STONEHAGE FLEMING

5 April 2019

Dear Equity Client

GLOBAL EQUITIES – 1st Quarter 2019

The new year started off with a strong first quarter. The MSCI World Index (including Emerging Markets and dividends) appreciated by +12.2% (in US$ terms). This is the best first quarter return for over twenty years. The same point can be made for the S&P 500 index. In its case, interestingly, there have been only six other occasions with better first quarter results since the Great Depression ended in 1939.

This strong recovery occurred off the low base of the weak last quarter of 2018. The market realised that especially the December sell-off was more tactical than based on fundamentals and, despite the moderation in global economic expansion, the outlook remains constructive for equity investing. Astute investors utilised the good buying opportunities well.

All three months delivered positive results for both the above indices. This is a relatively infrequent event despite the first quarter historically being a positive one on average. In the case of the S&P 500 this has happened in less than a third of the number of years since 1950. Strikingly, in all but one year (1987) the remaining three quarters of these years also delivered positive overall results (on average +10% returns).

Against this positive backdrop, financial headlines are littered with fears of the US yield curve inverting and the implied risks of an imminent US recession. Some perspectives in this context may be of value. The fact that the yield curve has inverted (and subsequently has reverted back) reflects the drop of long rates (10-years or longer) below the very short rates (up to 3 months) rather than below the more fundamentally based 2-year rate levels at the shorter end. Whilst we do not perceive yield curves based on very short rates as fundamentally too well founded, an analysis of a number of such curves nevertheless indicates the possibility of a US recession about 24 months in the future.

The more fundamentally based yield curves are in the process of flattening but, importantly, have not yet inverted. If they flatten and invert on a sustained basis, it may signal the next US recession to be about 23 months away (considering data around the three most recent recessions). The S&P 500 index has historically peaked shortly before the recessions started, with an average 4-month lead time over the last five recessions.

We studied the average S&P 500 return levels after 12, 18 and 24-month periods following the more fundamental 2/10-year curve inversions. They were +16%, +20% and +20% respectively (in $-terms, excluding dividends). The lowest individual figure was -2% (18 months after the 1980 inversion event).

We do not attempt to forecast equity markets but take our duty seriously to always consider the risks of staying invested. With a continuing constructive global economic backdrop, the current headlines of yield curve inversion do not yet tempt us onto the proverbial side-lines.

We appreciate all your support.

With kind regards

Gerrit Smit
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