Investment Commentary

EQUIUM CAPITAL

March 2019

Easy Riders

Although investor focus remains firmly on the outlook for global economic growth and U.S.-China trade negotiations, we at Equium Capital have been attentively watching the about-face performed by monetary authorities. Given recent market volatility and the softening growth outlook, we certainly expected Central Banks to walk back some of their rhetoric; however, commentary over the last several months has been far more dovish than expected.

Bond markets clearly noticed the shift with interest rate change probabilities for the Federal Reserve swinging from an 80% chance of a hike in 2019 all the way to a 27% probability of a cut (Chart 1). Not to be left out, Mario Draghi, President of the European Central Bank, lowered the Eurozone growth outlook and announced an additional round of liquidity operations (TLTROs) at the most recent ECB meeting. After the release market interest rate hike expectations for the year were cut by more than half. You can also add Canada, the UK, Australia, Japan and a host of Emerging Markets to the list of countries where monetary expectations are easing.

This is a dramatic reversal from where we stood only a few months ago and led to a complete recovery in financial conditions across most global regions (Chart 2) save notably for Canada. Additionally, the drop in long bond rates has driven the amount of negative yielding debt up to nearly $10T USD. So much for the end to unconventional monetary policy.

But are markets appropriately discounting the dovish pivot of Central Bankers? Much will depend on the path of economic growth and inflation for the rest of the year. Will Chinese stimulus drive a recovery in global PMIs? Will wage gains and declining output gaps finally drive inflation higher? Will the U.S. Dollar continue to levitate as fiscal deficits blow out?

While we don't yet have answers to these questions, we would note the difference between what bond and equity markets are currently pricing (Chart 3). We do not believe that this divergence is sustainable as the conditions that would lead to rate cuts do not seem compatible with higher equity markets and vice versa.

Given the significant levels of debt and the limited capacity of Central Banks to cut interest rates, we believe that investors would react with a high degree of skepticism that further monetary easing would restart the economic cycle. In other words, markets may begin to price in a repeat of the oft-maligned Japanese

Chart 1 | Federal Reserve Rate Policy Expectations (Dec-19)
source: Bloomberg, Equium Capital

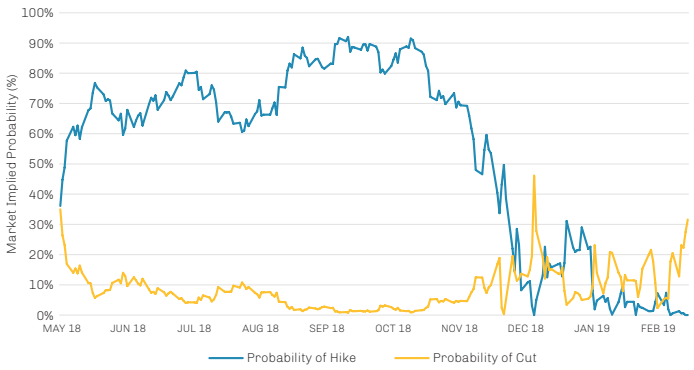


Chart 2 | Global Financial Conditions (1Yr)
source: Bloomberg, Equium Capital

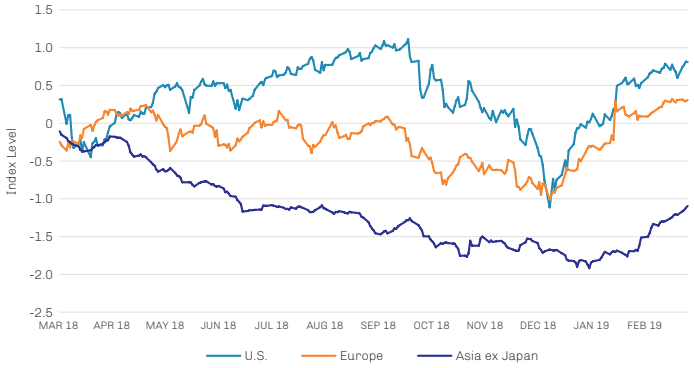
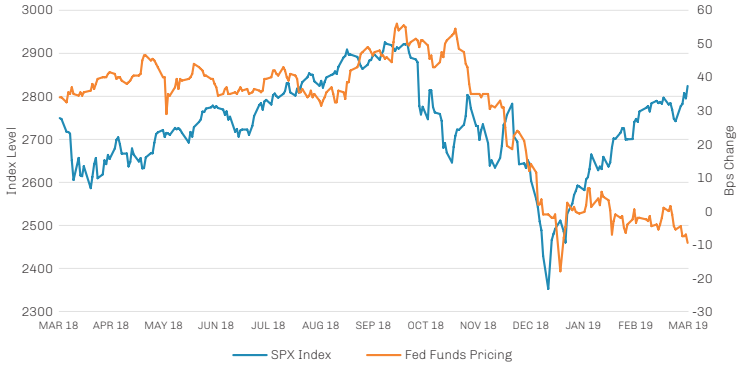


Chart 3 | S&P 500 vs. Fed Funds Pricing (1Yr)
source: Bloomberg, Equium Capital



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experience with extraordinary monetary policy. As a reminder, the Nikkei Index is essentially unchanged in local terms since the crisis of 1990 and after 20 years of quantitative easing.

