# Market Synopsis – July 2019

As discussed in last month's Market Synopsis it is currently, probably more than at any point over the last decade post the Global Financial Crisis, critical to gauge whether a global recession is lurking. Answering yes to this question means bond prices will continue to rise, the USD will rally further, equities will weaken, and defensive stocks will keep outperforming cyclical ones. Answering no, one should sell bonds, sell the USD, buy equities, and overweight cyclical sectors. As we confirmed, we stand firmly in the "no" camp. While the recent growth slowdown has been painful, it is not the end of the current business cycle.

In devising an appropriate investment stance, it is critical to analyse economic and financial market cycles. Three types of cycles, in particular, have proven to be important to investors:

- Short-term manufacturing cycles lasting roughly three years;
- Medium-term business cycles affecting the entire economy; and
- Long-term super-cycles that can span decades. These often involve significant economic, social and political changes.

Much of the current uncertainty regarding a potential economic recovery has hinged on the sluggish global manufacturing cycle. The latest global manufacturing downturn has been widely attributed to the escalation of the trade war, the Chinese deleveraging campaign and the end of the fiscal boost from the Trump tax cuts. All these factors have probably exacerbated the downturn. However, it is not clear whether they necessarily caused it. The Chinese deleveraging campaign began in late 2016, more than a year before the global manufacturing sector peaked – see Figure 1. The trade war only heated up in the second quarter of last year, after manufacturing activity had already begun to roll over. The jury is also still out on the extent to which US corporate tax cuts spurred capital spending, as opposed to being funnelled into retained earnings and share buybacks to boost financial performance and balance sheets. Regardless, the fact that capex has weakened less in the US than abroad over the past 18 months suggests that the fading impact from US tax cuts was not the main culprit – see Figure 2.

