Market Outlook
Fourth Quarter 2018

SIGNATURE GLOBAL ASSET MANAGEMENT™

Fourth-Quarter Outlook
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A World in Transition

A decade after the collapse of Lehman Brothers tipped global financial markets and the global economy into a depressionary spiral, the global economy has recovered and is in remarkably good condition, despite popular belief. But it is also obvious that we are living in a world of transition as technology, globalization and politics significantly impact business and the economy. While we are certainly living in far more uncertain times, it is not the end of the world. It is merely the end of the world as we know it! The status quo no longer holds on many levels across the economic, political, social and investment spheres. Systems that were in functioning equilibria have become unmoored and disoriented over the past decade for many disparate reasons and have yet to settle into an equilibrium state consistent with new realities.

I am not a historian, but it is my sense that once long periods of relative economic and social stability end, it can take decades of elevated instability before we settle back into a new more stable economic, social or political pattern. 2008 may one day be seen as the end of a period of broad social economic and political stability and that 10 years later, we have merely recovered from the economic crisis era and are only starting to wrestle with the broader social, geopolitical and geo-economic aspects.

If there is one broad mega trend that can be seen as a dominant factor, particularly in an economic and geopolitical context, it is the ongoing rise of China as a challenger to the U.S. hegemon from an economic, political, technological and military perspective. This is not new – the re-emergence of China began 30 years ago – but in the past decade the size and sophistication of the Chinese economy and its capacity have begun to have significant global implications. That is the world we live in today and what we must understand when implementing an investment strategy. From an investment perspective, the world today is far more global, interconnected and complicated than any time in recent history. It is in this context that investors must dig deeper in their analysis to better understand what is taking place and stop relying on superficial analysis of complex systems and superfluous statements as guides on where to invest. Looking toward the final quarter of 2018, I want to attempt to shed some light on the complex investment environment that exists today and poke a few holes into many of the common beliefs I hear investors repeating that have either absolutely no meaning or fall into the category of "don't let the facts get in the way of a good story!"

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To paraphrase a quote often misattributed to Mark Twain: “It ain’t what you know that gets you in trouble. It’s what you know that just ain’t so.”

Two of the most common useless pieces of investment knowledge I hear often are:

1) we are late in the cycle, and it’s been the longest expansion/bull market in history so it must be about to end (this is complete rubbish; all parts are misleading or plain wrong), and

2) the market is only led by the FANG stocks (Facebook, Amazon, Netflix and Google-parent Alphabet) and they are in a bubble (this is also complete rubbish on both counts).

Investors must question and probe such assertions for validity, particularly those broad sweeping statements that seem intuitive, but actually say nothing or are just wrong.

Signature positioning

Before digging into the fundamental views that inform our positioning, here is a quick summary of that positioning: Within the context of the Signature Global Income & Growth Fund, we expect that the current economic expansion and bull market will continue to grind higher. We believe that equities will be the best-performing asset class over the coming 12 months, followed by credit and then government bonds. This remains consistent with our 12-month forward expected returns from the start of 2018, based on steady underlying economic growth driving expected earnings growth and modestly rising interest rates as central banks continue to normalize monetary policy, but not yet to the point that policy becomes restrictive.

We also believe there are several concerns that may become catalysts for healthy market corrections. This is an inherently more fragile and potentially volatile stage of the economic and monetary policy cycle and it is not the time to have the “pedal to the metal” on risk assets. Rather, “respect the widening tail risks” is a better mantra, and we have positioned our portfolios accordingly. Having been fully tilted toward risk assets since mid-2016, Signature is currently broadly neutrally positioned in our asset class weightings while retaining a more cyclical tilt within our equity sector exposures. To account for and be ready to take advantage of elevated volatility and tail risk events (such as we experienced in February of this year) we recently reduced our equity exposure to below neutral, while simultaneously deploying an option overlay strategy to retain exposure to upside moves in the S&P 500 Index.

