Note from London & Capital's Chief Investment Officer, Pau Morilla-Giner.

Heading for recession or long slowdown?

Recent market events are shaping our outlook:

- The value of global sovereign bonds with negative yields has doubled since last October to $11 trillion in May (only $1 trillion below the all-time high registered in mid-2016). And all this while the US economy is 'booming'…
- The US Treasury 30-year bond yield has breached its 2017 and 2018 lows. The yield on the long bond is trading only 0.47% above the mid-2016 bottom and is down a huge 0.9% from its October 2018 peak
- Capital flight into US bonds has accelerated: every bond sector ETF – except high-yield – has surged to a new high in terms of assets
- Metal and mining equities (XME) have plunged to new lows
- The export-heavy KOSPI (South Korea) has given up nearly all the gains achieved in the January-April rally
- A sell-off in copper is testing the important 2016 uptrend-line

A few months ago I drew attention to the fact that the US yield curve had inverted – a rare occurrence which in the past has been a predictor of recessions. At the time I was sanguine about its significance, and soon after, the curve reinverted to its more normal configuration.

The yield curve has inverted again, and it is now much harder to ignore this renewed, downward direction of travel.

When the US Treasury 10-year yield is lower than the 3-month yield, it effectively means that investors are betting on rates being lower in ten years' time than they are now. Since they are already very low, that is a powerful deflationary signal.

Justification for this exceptionally gloomy view is not hard to find: the shocking trade attacks on Mexico and India – two very important US allies – within days of each other are clear signs that Trump has decided to take the gamble of latter-day protectionism and is prepared to go down a slippery slope.

If the US economy was to slow – and it already is, irrespective of the trade issues – Trump will respond by becoming even more protectionist.

The great question of our age is how the rest of the world will respond. Will they maintain open trade and multilateral agreements, or will we end up in a situation similar to the 1930s and 'beggar-thy-neighbor' policies?

Why does Trump sabotage his trade deals?

Is it about merely levelling the playing field and clamping down on intellectual property theft – in which case there is a deal to be done – or is it at its root about containing and decoupling from China, after more than 40 years of progressive integration?

I suspect that as investigations into his conduct increase (these include matters relating to Deutsche Bank, tax returns, involvement with Russia, obstruction of justice, impeachment proceedings etc.), he will shift the narrative away from his problems to the bogeyman – whether it be China, the EU or Mexico. **Dangerously, he may believe drilling down on protectionism as a way to win in 2020.**

What about Europe?

The capital glut is alive and well. The global savings rate has reached a record of 26.8% of GDP, according to the World Bank. This is even higher than in 2007. The exact causes have changed, among which is the fact that China is no longer building FX reserves, but the tide is just as powerful:

- Modern corporations no longer need as much capital as in the past: Apple, Google, Qualcomm, Oracle, and Facebook are money hoarders on a grand scale;
- Ageing nations borrow less; and
- The Eurozone's workforce is shrinking at the same pace as Japan.

The result is too much capital sloshing around with nowhere to go, so one of the only ways for governments to stimulate economies will be to smash into the limits of the 'lower zero bound': wide increases in public spending or outright 'monetisation' of deficits.

In this brave new world, the Eurozone will not do very well, as it remains hostage to Germany's austerity. Europe's government bond markets seem to agree: the 10-year German Bund has dropped below Japanese levels to -0.1%. France and Sweden can borrow at negative rates all the way out to seven years, Belgium and Slovakia to six, Spain to five, Portugal to four and Bulgaria to three. **You pay to park your money in the Balkans!**

Meanwhile bond yields are still not low enough for Italy. Its 10-year yield is stuck at 2.7%, while its debt service costs are 5.3% of GDP and economic growth is basically zero. Nominal GDP dynamics are unworkable. The next global recession will expose this.

Conclusion: the Eurozone is now in the grip of full 'Japanisation'. Except that it is not Japan – it is not a cohesive nation state with a joined-up central bank and finance ministry operating in tandem.

Macro Summary

- **Structural deflation is now being compounded by a cyclical deflation shock as global trade contracts.**
- We are heading for a **prolonged stagnation, driven as much by political uncertainty as underlying fundamentals.**
- The yield curve seems to be looking beyond the current cycle and is already anticipating that the next move from the Fed will be to cut rates.
- While a US recession is not around the corner, **in a slow-growth environment, everything is much more vulnerable. There is a high risk of profit recession or indigestion for the US equity market.**

Asset Allocation Implications

- The combination of **structural deflation and cyclical slowdown means that we are entering a decisive phase for investors.**
- This new phase – and the monetary and fiscal policy stances that it will bring – will remain much **more bond-friendly than equity-friendly .**
- **Higher cash positions are advisable. A portion of this cash should be in gold, which is gathering momentum as the strongest currency in the world.**
- We recommend a deep underweight in equities, and equity exposures should target areas that are both defensive and that tend to do well in a world where USD real rates are about to start moving down quicker than many expect. **STAR-type equities look like the perfect place to shelter.**
- While friendlier to bonds than equities, at some point the **macro and policy environment will soon separate good bonds from bad bonds.**
- **Overall, investors must be as selective, cautious and alert as they have been since the Great Financial Crisis 10 Years ago.**