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Global CIO Outlook
Amber Lights Flash at Davos

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I'm always struck by the way the mood at Davos holds predictive power for returns on investment for the coming months. Last year, from the moment of my arrival the air was electric with the bullish outlook for global growth. Stocks were in a parabolic rise on tax cut euphoria. As stocks soared, nothing but blue skies were ahead.

As I noted at the time, I had begun to consider the prospect that the mood at Davos served as a contra-indicator for the investment outlook. Past experience showed that Davos consensus had proven to provide disappointing investment outcomes in the short run. Last year, we did not have to wait long as stocks fell into a sickening plunge in February.

This year, concerns about the global outlook are palpable. Just as the G650 and Global Express aircraft—the choice air transportation of the elite—were lining up to land in Friedrichshafen, the International Monetary Fund's Christine Lagarde pronounced from Davos that the growth outlook was dimming, partly as a result of policy blunders by world leaders. On the first two days of meetings at the World Economic Forum, global markets were warning as the prior month's risk-on rally has begun to fade.

In China, Xi Jinping sounded the alarm that the domestic economic slowdown amounts to an existential threat not just to his political career but to the Communist Party itself. In Britain, Prime Minister Theresa May went so far as to inform Parliament that failure to agree on her Brexit proposal could result in a second referendum which would undermine the very existence of democratic institutions.

Wow! How much more negative can you get?

The last I looked, global growth, while slowing, was still plowing ahead. Growth in the U.S. will probably slow but remain at or ahead of potential in 2019.

Additionally, the Federal Reserve is virtually certain to remain on pause well into the second quarter with the market pricing in a possible rate cut if necessary to sustain growth.

In Europe, growth prospects are dimming. While Germany may be entering a technical recession, Chancellor Angela Merkel is calling for new tax cuts. Of all nations that can afford fiscal stimulus, Germany stands at the head of the class. It has a history of fiscal discipline and is well-positioned to deliver. As the largest economy in Europe, Germany will play a pivotal role as the locomotive for European growth, with monetary fuel likely to be provided by the European Central Bank in the form of a new long-term refinancing operation (LTRO) under Mario Draghi's leadership.

Meanwhile, despite Xi's defensive rhetoric, policymakers are alert and engaged. Beyond tax cuts and new infrastructure programs, the People's Bank of China has begun easing monetary policy—it announced cuts to the reserve requirement ratio (RRR) with the prospect of actual rate cuts if necessary. Chinese equities, which have recently stabilized after a long slide, are beginning to offer value good relative to their global counterparts.

The only major economy left to weigh in is Japan. While inflation continues to slow, the Bank of Japan (BOJ) is the only central bank still engaged in quantitative easing (QE). If inflation and growth were to continue to slip, the BOJ still has flexibility to increase asset purchases given that it currently is purchasing only about half its annual target. With a lot of dry powder, the policy response could come quickly.

While I concur with my colleagues here in Davos that a synchronized global slowdown is underway, fears of recession are overblown. If anything, the outlook is brightening as policymakers are beginning to awaken to the mounting risks arising from a protracted trade war and increasing nationalism.

While the foolishness may continue, no one wants to face the risk of global recession. Even the most hardened positions are likely to soften in the weeks ahead as politicians consider the political gambles that they have undertaken.

Markets are likely to remain choppy, but values abound. If we do not face a near-term recession, risk assets are likely to recover and, in some cases, explore new highs. For instance, U.S. stocks are cheaper today than when the bull reigned at Davos last year. If they were a buy then, they must be a bargain now.

The somber mood of Davos could again prove to be a contra-indicator. The amber lights flashing in Davos are signaling the consensus view that global growth is slowing. Given past experience, this may be the signal that the economy is likely to re-accelerate soon and that the party in risk assets continues.