By contrast, a rebound in growth and inflation expectations would likely provide Central Banks with the cover they desperately need to normalize policy. Our view is that the recent commentary out of the Fed wasn't nearly as dovish as interpreted by the bond market and that any positive uplift in their indicators will be quickly met with more hawkish commentary. Assuming they don't over do it, better global growth and rising inflation would extend the outlook for the economic cycle and be positive for equities while driving bond prices down.

So what's an investor to do? Our process argues for continued patience while focusing equity exposure on areas of the market that exhibit positive fundamental and technical trends, such as Software, Mobile Payments and Medical Equipment. We also continue to be unimpressed with the rally in cyclicals, such as Financials and Industrials, where we remain underweight.

In the meantime, there are several key indicators that we suggest investors monitor. One is the Federal Reserve Bank of New York's Underlying Inflation Gauge (Chart 4). We have seen the recovery that we expected over the last several years but it has now stalled out around 3%. We do not see these levels as sufficient to force the Fed back to hiking, so we expect that a move higher in this data set will be required before a pivot in policy is likely.

On the growth front, regional manufacturing PMIs and export data should help to provide an indication that the slowing momentum experienced over the last several quarters is finally abating. As a critical cog in the global growth engine the focus will rightly be on China. However, we worry that investor expectations surrounding Chinese stimulus coming to the global economy's rescue is likely misplaced. Although expansionary fiscal and monetary policy will certainly help, the recently announced 0.2% increase in deficit expectations for 2019 is hardly sufficient to turn the global economy. More importantly, we are not convinced that the reserve ratio reductions and other liquidity enhancements to-date are likely to reignite a robust credit cycle. We look to the credit impulse indicator for signs that monetary easing is translating into credit expansion (Chart 5). So far, the evidence does not point to another uplift as in prior cycles, which investors seem to be anticipating.

Until we have more clarity, patience seems the order of the day. That said, with global central bankers back to pumping liquidity, the ride should at least be easier.

Chart 4 | FRBNY Underlying Inflation Gauge (25Yr)
source: Federal Reserve Bank of New York, Bloomberg, Equium Capital

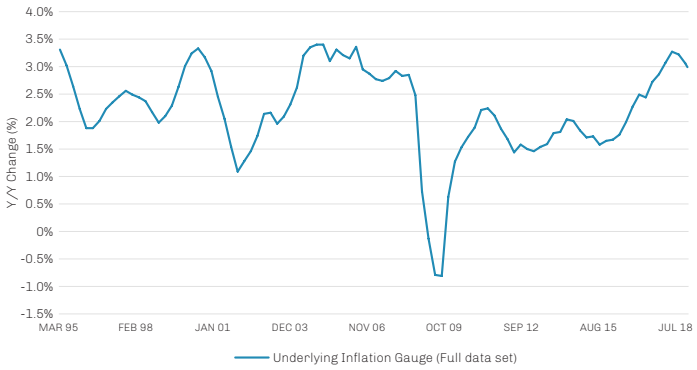

Chart 5 | China Credit Impulse 12m % Change (10Yr)
source: Bloomberg, Equium Capital

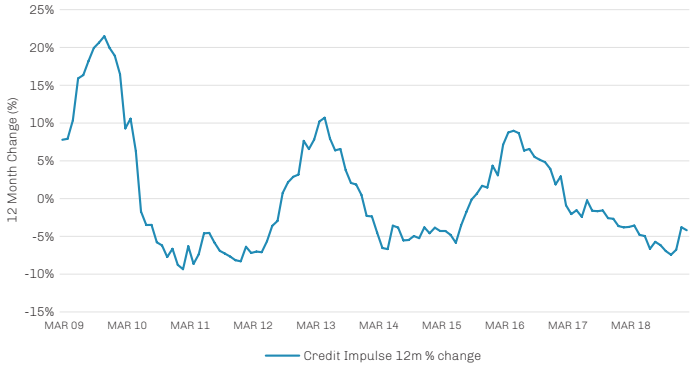

Table 1 | Investment Recommendation Snapshot
source: Equium Capital

	Sector	Region
Overweight	Energy Health Care Software	U.S. Emerging Markets
Underweight	Credit Financials Discretionary	Australia Canada United Kingdom

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