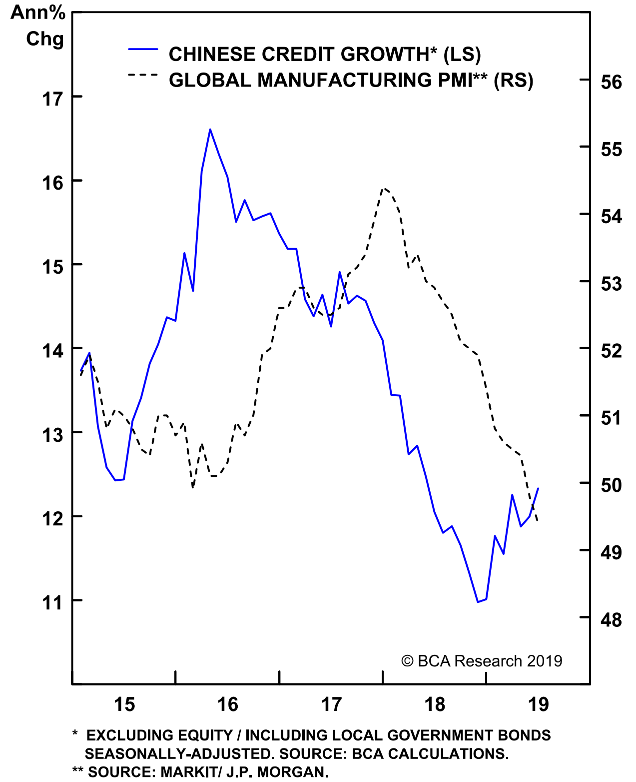



**Figure 1: Chinese deleveraging caused manufacturing slump?**

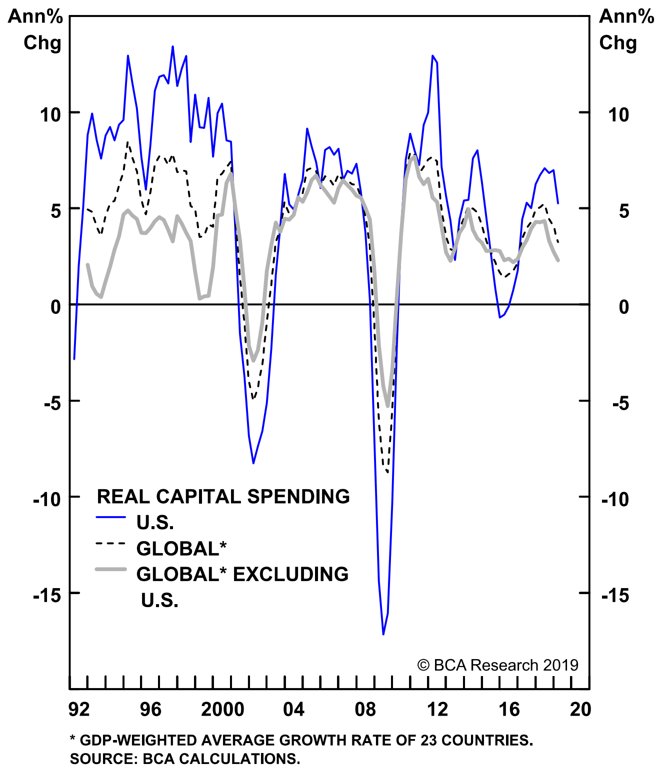
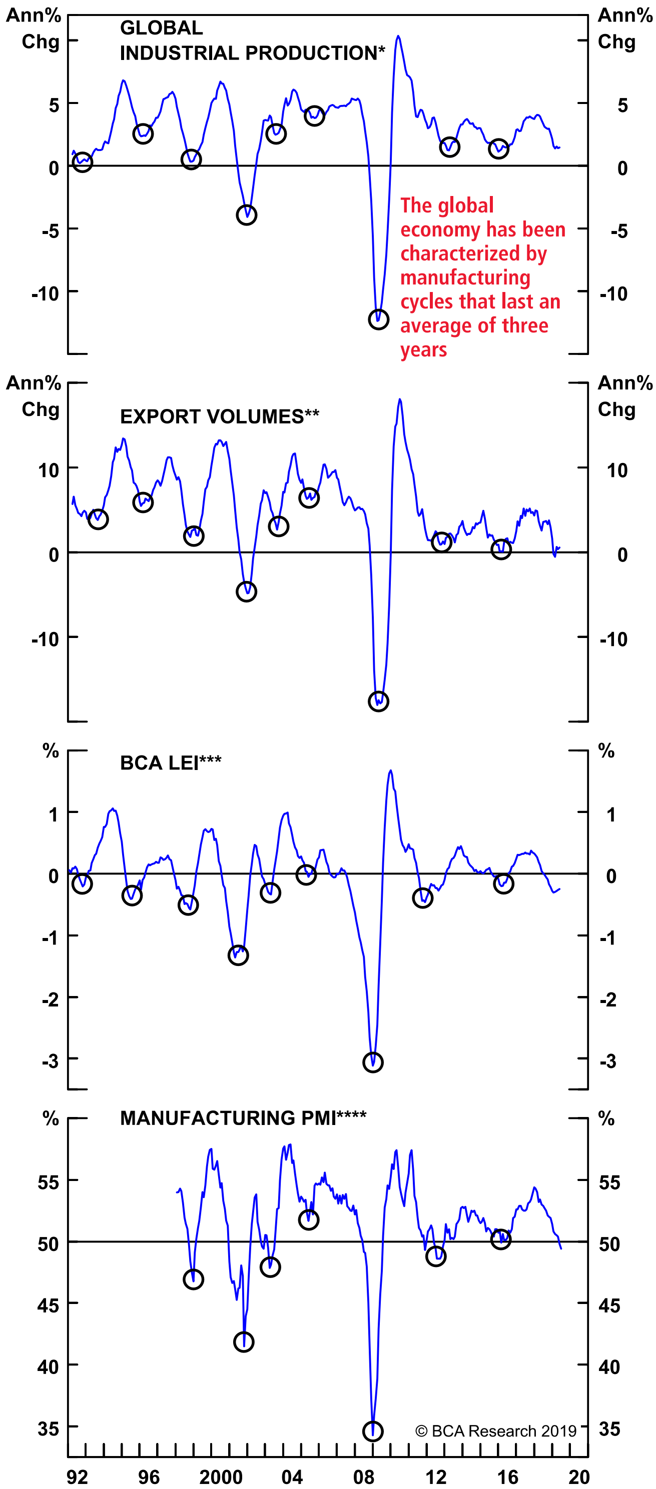



