Macro-Equity Framework

Budget Risk

Clients determine the proportion of equity they feel confortable with in their budget risk. It becomes a strategic invariant in their portfolio and as such it needs to be enforced with the utmost discipline.

Rebalancing

Price actions on the equity market cause at times an over- or under-shooting of that strategic invariant. Advisers are responsible for the timely rebalancing of their client's portfolios at PARfinance according to the in-house macro-equity outlook, detailed herewith.

Growth

World growth is slowing to 3.2% in 2019 from 3.5% in 2018. In Europe, growth will slow from 1.8% in 2018 to 1.2% in 2019. In the U.S. the economy will slow from 2.9% in 2018 to 2%[1] in 2019 while in China the growth rate of the economy will come down from 6.6% in 2018 to 6.2% in 2019 and to a much slower rate probably below 5% beyond that. It seems therefore that the powerful Kondratiev's cycle, which began in 1998, remains in place and continues to power most of the world economies. We therefore expect no recession[2]

[1] This figure is above the CBO (1.9%) and the Fed (1.8%).

[2] The Q1 GDP figure in the U.S. (3,2%) did not look like the well-heralded recession by the so-called inverted yield curve. No recession in Japan either where Q1 GDP figure (0,5%) for the quarter now points to a 2.1% growth rate for the end of the year.

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until the end of that long-term structurally driven economic cycle, (2023).

Inflation

The Dollar is currently curbing imported inflation. But wages (Push) continue to rise at a clip of 4.5% in the bottom quartile, which fuels consumption (Pull). Hence, a potential resurgence of an inflationary "Push-Pull" dynamics, which (1) tariffs, (2) migration, (3) interest rates and (4) oil could easily exacerbate. An uptick in Inflation is therefore not to be ruled out[3] and a genuine risk prevails therefore on interest rates, bond yields and equity valuation.

Earnings

They will unfold linearly along nominal GDP growth over the next five years. 76% of the corporations in the U.S. have just reported surprises on earnings in Q1, while it was 53% in Europe. JPM expects top-line growth to remain resilient[4]. We do likewise based on our constructive outlook for the world economy in the long run.

Valuation

P/Es distort the linear progression of equity prices along the unfolding earnings growth on the upside as well as on the downside depending on investors' sentiment. Valuation not Earnings are caused of market volatility. Geopolitical events (Iran, China, Brexit) trigger wide swings in investors' appraisal. Of all three, the conflict with Iran is the most impactful situation, and it could potentially send the barrel of oil to $200. Yet, few seem to be factoring that in[5] of late.

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[3] L.Mutikani - « Consumer prices as measured by the personal consumption expenditures (PCE) price index increased 0.3% last month, the biggest gain since January 2018.» - Reuters 05/31/2019.

[4] Anecdotally, several titans of US financials have suggested the economic expansion can go on for some time.

[5] Amy Whyte - As the world fractures, asset allocators are doing…nothing - Institutional Investors, 05/9/2019. "Many routinely advise allocators not to react to geopolitical events by changing their portfolios."

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Fed

The Fed has great difficulty to appraise what is hiding in the shadows. Cost-push feeding demand-pull! But at a growth rate of 3,2% for GDP in the first quarter, they have no reason to reflate. Hence, a pause that could be ever lasting[6.] Ignore the repeated calls from advisers, who expect the S&P to reach a new historical record of 2'925 by the end of the year and of 3'500 beyond that. They repeatedly call for absurd rate cuts with increasingly unrealistic arguments[7.]

Policy

Over twenty years periods since 1928, the equity market generates an average 7% total return resulting from 2.3% in dividends and 4.7% in capital gains, except for the last 20-year stretch (6%) because of the two most severe crashes, i.e., Dot.com (2000) and Subprime (2007) [8.] During such long-time period valuation swings have constantly been smoothed out.

However, during much shorter periods, valuations can produce either a 14.7% return (March 11, 2009 to the present) or a 8.5% return (Sept. 7, 2007 until March 9, 2009), simply because the 50% decline in the S&P-500 has been phased out almost overnight from the most recent statistics.

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[6] T. Hunicutt, R. Leong - The minutes from the Fed revealed on that the Fed's current patient approach to setting monetary policy could remain in place "for some time" – Reuters - May 23, 2019.

[7] "President Trump has stated publicly that if the Fed dropped US interest rates, the trade war with China would be over. The US would win the trade dispute hands down. » TIS Group, The Institutional Strategist, Global Market, May 20, 2019

[8] Jeff Sommers - A quirk of the Calendar is messing with Stocks – The NYT – May 9, 2019.

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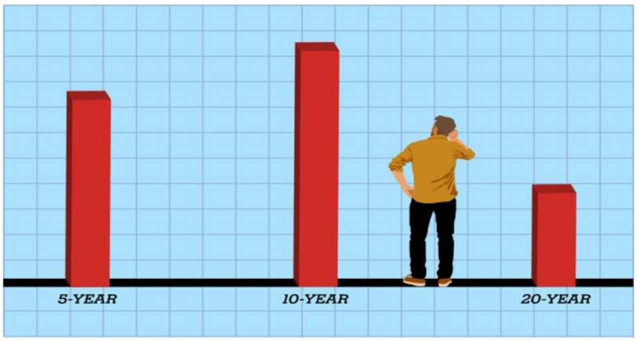

To stabilize performance over the short-run investors might in addition consider a position in real estates (REITs) to their equity distribution, given that REITs have produced in the past much similar returns to equity.

Conclusion

Hence, our recommendation to rebalance portfolios with upmost discipline towards their strategic invariant in time of over-shooting (sell) as well as in time of under-shooting (buy), which is by far a more difficult task, in order to capitalize on valuation swings and potentially enhance performance. But in no circumstances, do change asset allocation, i.e., the invariant, nor substitute rebalancing discipline for market timing since the latter is impossible.

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