STRATEGIST VIEW

The cyclical peak is behind us, be aware of the sentinels

The essential

Moving towards 2019, as the cycle further progresses, it is vital to assess the potential areas of excesses in the market and detect possible indicators that could signal when market conditions are starting to reach the tipping point. In our view, the key sentinels to watch, those which in the past have proved to be good leading indicators of market correction, are global liquidity, EPS revisions and momentum and risk-adjusted valuations.

We entered 2018 conscious that the asset reflation regime would have switched to a late financial cycle in H1, with central banks finally recalibrating their monetary policy stance and the global environment becoming progressively more challenging. As a consequence, we adjusted allocations to prepare for less liquidity, higher volatility and, eventually, gradually lifting interest rates. Our rationale to investing was risk rotation and progressive mitigation, however, at the end of Q1, rising tensions on global trade and the US's unexpected fiscal supercharging shifted our attention from inflation expectations and rates to the global trade slowdown and its spillover to global growth, EM in particular. At the same time, in the US the fiscal policy measures supported further profit expansion and eventually boosted the US financial market. The USD strenghend, treasury yields and oil prices increased, putting pressure on EM.

We note that excesses have been accumulating over time amid liquidity abundance, while financial imbalances continued to build up. We now see a potentially dangerous configuration of financial forces related to the late credit cycle deterioration, a stronger USD, an elevated leverage (both in public and private sectors, with different distributions in DM and EM between the two sectors) and less supportive equity and credit valuations. Tariffs and raising trade barriers, tighter labour market conditions and the consequently higher unit labour cost, and the higher producer price index (higher oil prices) are starting to weigh on profit margins, more so than on headline inflation. In the EM, financial conditions have broadly tightened. The intensification of domestic political concerns in some cases, a stronger USD and higher US rates generated capital outflows (for the time being these are largely contained in the fixed income space and more evident in equities). This could prove to be potentially risky for those countries that have large borrowings without adequate capital buffers (Poland, Chile, South Africa, Turkey).

Key sentinels to watch in 2019

Looking ahead, investors should acknowledge that the longer the late cycle and the tighter the financial conditions, given the current level of valuations, the higher the risk of a material market correction generated by financial market turmoil, even though economic conditions remain sound. In fact, financial volatility, mainly inspired by the poor state of global politics, has shaken investors' spirits but has not yet destabilised economic and macro fundamentals.

> "In our view, financial risk dominates economic risk."

As happened in the last two cycles, **we think that financial risk dominates economic risk**. Therefore, it is crucial to monitor financial and financing conditions along the profit cycle evolution. In fact, in this late phase of the cycle, asset prices will move on fundamentals rather than on abundant liquidity, as has been the case over the last years.

In our view, the key sentinels to watch, those which in the past proved to be good leading indicators of market correction, are global liquidity, EPS revisions and momentum and risk-adjusted valuations.

1 - Global liquidity

We think real rates, credit spreads and the trade-weighted US dollar index are, broadly, good trackers of global liquidity conditions. In particular, an appreciation of the USD is a strain on EM external credit conditions, which could propagate to EM FX first but also potentially create global stress in the financial markets. At the same time, there has been a preponderance of global rates increases in the EM on a gradually tighter Fed policy, which together with trade concerns and some idiosyncratic stories (ie. Argentina, Turkey, Brazil, South Africa), has resulted in much tighter financial conditions in EM. In the DM, the US Treasury moves in real terms did not point to higher inflation expectations (structurally anchored in our expectations) and financial conditions remain broadly easy. We expect that as central banks continue in their normalisation process global liquidity will tighten. At the same time, as the Fed is probably at the end of the tightening cycle, we could expect less pressure on EM.

2 - EPS: revisions and momentum

Profit cycle paves the way for risky assets to lift. As we do not expect multiples (i.e. price/earnings ratio) to expand as was the case during the asset reflation regime (2012H2 - 2018H1), we believe the equity markets will eventually have to move on fundamentals. We can also expect higher volatility related to trade tensions and technical factors (i.e. systematic trading, unwinding of risk positions) that could exacerbate asset price movements. We expect negative revisions and some slowdown in EPS momentum to occur concurrently with a late financial cycle regime. At the time of writing, EPS revisions had already turned negative everywhere except the US due to trade and currency tensions. We will continue to monitor EPS revisions and top line guidance to capture how the corporate sector prices in higher tariffs and likely higher unit labour costs (another variable worth monitoring).

