MONTHLY HOUSE VIEWS

August 2019

The Autumn beckons, but not the fall

Despite a burst of volatility early in August – not uncommon in markets – the equity bull run barrels on for an eleventh year with the MSCI All-Country World index of global equities into double-figure territory year-to-date*. Simultaneously, central banks' monetary policy continues to anchor the latest leg in a multi-decade bond bull market. The Bank of Japan is actively buying bonds and other assets. The European Central Bank is running a negative base rate and has signalled it will reverse its seven-month hiatus on its quantitative easing program in September. The US Federal Reserve reversed a string of nine rate increases, cutting its base rate late in July. Market expectations are for the Bank of England to do much the same. **Indeed, rising asset prices underpin what has been a great year thus far for investors.**

But the mood is far from buoyant. The current equity bull run has been seriously challenged when fears of a sudden **slowdown in the Chinese economy** have risen. That risk is clearly exacerbated by the **ongoing trade war**, with market ructions in early August a recent testament. The developed world remains under the cloud of **weak growth and anaemic inflation** – shocking considering the current monetary paradigm and low levels of unemployment. Closer to home, **Brexit** remains as unresolved as ever. A new occupant in Number 10 Downing Street will certainly act as a catalyst, but to what end? Sterling volatility has shot up higher than that of some emerging market currencies, a clear sign of uncommon stress. This list is far from exhaustive.

Bottom line

Nonetheless, we remain sanguine: **equities** are still our most significant allocation. Why? First, the discomfiting backdrop is itself a reason to be invested. While equity valuations now stand between fair to slightly expensive, the asset class is in an uptrend, but without the over-bullish sentiment which would be a red flag. And while the absolute valuation case is mixed, the relative valuation case is far clearer: other core alternatives – cash and government bonds – are hideously expensive.

However, we recognise equity bear markets can be upon us with staggering speed – thus we continue to have significant allocations to **government bonds** despite record low yields. Earlier this year, we increased the duration in our government bond holdings – going from short to neutral. While yields have fortuitously fallen further since, these safe-haven assets are held primarily to diversify away from equity risk. In a similar vein, we have also decided to increase positions in **gold**. While it has rallied by about 15% thus far this year*, and is trading at a six-year high, the commodity has been a crisis hedge for thousands of years.

To be clear, we are not expecting a crisis, or a sell-off in equities: it remains the most compelling asset class from a valuation perspective. **However, there is plenty to test that view. Thus, we are content to hold a variety of safe-haven assets, even as we recognise their cost**.

Moreover, we remain comfortable with our **mix of Sterling and non-Sterling exposures** given Brexit-linked currency volatility. There are a range of outcomes possible, and the future is impossible to predict with certainty. Should further Sterling weakness occur, globally-oriented strategies should benefit. Should Sterling strengthen, globally oriented strategies should face a currency drag; thus we "hedged" part of the non-Sterling exposure earlier in the year and may do so again. As we have always done, we will stand by our investment process to navigate the uncertainty.

*As at 5 August 2019.

CA223/AUG/2019

OUR ASSET ALLOCATION

The table below presents the latest conclusions of our Global Investment Committee

			Summary house views					
			Strong UW	UW	N	OW	Strong OW	Change since last KHIC
EQUITY		GLOBAL EQUITY			■			
		United States			■			
		Eurozone			■			
		United Kingdom				■		
		Japan			■			
		Emerging		■				
FIXED INCOME	SOVEREIGN	GLOBAL RATES		■				
		U.S. Treasuries		■				
		Bunds		■				
		Gilts		■				
		EM Govies ($)				■		
		Duration USD*			■			
		Duration EUR*			■			
		Duration GBP*			■			
	CORPORATE	US Investment Grade		■				
		Eurozone Investment Grade		■				
		UK Investment Grade		■				
		High Yield				■		
FOREX		EURUSD			■			
		USDJPY			■			
		GBPUSD				■		
		EM FX (vs. USD)			■			
ALTERNATIVE		COMMODITIES				■		
		Brent			■			
		Gold					■	+
		ALT. STRATEGIES			■			
		L/S Equity				■		
		Event-Driven				■		
		FI Arbitrage		■				
		Global Macro		■				
		CTAs				■		

	Positioning	*Duration
O/W	Overweight	Long – 7-10 years
N	Neutral	Intermediate – 5-7 years
U/W	Underweight	Short – 3-5 years

