Monthly Newsletter
Savings and Investments

Shaky stock markets are sending different signals

January 2019

Market overview

The **final quarter of 2018 brought great turbulence** in financial markets and the year ended with high price fluctuations. Investors have had to contend with rising US central bank interest rates, quite sharp slowdown in Eurozone's business confidence, weaker Chinese growth and rising geopolitical concerns (including Brexit, Italian politics and the ongoing trade conflict between the US and China).

Last year will go down as the weakest year in the world's financial markets since the financial crisis of 2008. Most major stock exchanges ended up in declines (look in the table below), and widening yields in bond markets (yield gaps between government and corporate bonds) that generated headwinds for corporate bond investors. Meanwhile in 2018 we saw the strongest performance for many years both in terms of growth and earnings of companies, although the latter trend was driven by US tax cuts.

There is no doubt that the growth peak has passed. We see signs of deceleration in both the euro zone and China. Meanwhile such indicators as US purchasing managers' indices (PMI) are now pointing downward. Like most observers, we expect global growth to be a bit lower this year comparing to 2018, but this is not the same thing as predicting recession. **Annual growth remains at satisfactory level of around 3.5% globally**. This relatively strong picture is supported, for example, by solid US labor market statistics.

The question most people are asking is **whether growth will now slowly level off** and decelerate slightly, or **whether there will be a more significant deceleration** to clearly lower growth. If the former occurs and growth remains at reasonable levels, the stock market slide of recent months is probably an overreaction, and share prices should manage to rebound. Purely in valuation terms, such scenario is also supported by the fact that valuations have fallen to reasonable levels, especially if today's corporate earnings forecasts prove correct. On the other hand, if deceleration is sharper earnings forecast will need to be adjusted downward more than they have so far, a situation that suggests stock market downturns.

In recent weeks, various **positive signs have provided support to stock markets**. The US Federal Reserve (Fed) has signaled that it may consider raising its key interest rate more cautiously if growth and/or financial markets continue to weaken. And the tone has become more positive in the US-Chinese trade war, probably because both investor worries about economy and stock market downturns have been specifically attributed to the trade war. It is not in the interest of either side to contribute to such effects in the long term.

We are now entering the report season, with companies publishing their 2018 Q4 earnings. The fact that expectations (and forecasts) have already been lowered somewhat suggests that there is room for upside surprises. On the other hand, weaker order statistics and general worries about economy may cause companies to become more cautious in their own forecasts. We anticipate great volatility and major share price fluctuations in cases where earnings surprise investors, either on the upside or downside, but it is not self-evident that stock markets as a whole will necessarily experience large movements.

We are maintaining our slight overweighting risk assets such as equities, but given uncertainty, we are prepared to decrease our risk if the beginning of the report season justifies this.

Stock market indexes' performance (until 31 December 2018)

Region	Index	Currency	Performance							
			2018 Dec	2018 YTD	12 Months	2014	2015	2016	2017	2018
USA	S&P 500	USD	-9,2%	-6,2%	-6,2%	11,4%	-0,7%	9,5%	19,4%	-6,2%
Europe	MSCI EURO	EUR	-5,8%	-14,2%	-14,2%	2,3%	6,1%	1,7%	8,7%	-14,2%
Eastern Europe	MSCI EM Eastern Europe	USD	-2,8%	-8,3%	-8,3%	-40,0%	-8,1%	33,0%	12,9%	-8,3%
Asia	MSCI EM Asia	USD	-3,4%	-17,3%	-17,3%	2,5%	-11,8%	3,8%	40,1%	-17,3%
Latin America	MSCI EM Latin America	USD	-1,3%	-9,3%	-9,3%	-14,8%	-32,9%	27,9%	20,8%	-9,3%

Major events and expectations

US. Despite all that have happened over 2018 the **US had remained the bright spot in terms of growth**. This was proved by the latest data from **labor market** – in December it was created much more new jobs than it was expected. This shows that the labour market continues to create jobs and also deliver rising real wages, which lowers the risk of recession. However lately we also saw some **decline in tactical macroeconomic momentum**. The **ISM non-manufacturing and manufacturing indexes were much weaker than expected** in December. The drop was driven by a sizeable fall in the business activity index. On the positive side, the headline index was at the second highest level since 2005 in November. The weak ISM data have added to worries about a US growth slowdown but despite the drop in December the ISM manufacturing and non-manufacturing indices actually still point to solid GDP growth. As expected, the **Fed raised its key interest rates in December**. The strong US economy and inflation close to the Fed target caused its continued monetary policy normalisation to prevail despite the stock market slide and Trump's criticism of Fed rates hike. But **the Fed now is more dovish and signalling "only" two hikes this year, compared to the earlier-projected three**. The **US and China are back at** negotiations. It is in investors focus and it is interpreted as a positive sign. Both sides have good reasons to reach an agreement. In China, there is mounting evidence of an economic slowdown while President Trump is worried about negative stock market reactions. Talks are held between mid-level officials and are not expected to produce a deal. However, hopes are that talks will create conditions for starting higher-level negotiations later this month.

