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An inverted yield curve, a pig that can fly and the tail end of a bull market:

Three big market themes happening right now, what to make of them and what to do next.

Part 2: China's Year of the Pig – Is the economy ready to fly again?

Will the U.S. be aligned or at odds with China's economic and market outlook?

If you haven't read Part 1 of this 3-part series, we suggest you start there.

Part 1: The inverted yield curve – It happened – the dreaded 'inverted yield curve'.
Late in March, financial media lit up with word the yield curve had 'inverted'.
Market pundits hit the air to issue dire warnings for days ahead.
So, what's the big deal?

COMING SOON

Part 3: Riding the backside of the U.S. bull market – It ain't over 'til it's over!

All data is current as of April 15, 2019, unless otherwise noted.

Publishing date: May 2, 2019

This is China's Year of the Pig, symbolizing good fortune and prosperity. We see a lot of reasons why this is the year the Chinese economy will once again take flight, leading to our play on the idiom "when pigs fly". In fact, we believe this year will mark the third time since 2009 a rebounding Chinese economy will reinvigorate global growth and trade and lift equity markets and bond yields during the latter half of 2019. In addition to a recovery in China, we expect the U.S. economy to improve during the same period.

China's pro-growth moves

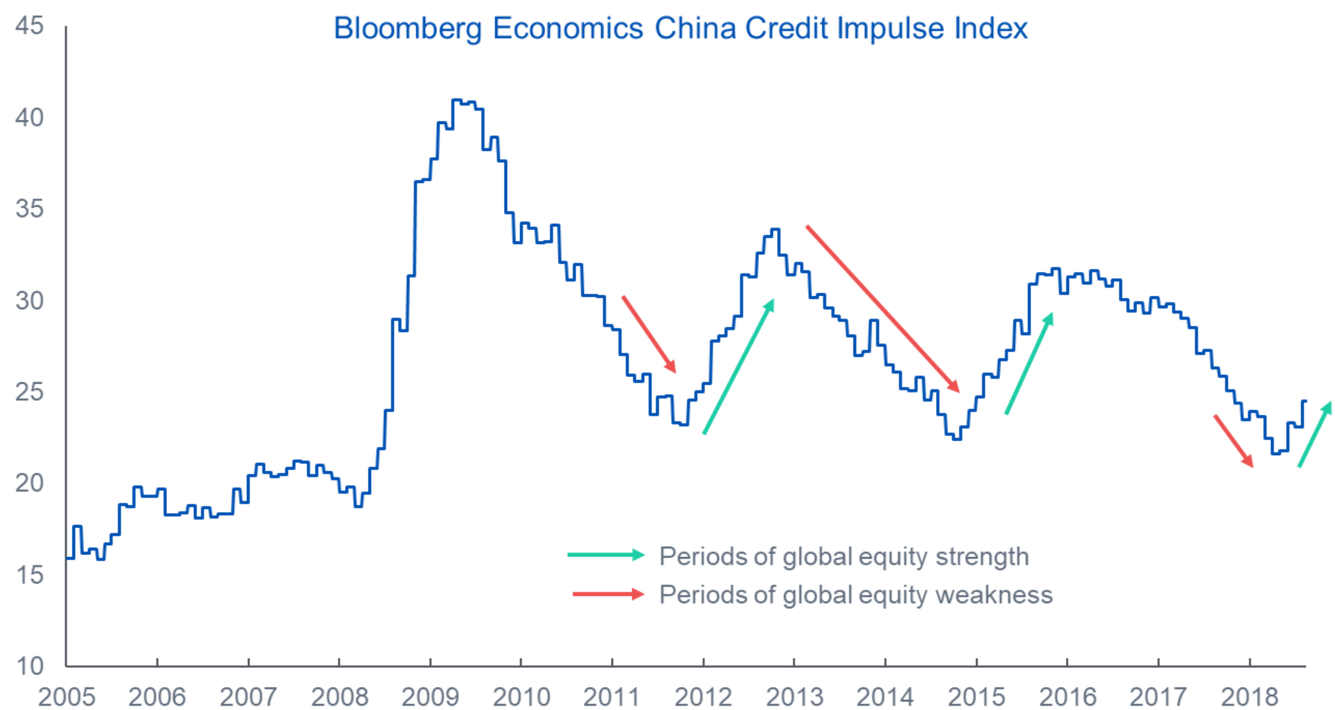
After three years of China reigning in credit expansion, bringing about a slowing domestic economy that has spread to the rest of Asia and Europe, they've shifted into pro-growth mode – embarking on a substantial set of reflation and economic growth policies by:

- Reducing the interbank lending rate to extremely low levels;
- Cutting banks' required reserve ratios five times since January 2018 (four in 2018, one in 2019) for a total reduction of 3.5%;
- Reducing taxes (on sales taxes, personal income and small and medium enterprise business taxes) totaling 2 trillion Rmb or 2% of GDP;
- Increasing government fiscal spending;
- Front-loading special construction bonds to increase the amount allowed for 2019 and allowing local government bond issuance to start earlier;
- Creating a January-February surge in overall bank lending and shadow banking, implying less restrictions and less regulatory clampdown on shadow lending;
- Announcing a new central bank program aimed at strengthening the banking system (whereby banks can swap perpetual bonds with the central bank to improve their capital buffer) as a form of quantitative easing.

Unfortunately, these policies take time to work their magic on the economy and markets, during which time a détente or deal between the U.S. and China on trade would also help to reignite economic growth. Every global expansion since the financial crisis has come in concert with a reflating Chinese economy (see Exhibit 2.1).

2.1 | China's Credit Impulse

The post-financial crisis global equity cycle has been heavily influenced by China's flow of credit



Source: Bloomberg: April 15, 2019.

