That Was Fun, Now What?
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Following one of the worst year-end routs for risk assets in a long while in the fourth quarter of 2018, markets rebounded tremendously to start 2019, returning most equity markets to levels roughly in line with where they were last September. As of early April 2019, both the S&P 500 Index and the S&P/TSX Composite Index were only a couple of percent below their all-time highs. Signature's view from late last year that the sell-off was overdone and not warranted by fundamentals has been vindicated, and our funds have rebounded nicely to commence the year. The questions we need to ask now are: First, why have markets rebounded so strongly, and second – and more importantly – what now?

Why?
I have argued that the sell-off in the fourth quarter was a major overreaction to the perceived fears that the U.S. Federal Reserve's actions and the U.S. trade war with China would drive the U.S. into a recession. The key catalysts that have served to quell the market's fears and drive the rebound in asset prices in the first quarter were threefold.

First, there has been a clear pivot in the Fed's reaction function to a more dovish stance from both a cyclical and a structural perspective. Cyclically, the Fed has clearly signaled that it is done with rate hikes for now, and potentially for the cycle, and that it will begin to taper and then end its balance sheet reduction sooner than originally anticipated. At the same time, the central bank has announced a structural review over the course of 2019 into how it will conduct monetary policy under a scenario in which interest rates are expected to remain near zero and deflation remains a more serious threat than inflation. While the outcome of the review will not be known for some time, it implies that the Fed will be biased to a far more dovish stance so long as rates and inflation remain structurally lower than otherwise desired. The Fed is expected to tolerate inflation overshooting the 2% target in the future to counter periods of undershooting, with the implication that it will be less likely, or move more slowly, to tighten monetary policy as inflation picks up. This would have the effect of biasing rates, particularly real rates, lower in the future versus the current policy reaction function. If fears of a hawkish Fed helped to drive markets lower in the fourth quarter, Chairman Powell clearly put an end to that notion in the first quarter.

A second catalyst has been increasingly positive signals from the White House that the Trump administration is close to agreeing to a trade deal with China. An easing of trade tensions with China would be an unambiguously positive development, although it is important to stress that while there may be a trade truce, the broader U.S.-China geopolitical tensions that include 5G

and other technology, intellectual property, etc. are not going away. The rise of China as a challenge to the U.S. hegemon, how it plays out and is managed is arguably the single most important geopolitical dynamic of our time. This will continue to evolve over the coming decade.

The third catalyst that helped restore market confidence in the first quarter was the emerging signs of stability in China's economy. The headwinds from credit tightening and trade fears have abated with ongoing incremental stimulus, both fiscal and monetary, to prevent a more significant slowdown in China. As the world's largest driver of global growth, signs of recovery and stabilization in China are critical to stabilizing global growth expectations. It is a key plank in our increased optimism towards emerging markets, where we have increased our exposure, and it should also help to underpin stability in the Eurozone, where the slowdown has been driven significantly from slower external demand. I cannot overemphasize the importance of understanding developments within China for investors in all asset classes. China is the world's second largest economy at roughly 16% of global GDP (Japan is third at only 6%!), and with growth of over 6% per year it is by far the world's biggest growth engine, followed in the distance by the U.S. This is why Signature continues to build on the expertise of our Hong Kong office.

OK, so what now?

Our 2019 outlook piece was titled Monetary Policy Normalization: Mission Accomplished, and as mentioned above, much of what we forecast has already played out in spades during the first quarter alone. In that 2019 outlook I forecast double-digit equity market returns for the year. With global equity markets up roughly 12% in the first quarter alone, the question may be: what now?

Although I don't believe that the rally in risk assets is necessarily over, the best returns for the year may be behind us. I still expect modestly positive returns for equities and credit from current levels, albeit with some bumps and pullbacks along the way. Markets should return to a one step forward, pull back, and grind forward environment. The rationale for higher markets from here rests on the previously outlined catalysts that helped spark the risk rally also having longer-term positive implications for both the underlying economic and market fundamentals.