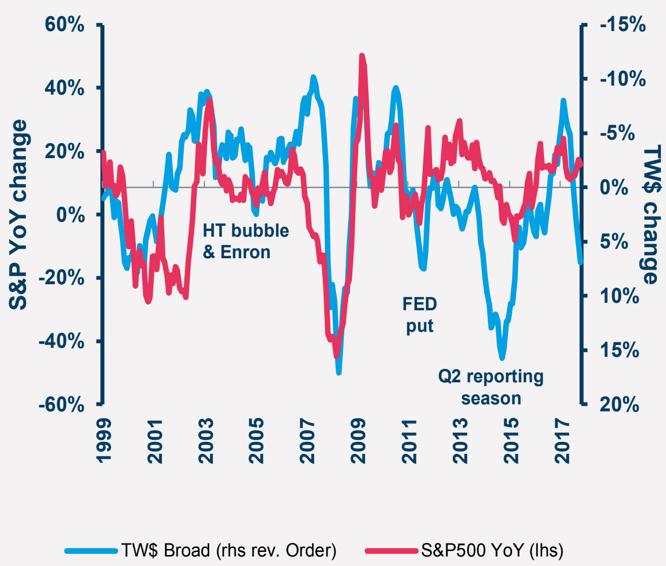
This will be particularly relevant for the US. Having said that, while we see a slowdown in global EPS growth in line with a late cycle, we maintain a constructive expectation at almost a 10% global EPS forecast for 2019. We are conscious that risks are on the downside as trade and currency conflicts raise material costs, which will likely crimp profit margins. In the remainder of this year, we might observe a temporary rebound in Europe (where the issues remain primarily political) and possibly in the EM, if trade tensions fade away. However, the convergence of profits is unlikely to lead to marked geographical recommendations in 2019.

3 - Risk-adjusted valuations

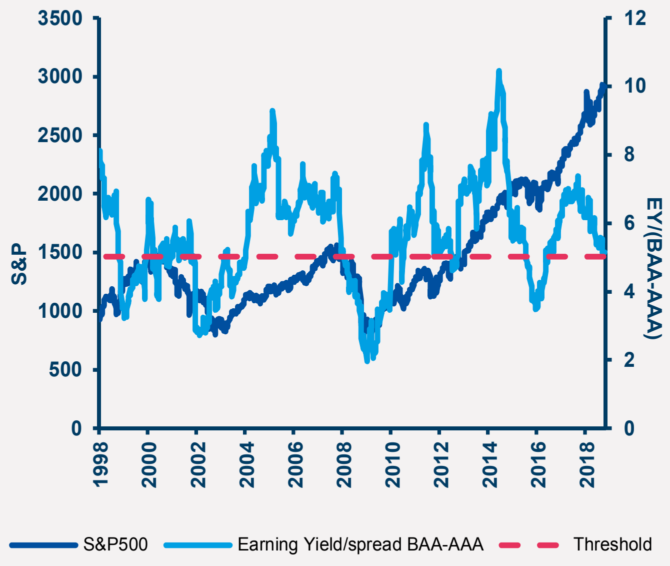
F**ocus on earnings yield/Moody's spread BAA – AAA indicator**. Credit spreads are a function of leverage and maturity or funding mismatch. As such, a spread widening is symptomatic of financial vulnerabilities building up. Within this framework, we believe the Moody's spread BAA – AAA is a good anticipator of a risky asset downturn. In this regard we have not yet reached a tipping point, but since March we have been progressively moving towards its alert threshold (=100). At the same time, we compare the Moody's spread (or its proxy for regions other than the USA) to the earnings yields. This valuation gap is risk-adjusted to discount the equity market, implicitly considering corporate leverage (high), implied volatilities (on the rise) and default rates (historically low).

To sum up, our sentinels have not reached the tipping point yet, but we are not far from it. In our view, the best strategy is to stick to a modest overweight to equities, but start rotating portfolios towards a more granular allocation on both defensive sectors and quality stocks, to increase portfolios resilience. In the second half of the 2019, when we expect the US profit cycle to slow, we could also expect further adjustments, to reduce the overall risk of portfolios.

1/ **Trade-weighted US dollar index vs S&P500**



2/ **Earnings yield/ Moody's spread vs S&P500**



Source: Amundi Research, Bloomberg. Data as of 15 October 2018

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