House views

EQUITIES	
United States	Rich valuations and slowing profit growth are mitigated by increasingly supportive Federal Reserve (Fed) policy and a strong domestic economy. We stay Neutral.
Europe	Weak euro, fiscal easing and European Central Bank (ECB) policy are supportive, and valuations attractive. However, the market is sensitive to slowing global trade and faces myriad risks (e.g. Italian budget, US auto tariffs). We are Neutral.
UK	With an uncertain Brexit outcome and weak profit growth, many are overlooking attractive valuations, historically high dividends and a large-cap index largely insulated from domestic geopolitics. We are Overweight.
Japan	Despite attractive valuations, we remain cautious given the sensitivity of the market to the slowdown in global trade. A stronger yen would also be a headwind. We are Neutral for now.
Emerging	Dovish monetary policies, fiscal expansion and waning dollar strength help limit the consequences of tariffs on EM growth. However, EM investors are too sanguine about tail risks, which abound. We are Underweight.

FIXED INCOME	
Sovereigns	While government bonds offer poor value in absolute terms, the drift in yields upwards has lost its thrust across most major markets, and they continue to be critical in offsetting risks from equities in multi-asset portfolios.
Duration*	We have a medium duration position across most portfolios.
Investment Grade	Accommodative financial conditions, low inflation and steady growth are supportive, but spreads are tight and absolute yields are low. We prefer yield pick up further down the risk spectrum.
High Yield	The yield pick-up offered by High -Yield corporate bonds remains attractive, especially as default rates are expected to remain low.
Emerging debt (in $)	Given the more favourable macro backdrop – a US rate hike cycle has reversed and Chinese stimulus will likely support growth – we see room for further narrowing of emerging yield spreads.

CURRENCIES	
EUR/USD	Despite its cheap valuation, there remain numerous headwinds for the euro. We see range-bound trading this summer.
GBP/USD	Sterling is sharply undervalued, but the political backdrop is likely to delay any meaningful recovery.
EUR/GBP	Risks on both sides of the English Channel will keep the cross-rate steady.
USD/JPY	The yen is modestly undervalued and prized as a safe haven. However, A VAT-hike induced recession could exert some downward pressure.
Emerging	EM currencies have shown resilience despite trade war. However, several EM central banks have commenced easing and their currencies could remain weak against the dollar for now.

ALTERNATIVES	
Hedge funds	We prefer low volatility strategies which hold their own in bear markets, such as Merger Arbitrage.
Gold	While it has rallied by about 15% thus far this year and is trading at a six-year high, the commodity has been a crisis hedge for thousands of years. We have increased positions as we seek increased protection in multi-asset portfolios.
Oil	Expect global demand to soften as growth slows, keeping a cap on upside in oil prices. We expect Brent to remain between $60-70/b.

Source: Kleinwort Hambros 07/08/2019
*Duration: short = Up to 5 years, medium = 5-7 years, long = 7+ years
HY = High Yield bonds (higher return but greater risks), IG = Investment Grade bonds (higher quality but lower return)

ECONOMIC OUTLOOK

Headwinds offset by supportive policy

The global economy faces headwinds which have already slowed GDP growth, particularly in industry. However, consumer spending and services remain strong. And given low inflation, central banks have signalled easier policy ahead and government budget policies are being adjusted to shore up growth prospects.

Downside risks continue to loom over global economy

The global economy and, by extension, financial markets face two major event risks – trade war escalation and a "no-deal" Brexit. These factors have already begun to impinge on global trade, where there has been no growth in volumes over the past year, and on UK business confidence which has dipped into contraction territory. Both risks have escalated in late-July / early-August. Donald Trump unexpectedly announced a 10% tariff on $300 billion worth of Chinese goods, in addition to an existing 25% tariff on $250 billion of imported items. Boris Johnson's ascension to the office of Prime minister signals a new phase in the UK's Brexit negotiations where a hard, "no deal" position is a genuine policy option.

These factors have hit business confidence, particularly in manufacturing, and corporate investment plans. In addition, inventories have accumulated, and order books have shrunk, notably for exports.

