Behind Rising Stocks

Lower Risks Driving Higher Returns

Trade War: Truce or Intensification?

The Cost of Caution

US equities are up over 4%, in the past 30 days capping very nicely in a already strong year for global equities.

What's behind this latest move? We think a reduction in perceived risk is driving markets higher. Let's take a deeper look.

For investors, lower risks are often as important as better opportunities. And that's what we think is happening as we approach year end. First, signs of a bottom in the manufacturing sector and continued strength in the service sector have led many pessimistic investors to reassess their concerns about a recession in 2020 and 2021.

In addition, the Federal Reserve cut rates for a third time and indicated they have a high bar for raising them again. So they won't be making the same mistake in 2020 which they made in the second half of 2018. Finally, adding to the optimism, corporate earnings came in better than expected in the third quarter. And consensus calls for 7% EPS growth in 2020.

So there won't be an earnings recession either. All this gave the market more confidence.

We also have had the trade war, a truce between China and the US. And that has been a very important removal of bad news, at least for now. As we get closer to the December 15th date for the next planned tariff increase by the US, the risk from trade will reemerge. These could be positive or negative risks. A very modest phase one deal is now expected in the market.

So anything much better likely will be another catalyst for equity gains. While no deal at all, with an implementation of new tariffs, likely will lead to a sharp sell off in equities.

So what should investors be doing? Given our base case of modest growth, accommodating central banks, and very low recession risk, we continue to advocate a fully-diversified, risk-on position. We remain overweight US equities, US high yield, and the interest rate equity sectors of global REITs and listed infrastructure.

The major short-term risk is a return to our trade war footing between China and the US. But that seems more likely to happen in 2020 as they discuss a much more complex phase two part of any deal, not the near-term phase one. For the most part, this year has been a great example of the costs of being too cautious too early. And we continue to believe that investors are getting paid for their risk on the horizon.