Europe. **Signs of weakness persists in Europe**. **Business surveys** in region have been **weakening all year** and in 2018 Q4 moved closer towards the level that does not indicate economic growth in nearest future. **Political tensions** likely contributed to a sharp fall in both the Italian and French business surveys. Germany appears to be slowing but still growing, at least for now. **Part of the reason** for the slowdown in Europe has been a sharp decline in the manufacturing sector's new export orders, which appears attributable – at least in part – to a **slowdown in demand from China**. But domestic political factors have also been a drag. The Italian government's confrontation with the European Union over its budget led to higher borrowing costs in Italy over the course of 2018. Meanwhile in France, protests led to widespread unrest in key cities and this appears to have significantly dented business confidence. Despite the slowdown in growth, the **European Central Bank (ECB) ended its quantitative easing programme** in December, noting the broad-based nature of the firming in wage growth across the region.

Brexit. On January 15 **British Parliament voted on the withdrawal agreement** prime minister T. May has negotiated with the European union. Outcome – **Mays proposal was defeated in parliament**. The loss was expected but not such a big one (432 voted against and 202 for). The government now has to produce a plan B. It is uncertain what the next step will be but one way is to hold a number of indicative votes in Parliament on various options (e.g. hard & soft Brexit, new referendum) to probe what Parliament really wants. **There is no support for a hard Brexit, the likelihood of softer alternatives are now increasing** and the time to reach an agreement with the EU needs to be increased.

Emerging markets. After the sell-off in **Emerging markets (EM)**, **equity market valuations have improved**. Also there are some tentative **signs of an underlying improvement in EM** macroeconomic and corporate earnings performance. The structural characteristics of EM are significantly better than in the past. There is also scope for improvement in macroeconomic performance in 2019, especially given policy easing in China. **China** has launched a new round of **fiscal stimulus** to be implemented in 2019. On the other hand, there are **risk factors to consider**. Aggregate EM growth momentum has weakened in 2018, with US-China trade tensions and further Fed policy tightening weighing on the outlook. Rising inflation in some economies limits the scope for monetary policy easing. Furthermore, although Chinese authorities have eased policy, it remains to be seen if this will provide enough support. Latest trade data from China provided much weaker results than expected – in December exports decreased by 4,4% (2% increase was expected) while imports decreased by 7,6% (4,5% increase was expected). This suggests that the impact of a trade conflict with the US is stronger than previously believed. Therefore, **further US-China negotiations will be very important and will be in investors' focus**.

The **reporting season has started** – 2018 Q4 corporate earnings started to be published. After many downward adjustments and profit warnings from biggest technology companies like Apple and Samsung, it will be exciting to see whether the market manages to end up meeting reasonable expectations. **Analysts' full-year earnings forecasts are for 6-10% increase**, while indications from **investors** are instead **3-4 percentage points lower**.

Overall, the **risks are probably higher now** than they have been during last 2-3 years. But there are risks both to the downside and the upside. **Things that could potentially help the global economy** in 2019 include Chinese stimulus, avoidance of a no-deal Brexit, a potential trade deal between the US and China and lower oil prices boosting growth and slowing the pace of interest rate rises.

Glossary

Terms used	Explanation
Fiscal policy	Fiscal policy relates to government spending and tax collection. Fiscal policy refers to the use of the government budget to influence economic activity. For example, when economic growth is slowing down, the government can step in and increase its spending to stimulate demand and economic growth. Or it can lower taxes to increase disposable income for people and businesses.
Gross Domestic Product (GDP)	The monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

Investment grade bonds, high yield bonds	Investment grade bonds – bonds (sovereign or corporate) with credit ratings that indicate a relatively low risk of default. High yield bonds – bonds (sovereign or corporate) with credit ratings that indicate a relatively higher risk of default than investment grade bonds. Because of the higher risk of default, these bonds pay a higher yield than investment grade bonds. Two main credit rating agencies Standard & Poor's (S&P) and Moody's, use different designations consisting of upper- and lower-case letters 'A' and 'B' to identify a bond's credit quality rating. S&P designations of 'AAA' and 'AA' (high credit quality) and 'A' and 'BBB' (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations ('BB', 'B', 'CCC', etc.) are considered low credit quality, and are commonly referred to as high yield or "junk bonds".
The Institute of Supply Management (ISM) manufacturing, non-manufacturing indexes	An index based on surveys of manufacturing/non-manufacturing firms by the Institute of Supply Management in US. An index with a score over 50 indicates that the industry is expanding, and a score below 50 shows a contraction. By monitoring ISM manufacturing and non-manufacturing indexes, investors are able to better understand national economic conditions. When this index is increasing, investors can assume that the stock markets should increase because of higher corporate profits. The opposite can be thought of the bond markets, which may decrease as indexes increases because of sensitivity to potential inflation.
Monetary policy	Monetary policy is the process by which the monetary authority (usually the central bank) of a country controls the supply of money (the size and rate of growth of the money supply), for the purpose of promoting economic growth and stability. For example, if the money supply grows too fast, the rate of inflation will increase and the economy will "overheat". If the growth of the money supply is slowed too much, then economic growth may also slow. The main tools to control money supply include open market operations (buying or selling assets), changing interest rates and changing reserve requirements for commercial banks.
Purchasing managers' indexes (PMIs)	An indicator of the economic health of the manufacturing sector. The PMI indexes are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. A PMI of more than 50 represents expansion of the manufacturing sector, compared to the previous month. A reading under 50 represents a contraction, while a reading at 50 indicates no change.
Yield	The income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.