MOMENT OF TRUTH Earth, Wind & Fire, 1971

Corporate earnings season for the second quarter of 2019 has begun and will kick into high gear over the next two weeks. Following a significant turn in monetary policy and continuing geopolitical risks such as a trade war and tensions with Iran, investors seem to have a fairly subdued assessment of earnings results. The mood has changed notably since the 3Q 2018 earnings season, when aggregate earnings-per-share (EPS) growth for firms in the S&P 500 was 27% year-on-year, beating lofty expectations. Despite the current dour mood, with Q2 2019 EPS growth for US firms expected to decline by 2% compared to a year ago, this earnings season is an important one to follow, and we are closely monitoring this moment of truth for an indication of the likely direction ahead for the economy and asset returns.

WHAT'S NEXT?

Corporate profitability reveals much about the economy

As investors know, the global economy has slowed significantly from its highs in early 2018. By our measures, growth hit potential levels in the early part of this year and over the last few months has shown signs of stabilisation. However, any coincident measure of economic activity is imperfect, and the earnings season provides an additional point of triangulation to confirm how deep the slowdown has been and its future direction.

Looking at sales growth, we see a clear peak for US and Eurozone firms in mid-2018. Since that time, sales growth has slowed for S&P 500 companies toward the post-2009 average of 5%, while sales for firms in the Euro Stoxx 50 have fallen from their 2017-2018 levels. Given this context, a key question is to what extent the stabilisation in growth has helped to support corporate sales growth. For much of 2018, firms in the US and, to a lesser extent, Europe had been able to combat slowing sales growth with margin expansion. But margins are showing signs of flattening in the US and contraction in Europe as many of the tailwinds that had supported margin growth – globalisation, consolidation, moderate wage pressures, and lower taxes to name a few – are fading. The logical result is that firms' bottom lines have been under pressure, and earnings growth has declined meaningfully. Firms in the S&P 500 are now seeing EPS expand by about 7% in aggregate, whereas EPS for firms in the Euro Stoxx 50 is contracting. Will this trend continue, or will we see a stabilisation and perhaps a modest recovery in earnings growth?

Declining profitability is a useful presage of oncoming recession: as firms contend with lower income and pressures on their free cash, they typically cut back spending and hiring. These cutbacks, in turn, negatively impact other businesses, whose sales take the hit, and households, who lose their jobs or see their take-home pay reduced. And the cycle continues, with sales and profitability falling further, causing the slowdown to deepen and transform into a recession. Indeed, declining profitability preceded nearly every US recession. To be clear, we do not believe we are at this point now, but we will be tracking this earnings season closely to see how resilient profits have been in the face of the economic slowdown thus far.

Importantly, the reporting season should also give a clearer picture into how tariffs and the trade war more broadly are impacting corporates. We have seen the impact of trade tensions on global trade, but so far it seems much of the increase in imported goods' prices has been absorbed by margins (see "You Spin Me Round", 28 May 2019). Can firms continue to bear these costs, and how are they adapting their investment plans given the uncertainty they face? These and other second-round impacts of tariffs and trade tensions are very difficult to quantify, but we should get a better sense when firms hold earnings calls over the next couple of weeks.

Pay close attention to forward guidance

There is a lagged affect in financial markets to a turn in earnings growth. Typically, equities continue to rally higher as investors extrapolate the recent past forward. And even though earnings growth moderates, it remains strong, supporting valuations and the case for a long equities bias. Corporate credit also reaps these benefits with attractive yields relative to sovereign bonds and de minimis probability of default given strong earnings. Once the turn in earnings growth becomes clearer and its decline becomes more entrenched, investors reprice their expectations for future earnings growth, typically from much too optimistic levels to much too pessimistic. They reduce the growth bias of their portfolios and increase their allocation to defensive sectors and hedging assets, such as sovereign nominal bonds that have typically underperformed equities and credit and now offer relatively attractive yields (though in the current context, nominal yields are already quite low). This shift aligns yields closer to the "Fed model," narrows the relative performance gap between equities/credit and bonds, and eventually reverses it months after the turn in earnings growth. Clearly, easier monetary policy can stimulate demand and ease financing costs, supporting earnings growth and outperformance of growth assets, but lower yields are not always a panacea for a deteriorating operating environment.