**Figure 2: Or the fading impact of Trump's tax cuts?**

Lost in the noise over the cause of the slowdown is that global manufacturing activity follows a fairly predictable three-year growth cycle: Up for the first 18 months, down for the second 18 months – see Figure 3. This is not an absolute law of nature, but it is a valuable rule of thumb. The last growth cycle began in the second quarter of 2016 and reached an apex in December 2017. For now, the global manufacturing sector remains in the doldrums. Recent, below expected, Markit PMI readings for both the US and the Euro area are prime examples. However, should history be any guide, activity should begin to rebound over the coming months. The large improvement in the Philly Fed manufacturing PMI earlier this month, strong US core capital goods orders as well as the slight uptick in Korean exports on a month-over-month basis, are positive signs in this regard.

What then drives the short-term manufacturing cycle? The answer is the same mechanism that drives all cycles: The existence of self-limiting feedback loops. In the case of the manufacturing cycle, the feedback loop is fairly straightforward to describe: A pickup in manufacturing sales boosts profits and creates new jobs. This causes consumer and business confidence to rise. Improving confidence leads to more sales, which generates even higher confidence. If that were all there was to the story, this virtuous cycle would never end. This is where the "self-limiting" part comes in. Most manufactured goods are durable goods, meaning that they retain value for some time after they are purchased. When spending on, say, automobiles or computers rises to a high level for an extended period of time, a glut will form, requiring a period of lower production. This, in turn, will generate a negative feedback loop where falling sales lead to lower confidence and so forth. The glut will eventually shrink. Once enough pent up demand has accumulated, a new upcycle will begin. We believe we are approaching this juncture. This implies that the slowing impact of the global manufacturing cycle might be dissipating and might even turn in to a tailwind.

Another critical tailwind for economic growth is the pending global liquidity spurt. As discussed in the recent past, inflation pressure remains benign. The lack of inflation allows central banks to ease policy in response to the slowdown in global growth. The US Federal Reserve ("Fed") trimmed rates by 25 basis points this week and is expected to cut again later this year. The European




* INDUSTRIAL PRODUCTION VOLUME EXCLUDING CONSTRUCTION. SHOWN AS A 3-MONTH MOVING AVERAGE; SOURCE: NETHERLANDS BUREAU FOR ECONOMIC POLICY ANALYSIS.
** SHOWN AS A 3-MONTH MOVING AVERAGE; SOURCE: NETHERLANDS BUREAU FOR ECONOMIC POLICY ANALYSIS.
*** BASED ON 23 COUNTRIES, BCA CALCULATIONS.
**** SOURCE: MARKIT/ J.P. MORGAN.

**Figure 3: Predictable manufacturing cycle**

Central Bank ("ECB") recently telegraphed a rate cut and potentially a resumption of its QE program for September. The Reserve Bank of Australia has lowered rates twice this year and the Reserve Bank of New Zealand, once. Meanwhile, the People's Bank of China has slashed the reserve requirement ratio by 3.5% in the past 15 months.

The Fed's interest rate cuts are crucial for US growth and emerging market liquidity conditions. Money moved into EM economies as interest rate markets priced in ever-deeper US rate cuts after the Federal Open Market Committee's dovish pivot earlier this year. As a result, many EM currencies stabilised, allowing EM central banks to ease policy to support their sagging domestic economies. The Bank of India, the Bank of Indonesia, the Bank of Korea, the South African Reserve Bank, the Bank of Russia, Bank Negara Malaysia, and the Turkish Central Bank have all cut rates. Central banks in Brazil and Mexico are expected to follow suit.

