# 50 shades of black.

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Author(s)
Didier Saint-Georges

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Our take on financial markets for 2019 hasn't changed: "A mere change of calendar year in no way signals the end of our three-way collision scenario" (involving concurrent monetary, economic and political shifts). We argued that, as before, "considerable caution [was] called for", while also mentioning "upside opportunities that shouldn't be left unexploited".

Financial markets have a habit of gyrating around basic trends, with what is often herd behaviour driving investors from caution to ambition, or from denial to high hopes. Such intermediate movements can even pick up sufficient steam to make it worthwhile for active fund managers to take advantage of them – as long as they don't stray off course in the process.

## The global economic slowdown has become both synchronised and unquestionable

As 2019 gets under way, even the most bullish economists feel compelled to admit that the cyclical slowdown is now broad-based. The leading indicators point downward, with all major world regions contributing to the decline.

## There is very little space for stimulus policies

It's hard to imagine the ECB rushing to the rescue of Europe's economy just when it has wound up its asset purchase programme. Nor will there be a great deal of help forthcoming on the fiscal front, with Italy and France constrained by deficits that are already slipping off-limits. In China as well, the government has only limited room to manoeuvre. Meanwhile, there is no resolution in sight for the shutdown hobbling the US government. The only hope left is that the Fed will opt for a softer monetary policy.

## Can the Fed kick-start financial markets again?

Fed Chairman Jay Powell created quite a surprise with his comments on 4 January. Rather than depict the run-off of the Fed's balance sheet as a process well under way and non-negotiable, he signalled a willingness to adjust the pace. More generally, he mentioned that market risk would be factored into his view of what monetary policy is appropriate. If a return by the Fed to greater "flexibility" were to occur concurrently with progress in trade negotiations between the US and China, the equity market sell-off at the end of 2018 could well be followed by a significant rally.

## Should that lead us to expect a lasting market recovery?

Jay Powell hinted that he might be more flexible on policy, but he made no commitment to do so. In fact, he didn't seem even mildly convinced that his institution's policies had contributed to market instability. In addition, US economic indicators are themselves sensitive to the direction in which markets are moving. Last of all, the Fed's dashboard for the US economy still shows full employment and 2% inflation, which is in line with the central bank's statutory objectives. In a word, there are no compelling grounds today for the Fed to "capitulate" on monetary policy.

## To sum things up, the underlying issues still haven't been addressed.

As the new year gets going, we will most likely see downward revisions to corporate earnings estimates, both in Europe and in the United States. The gradual rise in wages is beginning to eat into profit margins, which suggests that disappointing corporate earnings are in the offing – particularly as the economic slowdown discussed above gains traction. At the same time, there is nothing forcing the Fed as yet to abandon its goal of normalising monetary policy. As for the European Central Bank, it has little ammunition left. A turning-point in monetary policy could conceivably occur in 2019, but would require greater pressure from financial markets or the real economy.

A "technical" market rebound is a distinct possibility over the coming weeks. Depending on political developments, it could even take on enough scope to be worth "playing". Quality cyclical stocks, many of them badly battered over the past few months, clearly offer the best vehicles for gaining exposure to such bull forces. But even if events bear out the murmurs of a market recovery, it would likely be more of a temporary rebound than a genuine reversal of the trend that got going close to a year ago. Such a rebound should be faded by prudent investors.

Source: Bloomberg, 31/12/2018

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