Global economy

The global economy remains in a synchronized expansion, with all major economies growing above their potential growth rates. This remains one of the healthier global economic backdrops of recent decades, despite the elevated levels of angst. While the overall level of global growth remains healthy, we are no longer in a period of synchronized acceleration as different regions are at different stages of growth. The U.S. is coming off a recent fiscal policy-driven acceleration, while Europe's growth has slowed from about 2.4% in 2017 to what we expect to be a more stable 2% pace. Similarly, China continues to decelerate toward an expected 6.5% range as the impact of its near two-year long deleveraging effort continues to bite. Even Japan, at around 1%, is growing above its potential growth rate of close to 0%. Overall, the International Monetary Fund expects global growth of 3.9% in both 2018 and 2019, up from 3.7% in 2017.

To anyone who believes we are in the midst of the longest economic expansion in history I would like to shed a little light on the realities of the current expansion. We are 2.5 years into the current recovery, having exited a global recession in 2016. Since 2008, the world has stumbled from one crisis-driven recession and bear market to another. Post 2008, the global economy re-entered a European-led crisis and recession in 2011-12, followed by a severe recession in 2015-16 centered on both the global energy industrial complex and emerging economies. One reason oil prices tumbled from US$100 to a low of $26 was not because the global economy was in great shape, but was because the global economy was tipping into a deflationary spiral. It is also why former Chair Janet Yellen and the U.S. Federal Reserve pushed the panic buttons in early 2016 by pivoting away from a focus on inflation toward broad global economic and U.S. dollar stability. It was an unprecedented move and paved the way for wide open financial conditions and the lowest level of interest rates in history. It also signalled the start of the current upcycle in both the global economy and global markets. While the U.S. did not technically register two negative quarters of GDP growth, any deeper analysis of the economy shows significant deceleration in most economic metrics including, most importantly from the Fed's perspective, declining inflation expectations. Summer of 2016 also corresponded with Signature's Regime Change call reflecting the dramatic easing of financial market conditions as a precursor to the global synchronized recovery that has since unfolded. By dating the start of the current upswing as mid-2016, we are, in fact, less than three years into the current economic and market cycle. So it's no longer early cycle, but also not so old as to expect an imminent end.

U.S. economy

Within the developed economies, the U.S. is the clear driver of growth and will enter 2019 with significant momentum. Those continuing to expect a recession in the U.S. anytime soon are focusing in the wrong direction as the odds of overheating remain far greater than a recession in the coming 12-18 months. To put the current strength in perspective, the U.S. economy entered 2018 in robust shape with growth in the 2.2%-2.5% range, above potential and approaching full employment, hence the reason the Fed has been gradually increasing interest rates and normalizing monetary policy. The tax package delivered in late 2017 did two things to the economy. First, the tax reform portion was a major step in improving the tax efficiency and competitiveness of the U.S. economy. Secondly, the tax package added roughly $1.5 trillion dollars in stimulus over the next decade, in a front-loaded manner. In other words, we can expect to see roughly $200 billion in stimulus in both 2018 and 2019, which amounts to totally reckless and unnecessary fiscal policy in the face of a robust economy. The U.S. will be running trillion-dollar deficits during the best times of the economic cycle. But debt does not tend to be a problem, until it becomes a problem – which we do not foresee in the near term.

If that was not enough, in the January/February budget negotiations the U.S. government, after years of tea party-inspired spending restraint, debt ceilings and even government shutdowns over the need for fiscal responsibility, reached a budget proposal for $300 billion of extra spending over two years. Money for everyone and another $150 billion of stimulus in each of 2018 and 2019! The U.S. economy will not be tipping over any time soon. The bigger risk remains overheating but that takes time to show up in the data. To date the pressures remain mild, allowing the Fed to maintain its very gradual normalization path.

