disappointed expectations, falling back from March's reading to 50.2 for April, but still an improvement from a multi-year low of 48.3 in January.

The Service sector PMI increased for March. China's GDP grew 6.4% year-over-year in Q1 2019, above market expectations and flat from Q4 2018. Industrial production growth rose from 5.3% to 8.5% growth year-over-year in March, and retail sales growth inched up, delivering more evidence that fiscal and monetary stimulus is feeding through to the real economy. Monetary conditions also show signs of improvement. New yuan loans rose well above the level in February and the consensus forecast, while first quarter aggregate total social financing, at RMB 8.2 trillion, easily surpassed credit expansion in the previous years.

Economic activity recovered some strength after a poor performance ahead of the Chinese New Year. With policy gradually taking effect, growth seems to be near bottom. Credit growth is bottoming out, while fiscal spending has been accelerating. Local orders are recovering, as implied by PMIs. The latest data also suggested that the Auto and Smartphone sectors, which were major drags in H2 2018, have pasted the worst time. Meanwhile, exports in the region have avoided another sharp slowdown for now, after a positive Q4. For now, we expect the RMB to move in the range of 6.0-7.0 per US Dollar, but without breaching the resistance level of 7.0. If talks don't go relatively smoothly, there is a real chance that China could allow the RMB to breach that level of 7.0. The consensus is that the economy in China will hit bottom in Q2 of this year, we think it may actually take a little longer than expected. However, in our opinion some sectors may offer better value than others in the A-share market as domestic demand will work as a buffer against the damage caused by the tariffs and we will continue to see strong investment from the central government. We are constructive on consumer non-cyclical and technology companies. In our opinion, investors should dismiss the idea that U.S.-China trade talks could break down, albeit uncertainties remain. **We remain positive on China as we think some sectors may offer better value as they are supported by stimulus measures that have yet to kick in completely.**

Global Bonds

Speculations of an early rate cut from the Fed resulted in global bonds yields falling after having drifted higher in the first half of the month. In the U.S., 10-year yields ended the month at 2.50% (+0.09% higher) while the spread between the 2-year and 10-year yield widened from 0.15% to 0.23%. Meanwhile in Europe, German 10-year yields gradually rose to 0.08% around mid-April, before gently falling to finish the month at 0.01%. Peripheral bond markets outperformed mainly due to the higher carry on their bonds. Overall, the J.P. Morgan Global Government Bond Index posted a modest gain of +0.1% while the J.P. Morgan Emerging Markets Bond Index fell -0.7%. Credit markets continued to participate in the ongoing "risk-on" mood in April, with strong performance all across the credit spectrum. Spreads continued to tighten with the European iTraxx Main Credit Index tightening -0.07% to 0.58%, whilst the High Yield Crossover Index tightened -0.20% to 2.49%. The Bloomberg Barclays Euro Aggregate Corporate Index rose a healthy +0.7% and outperformed the U.S. Aggregate Corporate Index, which rose +0.5%. It was a similar story in the High Yield ("HY") space, where the Credit Suisse Global HY Index gained +1.5%, while the Credit Suisse Euro High Yield index did a little better gaining +1.6% in local currency terms.

The market is expecting a very dovish Fed and is starting to discount even an interest rate cut. This exposes the U.S. government bond market to some risk of upward pressure on yields, in case of stabilization and an improvement of the global economy in the second half of the year. German Bund yields are very low, and exposed to some risks of modest increase should the European Union economy mildly rebound in the second half of the year, as we believe it will. On the U.S. credit side, valuations have become tighter, and there is little room left in the short term for further spread compression. We see valuable carry in the high-yield space. The still sound economic picture is benign for the default outlook. Default rates are expected to remain very low in 2019.

European credit valuations have become less compelling after the aggressive spread tightening but the asset class is still attractive for carry reasons. Leverage is still low and default rates are likely to stay low in the next 12 months. In a scenario of stabilizing growth in the Eurozone, the asset class could provide attractive carry opportunities. Our view is still constructive on hard currency Emerging Markets debt, as financial conditions are supportive at the global level and the risks of a Chinese hard landing are receding. We have become more cautious on local currency debt in recent weeks, after the positive price action that reflects most of the expected good news. The asset class is still attractive for carry, while the overall spread tightening from current levels is limited in the short term. **We are Neutral on Government Bonds (neutral on U.S. Government Bonds and neutral on Euro Government Bonds) and Neutral on Corporate Credit (neutral on U.S. credit and positive on European credit), i.e. Neutral on Global Bonds.**

(1) Sectors of the S&P 500 (U.S. Equities), Stoxx 600 (European Equities, Topix (Japanese Equities), MSCI China (Chinese Equities) indices.

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