Thus, declining earnings growth has an important bearing on the relative performance of equities and credit versus nominal bonds. Credit tends to have a longer lag than equities since earnings growth needs to decline sufficiently to cause investors to reassess their assessment of firms' probability of default. But historically this relationship takes between six to twelve months to transpire. As EPS growth in the US peaked in late 2018 and valuations there are high, the forward guidance will be important.

If it is poor, then a quick recovery in earnings becomes less likely, as does the prospect of a continuation in the outperformance of equities/credit since the beginning of the year. And if the negative guidance extends beyond export-focused firms to the broader universe, concerns about trade contagion and a deeper slowdown will grow. We do not believe these risks are sufficient to adapt the portfolio to a more defensive posture, but it does motivate our relatively light overweight in equities and more positive view on credit.

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STRATEGY BEHAVIOUR

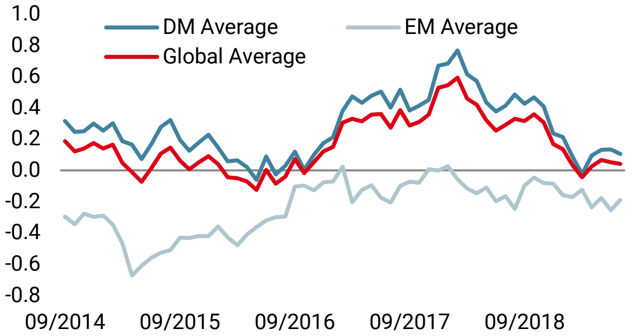
Our medium-term views remain cautious, and we prefer to get exposure to growth via high yield corporate credit. We are also complementing our modest equity exposure with options to protect the portfolio in the case of equity drawdowns.

PERFORMANCE REVIEW

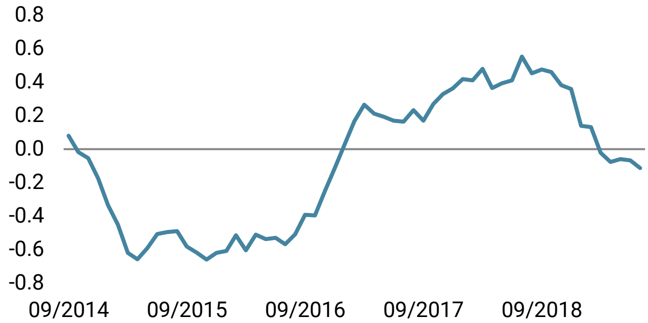
Over the month of July thus far, the Uni-Global – Cross Asset Navigator fund is up 0.8% versus 0.8% for the MSCI AC World Index and 0.4% for the Barclays Global Aggregate (USD hedged). Year-to-date, the Uni-Global – Cross Asset Navigator has returned 8.0% versus 17.1% for the MSCI AC World index, while the Barclays Global Aggregate (USD hedged) index is up 6.4%.

UNIGESTION NOWCASTING

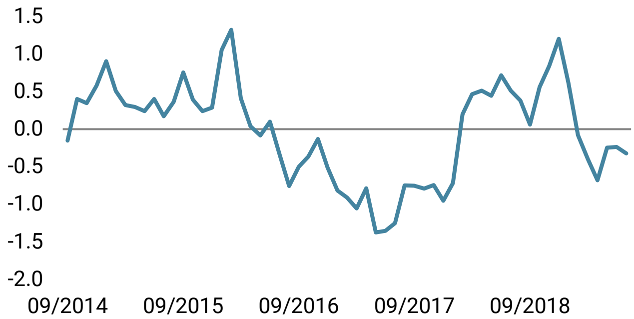
World Growth Nowcaster



World Inflation Nowcaster



Market Stress Nowcaster



Weekly Change

- Our world Growth Nowcaster remained unchanged this week, as an improvement in India was offset by broad weakness elsewhere, particularly Brazil.
- Our world Inflation Nowcaster decreased further this week, mainly driven by continued disinflationary prospects in the US.
- Market stress picked up modestly this week, as tighter liquidity conditions pushed up our indicator.

Sources: Unigestion. Bloomberg, as of 19 July 2019.

NAVIGATOR FUND PERFORMANCE

Performance, net of fees	2018	2017	2016	2015
Navigator (inception 15 December 2014)	-3.6%	10.6%	4.4%	-2.2%

Past performance is no guide to the future, the value of investments can fall as well as rise, there is no guarantee that your initial investment will be returned.

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