With North America, Europe and Japan all showing signs of slowing, the timing couldn't be better for China's economy to exit its slowdown sooner rather than later. We don't expect the timing to line up conveniently and 2019 may be subject to bouts of fear that the global economy is slowing.

U.S. economic growth issues are starting to fade

Coupled with the China slowdown is a U.S. economy whose growth rate has moderated from the high-flying days of 2018. A significant portion of this lower U.S. growth profile is a result of two issues, both of which we believe are fading:

- Higher borrowing costs; and,
- The normal U.S. inventory cycle that's likely been exacerbated by trade frictions.

Higher borrowing costs have the intended effect of slowing overall household consumption, especially for big ticket items, such as housing and automobiles. Higher borrowing costs also eat into corporate profits and dent corporations' appetite for future investment. With the Fed on hold, and bond yields retreating to 18-month lows, these headwinds are now becoming tailwinds. Case in point, many housing-related indicators are showing improvement and U.S. auto sales just matched their best month in over a year.

Why inventory 'stuffing' happens and how we're getting over it

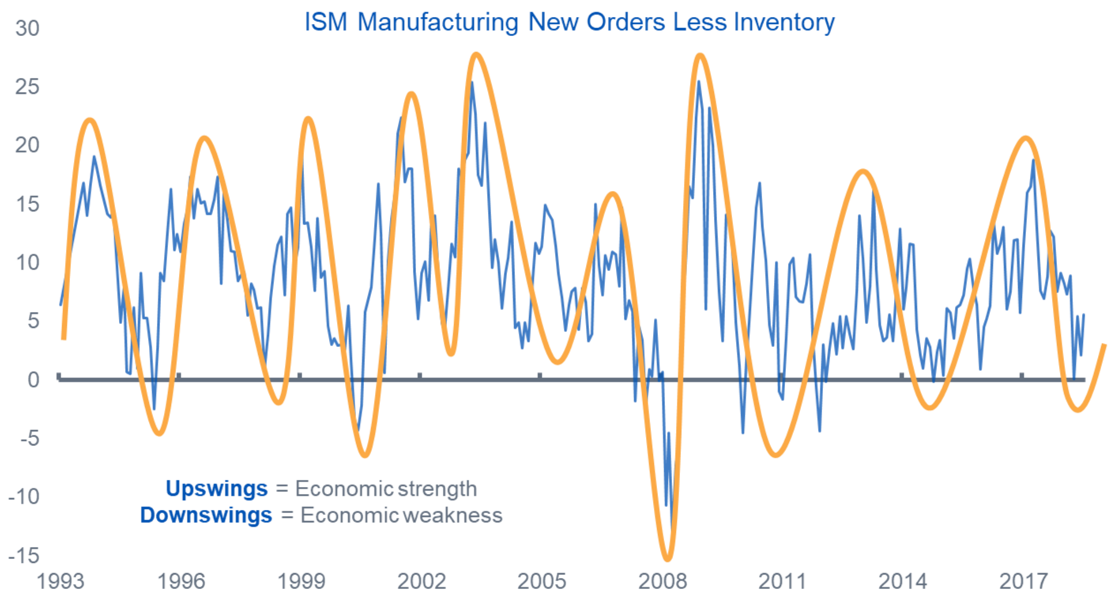
The U.S. economy has a very predictable pattern of inventory cycles – basically the natural ebb and flow of varying volumes of production, then warehousing, before final sale to the consumer. These cycles have historically lasted three to four years from peak-to-peak with the downside of these cycles being marked by weaker readings from the economy.

We're at the bottom of one such cycle now. The current inventory cycle slowdown was exacerbated by sharp inventory stockpiling in Q2 and Q3 of 2018, due to the myriad of trade threats overhanging the global business supply chain. The U.K. and Europe experienced similar 'inventory stuffing' behavior due to uncertainty around the future openness of the border and customs regulations brought on by Brexit.

Swings in the inventory cycle are largely a movement of production between time periods. Excess growth in one period (such as the first half of 2018) is followed by later weakness (late 2018 and early 2019) as there is no need to order new inventory, until the previous level is worked off (See Exhibit 2.2).

2.2 | The ups and downs of U.S. inventory cycles

The U.S. has a natural inventory cycle that lasts on average 40 months peak to peak



Source: Bloomberg, March 31, 2019.

The current inventory cycle is showing signs of turning and should relieve some of the recent weakness witnessed in U.S. economic data.

Addressing economic growth fears

Fears over the extent of the global economic slowdown are driving the current decline in bond yields – the heart of the current inverted yield curve. These events may spark periodic equity selloffs, but we see the worst-case scenario around growth fears as being over-blown.

The rise in equities thus far in 2019 will come to be justified by better global growth in the second half of the year. Investors need to be properly positioned to weather these periodic episodes of "growth fears" without panic. If corporate earnings results are better than expected, and/or the data from China signals that their new policy measures are taking hold, we see any equity selloff as a buying opportunity.

Bottom line: A positive turn in both the U.S. and Chinese economies will likely prolong the global economic cycle, making the recent 'inverted yield curve' signal a false alarm, or at the very least, too premature to warrant a near-term change in investment strategy. We see no reason to change our recommendation of a broadly neutral stance (risk tolerance aligned) between equities and fixed income.

Putting views into action: Aligned with our GLC 2019 Capital Market Outlook that suggests a neutral stance for investors, you may need to rebalance back into market areas where selloffs may occur to find yourself back at a neutral, long-term, risk-adjusted investment positioning.

Stay tuned for the last article in our **'Three Big Market Themes' series**, what to make of them and what to do next. **Part 3: Riding the backside of the U.S. bull market – It ain't over 'til it's over!**