While many commentators are calling for a recession in 2020, their reasoning is often as simple as they don't see one in 2018 and its unlikely to occur in 2019, so it must be 2020. I don't buy it. We may see a recession, but it remains way too early to forecast with any degree of confidence. In the meantime, we will stay focused on the data as it unfolds and monitor policy responses. We do expect to see a significant deceleration in the U.S. from the current torrid pace as the stimulus impact fades throughout 2019, but slowing closer to a trend growth level of +/-2% a year from now is a far cry from expecting a recession. Much will depend on how the Fed reacts, how the U.S. dollar performs, the state of play on trade and tariffs and how the rest of the world is performing.

China trade and tariff math

On the question of whether the current U.S. trade war will tip over the U.S. economy, it is worth looking beyond the headlines and digging a bit deeper into the numbers. The key trade issue in the U.S. involves China, and it has nothing to do with China's bilateral deficit with the U.S., despite what President Trump likes to tweet. The core issue, as mentioned earlier, is the rise of China as an economic, political, technological and military challenge to the U.S., and this will remain the backdrop for the coming decades. In other words, broad China tensions are a part of the world we live in and hence the need to better understand both sides of the story. Nor is it a new development. It was, after all, why the world was negotiating the Trans-Pacific Partnership in the first place.

The current tensions revolve around trade, but recall a couple of years back the tensions were focused on the South China Sea and how China's military was building islands and military bases on reefs claimed by several other nations. The concern then was that there would be a military confrontation between the U.S. and China. No one is focused on that today as the U.S. withdraws its military umbrella from the region, but the activity has continued unabated, as has China's broad Belt and Road Initiative across the Eurasia region. China will continue to surpass the U.S. in geopolitical and geo-economic influence in broad swaths of the world. China-related frictions will continue to evolve and surface in many different fields in the coming years. It is the world we live in today.

Today, that point of friction is trade. While it is unclear just what the U.S. wants on this front given the many different points of view in the administration, we can ask about the likely impact of current policies and whether the trade war and announced tariffs will tip us into a recession. Bottom line, a tariff is a tax on the consumer of the goods subject to the tariff. They are a tax on the U.S. consumer, not on China. While the shifting of relative prices from the tariffs will cause disruption in global supply chains and hence some trade diversions, assessing the actual impact is extremely complex and unclear. But assessing the first-round impact in a simplistic, back-of-the-envelope manner can help frame the scope of the issue. Also bear in mind that a large portion of imports from China are imports of goods from U.S. companies that saw final assembly in China, but very little actual value added from China. Think of the iPhone, of which most of the value-add is attributed to Apple, and for which China is only involved as the last step of assembling all the imported pieces together. A tariff on the iPhone would be paid by U.S. consumers and would hurt Apple more than any other company. That is the reality of the complex and interconnected world we live (and invest) in today.

Let's look at the rough tariff numbers and assess the likely economic impact. As I write, there are roughly US$450 billion of goods subject to the additional tariffs, including the most recent 10% on US$200 billion from China. The total tariffs expected to be raised is in the US$45 billion range. In other words, we have just hit the U.S. economy with a $45 billion tax hike. Will it slow the economy? At the margin, yes. But a good rule of thumb would be if you want to start a trade war, do it when your economy is humming along. Recalling the above stimulus math, we entered 2018 with about $350 billion of extra stimulus in an economy already seeing robust growth, now hit with a mere $45 billion tax hike. That is only taking back a bit more than 10% of the stimulus put into the economy. The initial economic impact, therefore, will be minor. There will be some winners and losers from trade diversion, but with the current strong economic backdrop the macro impact is small. We will be watching to see how events escalate through 2019, and monitoring corporate behavior to assess any loss of confidence in the outlook, but for now there remain scant signs of real adverse economic pain.

The current trade war is more about politics than economics. It is a fluid and evolving dynamic that cannot be ignored, but from an investment perspective, we must look through the noise and assess the actual likely economic impact. We are also aware that the potential short-term market impact may be worse than the underlying economic impact. Trade is a clear candidate as a catalyst for elevated market volatility in the months ahead. It is reason for some caution, but not for panic.

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