Global policy easing should solidify an improvement in many global liquidity indicators and thus, support global growth over the next year. In addition, we have discussed other growth drivers, at length, in recent editions of Market Synopsis past. Global growth should be buoyed by several factors, specifically a low inflation environment, an easing in both monetary and fiscal policy, a positive outlook for already improving global liquidity conditions, a healthy US consumer and the lagged impact of China's stimulus.

Against this backdrop, the window to own equity and other risk assets remains open. Equities have more upside on a medium-term basis, but are set to churn over the coming three to six months. The risk of sharp, but temporary, corrections is elevated. Equities, however, rarely enter a bear market when a recession is not imminent. As we have shown in the past, equites prices perform well in the 18 months before a recession begins – see Table 1. Should one expect growth to pick up over the next 6 to 12 months and policy to remain easy – which we do – then a recession will not occur before late 2021/early 2022.

| PRE-RECESSION S&P 500 RETURNS | | | | | |
|---|---|---|---|---|---|
| RECESSION START | S&P 500 PEAK (MOS.) | 18-12 MOS. PRECEDING RECESSION | 12-6 MOS. PRECEDING RECESSION | 18-6 MOS. PRECEDING RECESSION | 6 MOS. PRECEDING RECESSION |
| DECEMBER '69 | -13 | 9.8% | -4.5% | 4.8% | -9.3% |
| NOVEMBER '73 | -11 | 3.6% | -4.1% | -0.7% | 1.2% |
| JANUARY '80 | 0 | 0.6% | 7.1% | 7.7% | 4.9% |
| JULY '81 | -8 | 5.8% | 18.8% | 25.8% | -3.4% |
| JULY '90 | -2 | 14.5% | 11.1% | 27.3% | 1.3% |
| MARCH '01 | -7 | 3.5% | 11.1% | 14.9% | -18.3% |
| DECEMBER '07 | -2 | 10.3% | 9.3% | 20.5% | -3.2% |
| AVERAGE | -6.1 | 6.9% | 7.0% | 14.3% | -3.8% |

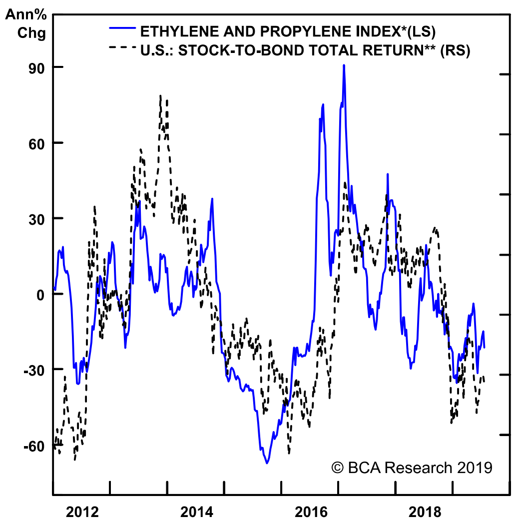
**Table 1: Equity performance around the onset of recessions**

In addition, the 2-year/Fed funds rate yield curve is inverted. Since the 1980s, after such inversions, the median 12-month return for the S&P 500 has been 14%. Stripping out recessionary episodes, the median returns would have been 18.6%, 13.1%, and 9.9%, over 12, 6 and 3 months, respectively – see Table 2.

| S&P 500 RETURNS AFTER 2-YEAR GOVERNMENT BOND YIELDS FALLS BELOW THE FED FUNDS RATE | | | |
|---|---|---|---|
| DATE | 3 MONTHS RETURN | 6 MONTHS RETURN | 12 MONTHS RETURN |
| SEPTEMBER '78 | -6.3% | -13.0% | 6.6% |
| NOVEMBER '85 | 12.2% | 22.3% | 23.3% |
| APRIL '89 | 11.8% | 9.9% | 6.8% |
| MAY '95 | 5.3% | 13.5% | 25.4% |
| DECEMBER '97 | 13.5% | 16.8% | 26.7% |
| MAY '00 | 6.8% | -7.4% | -11.6% |
| JULY '06 | 7.9% | 12.7% | 14.0% |
| MEDIAN | 7.9% | 12.7% | 14.0% |
| MEDIAN EXCLUDING RECESSIONS | 9.9% | 13.1% | 18.6% |

