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Economic slowdown speaks for defensive stocks with growth potential

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The US central bank (Fed) has made a change in its monetary policy: it has decided to take greater account of the development of the global economy and financial markets. The same is also true of the European Central Bank (ECB), which is hardly likely to be able to push through an interest rate increase this year. When central banks start to align policy with the likelihood of economic slowdown, investors should prepare themselves for precisely such a scenario. In phases of global economic weakness, defensive equities with growth potential that enjoy relatively more stable dividend and income development – as well as exhibiting lower volatility than other equities – become increasingly interesting.

The worst December for the US stock market (as measured by the S&P 500) since 1931 was then followed by the strongest January (+7.9%) for more than 30 years. Other equity markets also recorded a strong start to the year – particularly the emerging markets, which surged more than 12% in January. The key factor here has not been an improvement in the economic situation but an improvement in sentiment, triggered by the Fed's change of tack. However, this key driver of the equity market recovery has now also resulted in an increase in valuations. For example, on the basis of price/earnings valuations, the S&P 500 has become some 15% more expensive since the beginning of the year, while Eurostoxx and SMI valuations have risen some 12% and 10% respectively.

In the fourth quarter of 2018, the Fed stressed that US interest rates were not yet at a 'neutral' level (i.e. neither providing economic stimulus nor acting as an economic brake) for much longer. This led observers to conclude that further steep rate hikes were in the offing and prompted a sell-off in equity markets from November onwards. Following these sharp price corrections, President Trump demanded a change in course from the US central bank. The global economic slowdown likewise made a strong case for a pause in interest rate increases and the process of winding down the Fed's inflated balance sheet. Yet Fed Chairman Jerome Powell disappointed such hopes on 19 December when he stated that both the Fed's monetary policy and the normalization of its balance sheet were on "autopilot", and that gradual further key rate increases were indeed planned. Together with a dramatic slump in market liquidity over Christmas and a raft of hedge fund selling programmes, this led to the worst December performance of the US stock market since 1931, including a decline of 15% in just 14 trading days.

However, this triggered a U-turn in Fed policy. With the global economic slowdown having accelerated at the start of the year, the US central bank no longer referred to "further gradual increases" in its January meeting, stressing instead that it "can afford to be patient about further policy firming", and take into account global economic and financial market developments.

> "Given the weakening of the global economy, it makes sense to focus on defensive stocks with relatively more stable dividend growth and lower volatility."
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> Gérard Piasko, Chief Investment Officer

Quite clearly, the ECB must also pay greater attention to the weakness of the global economy, particularly given the clear waning of economic momentum in Europe. Following the most recent meeting of the ECB's governing Council, President Draghi observed that the bank could take action in response to any further economic slowdown. This clearly suggests that the ECB is retreating from its previously stated intention to increase key rates sometime after the summer. With Swiss economic development also having faltered, the Swiss National Bank is likewise not in a position to increase interest rates for the time being, as this could strengthen the franc excessively and undermine Swiss export activity. Switzerland's KOF composite indicator has declined by almost 14% over the last 12 months, thus painting a clear picture of economic deterioration. Elsewhere in Europe too, economic cooling is emerging as a clear theme. In the Eurozone, corporate sentiment slumped dramatically in January, while in Germany key leading indicators and manufacturing orders are both languishing at levels not seen for many years. Economic development is similarly weak in France, Italy and the United Kingdom. While German industrial production data published at the start of February revealed a year-on-year decline of 3.9%, which was even worse than expected, the growth slump now appears to have spread to the hitherto solid Spanish economy, which recorded a year-on-year decline in industrial production of 6.2%.

Although the US economy may be performing at a higher level than its EU counterpart, here too the slowdown in growth is apparent. Corporate sentiment is weakening in both the manufacturing and services sectors, and earnings forecasts have to be downgraded. Meanwhile, US consumer sentiment recorded its sharpest monthly decline for six years in January, falling back to levels last seen at the end of 2016. In China, leading indicators for the manufacturing sector are now exhibiting signs of contraction, and Chinese economic growth in 2018 turned out to be the weakest for 10 years. Consumer spending has proved difficult to stimulate, with retail sales recording year-on-year growth of just 8% or so, following on from 10% the year before. Automotive sales have proved particularly weak.

Elsewhere in Asia we see widespread evidence of declining export growth, as evidenced by data from Japan, South Korea and Taiwan. Also in Latin America, where hopes of reforms have been building around new Brazilian President Bolsonaro and the Brazilian equity market has soared some 40% since last summer, signs of economic slowing are now emerging. In view of this global economic weakness, it makes sense to pay greater attention to defensive stocks that exhibit more stable income and dividend characteristics in phases of economic weakness, while nonetheless possessing growth potential. Due to their lower market sensitivity (i.e. exhibiting a market beta of less than 1), such stocks have historically often performed better than their more cyclical counterparts in phases of heightened market volatility. The development of earnings and dividends of more defensive equities is less reliant on the economic cycle, which enhances their relative appeal against a backdrop of global economic weakness. Their lower volatility likewise makes them more attractive in phases of greater financial market nervousness, e.g. when geopolitical risks are on the rise.

Gérard Piasko

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