First and foremost is the implication from the Fed's pivot and apparent structural tack to a more dovish reaction function. It means not only that interest rate increases are done, but also that the Fed now has an asymmetrical reaction function. This is hugely significant (at least to the monetary policy nerds among us)! We believe that the Fed will overreact to weaker data by moving swiftly to cut rates to avert a buildup of deflationary expectations, and will underreact to stronger data, preferring to not raise rates and allowing inflation to overshoot the 2% target to

offset a decade of undershooting the target. Add to this the fact that rates in both the Eurozone and Japan are stapled to ZERO, or lower, and their gravitational pull is helping prevent the U.S. from raising rates beyond current levels. It seems clear that lower for longer rates are here for the foreseeable future.

Fundamentally, the slowing of the U.S. economy in the fourth quarter of 2018 was another clear signal that raising rates further would be a headwind for growth. With no meaningful signs of inflation picking up, a big component of the structural review of how the Fed should conduct monetary policy going forward is a recognition that deflationary pressures could result in interest rates regularly hitting the zero lower-boundary in the future, hence the need to both evaluate new tools and be less concerned with initially overshooting of the 2% inflation target. With a structurally more dovish Fed far less likely to overtighten, then its action in the first quarter of 2019 has clearly reduced the probability that the Fed would tip the U.S. economy into recession.

While there are clear signs that the U.S. economy is slowing down, we do not expect to see a recession in the coming 12 months and I believe the U.S. will continue to post above-potential growth for the year. We may be close to the trough of the current slowdown, and by summer it should become evident in the data. Already, lower rates have put a bit more of a bid into housing-related industries. The 50 basis-point rally in the 30-year Treasury yield and an almost 1% drop in fixed 30-year mortgage rates should help spur the U.S. housing market and act to stabilize the slowdown from the declining fiscal boost related to the government's 2018 tax and spending package.

With central bank tightening on hold for now, China's economy showing early signs of stabilizing and an expected easing of U.S.-China trade tensions, we believe the global economy should do better than feared in the coming quarters. Growth will be slower than last year as both the U.S. and China are slowing, but we expect both economies to stabilize and grow at above-potential levels of around 6.2% in China and above 2% in the U.S. This would be a very constructive outcome versus those fearing a hard landing in China and a recession in the U.S. As these two countries account for 40% of the global economy and most of the growth, if we are correct on our slower for longer economic cycle thesis they will, in turn, support growth in most of the rest of the world.

Investment implications: the yield desert

Low growth plus low rates bodes well for risk assets. Our base case sees the U.S. 10-year Treasury yield remaining below 3% (currently it is around 2.5%), while Canada's 10-year is yielding around a mere 1.7%. This is as good as it gets in rate-land and implies that real interest rates will remain effectively ZERO (or at least sub 1%) for the foreseeable future. Indeed, there is currently over $10 trillion of debt globally with a negative yield. Welcome to the yield desert! There is no real (after inflation) return to holding most developed market government bonds. For investors and savers this remains an incredibly challenging backdrop. It is hard to live off a near 0% return on your capital, yet that is the risk-free return available to investors today. It is not about to change. If you want a positive real return on your capital, you must be willing and ready to invest in risky assets and be able to understand and actively manage that multi-asset risk. Partnering with an active manager designed and equipped to manage multi-asset investment risks, such as Signature, can be beneficial.

The structurally low risk-free rates, while a major challenge for investors and savers, also inform our attractive outlook for risk assets. The U.S. yield curve is the reference discount rate from which most asset globally are priced. If U.S. rates have peaked in the current cycle, then the thirst for higher yields from global investors will drive them into other assets with higher yields. High-yield bonds, currently yielding around 6.4%, look pretty attractive to us. Global equities at a P/E ratio of 15 are offering an earnings yield of 6.5%, once again pretty attractive when government 10-year bonds offer only around 2.5% in the U.S. and 1.7% in Canada. For a Japanese or European financial institution getting a negative yield on their government bonds, the need to shift assets to higher-yielding sources becomes critical. As the penny drops that the zero-rate world is not temporary it will also continue to support a flow of yield-seeking investors away from the government bond yield desert and toward the dessert buffet of broader higher-yielding risk assets globally. So long as the global economy slows but does not tip over, as is our base case, institutional and retail investors will be forced to return to risk assets.

Source: Bloomberg L.P.

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