**Table 2: Equity returns post short-term curve inversion**

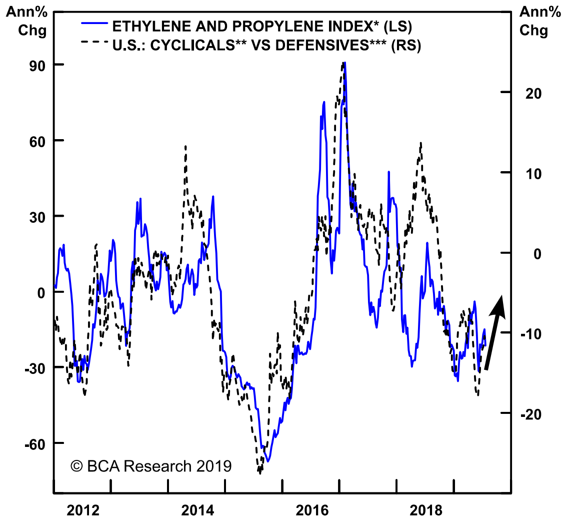
In addition, the stock-to-bond ratio performs well when global industrial activity rebounds – see Figure 4.




* EQUALLY WEIGHTED INDEX.
** S&P 500 OVER 10-YEAR GOVERNMENT BOND YIELD.

**Figure 4: Growth backdrop positive for equities**

Cyclical equities will likely outperform defensive equities on rebounding global growth – currently most of the value our bottom-up analyses find, sits in cyclical sectors. The bullish configuration in the price of chemicals is consistent with a period of outperformance for cyclical equities – see Figure 5.

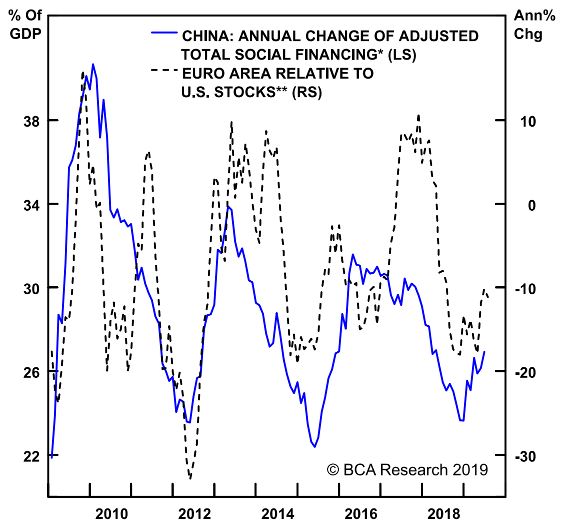



* EQUALLY WEIGHTED INDEX.
** AVERAGE OF INDUSTRIAL, ENERGY, MATERIALS.
*** AVERAGE OF COMMUNICATION, CONSUMER STAPLES, HEALTHCARE.

**Figure 5: Supporting backdrop for cyclicals**

Cyclicals also perform well when yields are moving higher, especially when central banks remain accommodative. A positive view on commodities fits within this pattern.

European equities are better placed than their US counterparts over the medium term. European equities outperform US ones when the Chinese Total Social Financing moves up, reflecting their higher sensitivity to the global business cycle – see Figure 6.




* BASED ON BCA CALCULATIONS; TOTAL SOCIAL FINANCING EXCLUDING EQUITY / INCLUDING LOCAL GOVERNMENT BONDS.
** SHOWN AS A 12-MONTH CHANGE. SOURCE: MSCI INC. (SEE COPYRIGHT DECLARATION).

**Figure 6: European equities supported by Chinese credit drivers**

Additionally, European equities are trading at a large discount to their US counterparts. The forward P/E and price-to-book of an equally weighted average of European equities stand at 14.4 and 2.1 respectively, versus 20.7 and 4.1 for the US Loan volumes will benefit from the large easing in European financial conditions resulting from the 166-basis-point drop in peripheral yields this year, with BTP (Italian) yields falling to a near three years low following the ECB's dovish tilt. This will remove some of the negative impact of soft net interest margins on bank profits. European banks could be an attractive trade.

Finally, global auto companies are trading at their lowest levels relative to the global equity benchmark since the beginning of the 2000s – see Figure 7.

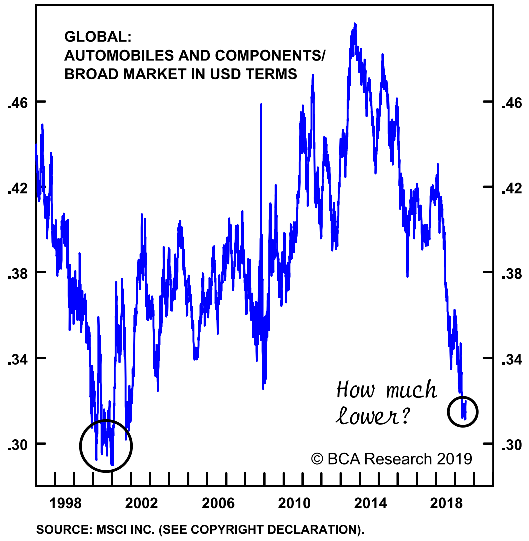



**Figure 7: Auto companies showing value**

In addition, global auto shares trade at 44% discount to the broad market on a 12-month forward P/E basis, the largest undervaluation since 2009. This sector should perform well in the next year based on purged global auto inventories, robust consumer real income, falling interest rates and rebounding global growth.

These views and opportunities are expressed in our fund and client portfolios based on our overweight exposure to European equity markets relative to the rest of the global equity market. Specifically to Daimler AG as well as BAIC Motor Corp Limited to take opportunity of the depressed market levels of automotive companies.

For more information on this Market Synopsis or to discuss solutions provided by Integrity Asset Management, please contact us at:

Tel: (021) 671 2112
Cell: 072 513 2684 / 084 601 1025
E-mail: nic@integrityam.co.za / herman@integrityam.co.za
Website: www.integrityam.co.za

integrity asset management

| Indicator | Spot | MTD | YTD | Y-o-Y |
|---|---|---|---|---|
| Gold | 1 430.89 | 1.5% | 11.6% | 16.9% |
| Brent Crude | 64.72 | -2.7% | 20.3% | -12.8% |
| USDZAR | 14.2165 | 0.9% | -1.1% | 8.5% |
| EURZAR | 15.8545 | -1.0% | -3.7% | 3.4% |
| GBPZAR | 17.2957 | -3.3% | -5.7% | 0.6% |
| JSE All Share TRI | 8 535.34 | -1.6% | 10.4% | 3.0% |
| JSE Resources TRI | 3 052.79 | -4.9% | 13.4% | 14.3% |
| JSE Industrials TRI | 14 396.43 | 2.0% | 16.0% | 1.4% |
| JSE Financials TRI | 9 299.39 | -6.2% | -0.1% | -2.7% |
| JSE Listed Property TRI | 1 933.69 | -1.0% | 5.0% | 0.3% |
| S&P 500 | 3 013.18 | 2.4% | 20.2% | 7.0% |
| Euro STOXX 50 | 7 321.85 | -0.2% | 18.1% | 0.9% |
| FTSE 100 | 6 937.47 | 3.0% | 16.6% | 3.1% |
| Nikkei 225 | 34 850.87 | 2.0% | 9.7% | -1.7% |
| Hang Seng | 80 642.01 | -1.0% | 11.6% | 2.0% |

**Source: Bloomberg, as at 30 July 2019**