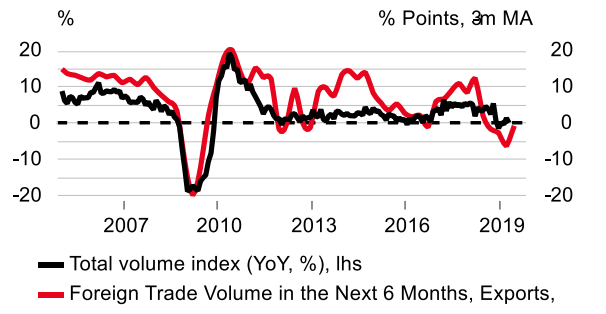
On the other hand, services and consumer spending – which represent the bulk of developed-world economies – show little sign of weakening. Unemployment is falling steadily across the euro zone and is close to 50-year lows in the US and the UK. Moreover, wages are rising steadily in real terms, helping bolster consumer confidence and household consumption.

Further monetary and fiscal easing

In addition, fiscal policy has turned easier across the globe. In Germany for example, the coalition has agreed on tax cuts and spending increases which should add some 0.3pp to GDP growth for the next three years. And in China, recently announced cuts to VAT and employer social insurance contributions should amount to around 2% of GDP.

Ever since the Federal Reserve's last rate hike in December, central banks have performed a U-turn in forward guidance on policy. It now looks likely that rate cuts, asset purchases and refinancing facilities for banks will combine to create a much more supportive backdrop for the economy.

Tariffs weigh on trade volumes



Source: Macrobond, IFO, CPB 18/07/2019

Recession not expected yet

Much attention has been paid in recent months to a number of US recession indicators which are flashing warning signals. These models are typically based on observations of differentials in Treasury yields – long-term yields often dip below short rates ahead of recessions. However, we would caution that global government bond markets continue to be influenced by central bank asset purchase programmes, which may reduce the reliability of such models.

Moreover, economic slowdowns do not always lead to recessions – these tend to occur when economies face major imbalances, such as a rapid build-up in private-sector debt, accelerating inflation or cyclical excesses in sectors such as housing or capital expenditure. Today, there are areas for concern – such as state-owned enterprise leverage in China, or corporate bond issuance in the US – but by and large economic and financial imbalances do not seem extreme, and banks are well capitalised.

Perhaps most importantly, economic slowdowns can last for years, and usually tend to be favourable environments for risk-taking. Should some of the risk events dissipate, conditions may even turn around, with a global expansion resuming again. The real danger is the slowdown deteriorating into an economic contraction, or recession. That clearly is bad for risk assets, and would be a signal for us to cut equities. However, our Leading Economic Macro Indicator (LEMI) indicates we are not anywhere near that stage yet.

FIXED INCOME

Still room for credit

While government bonds offer poor value in absolute terms, the drift in yields upwards has lost its thrust across most major markets, and they continue to be critical in offsetting risks from equities in multi-asset portfolios. For yield, we prefer riskier borrowers such as Emerging Market (EM) sovereigns and High-Yield (HY) corporates than investment-grade corporates (IG).

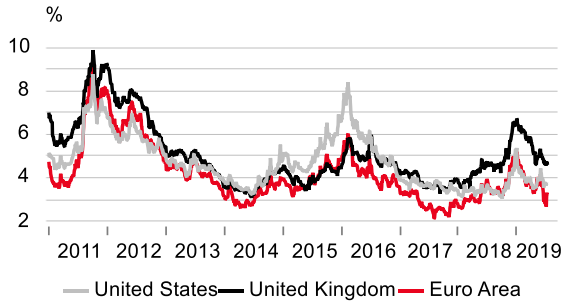
Sovereigns

US. From their highs last autumn at over 3.2%, 10-year US Treasury yields have tumbled to well below 2.0%. Inflationary pressures have abated, and monetary policy is being eased, again. However, further falls in rates seem unlikely from these low levels. We expect headline inflation to strengthen towards year-end given the low base effect after Q4 2018's slide in energy prices. Hence, we see modest upside in yields over the next twelve months and suggest intermediate maturities where expected returns should be positive.

Eurozone. Ten-year German Bund yields are at all-time lows, trading below -0.5%, far below the Eurozone's July inflation rate of 1.1%. This forms part of over $15 trillion in government debt yielding below-zero at present. Investors are clearly willing to pay out of their pockets for the privilege of lending to the German government – it speaks to their pessimism of the future in the Eurozone.

UK. Fears of a hard "Brexit" have soared, keeping downward pressure on Sterling. This in turn has kept UK inflation expectations over 150bps higher than in the US. Despite this, ten-year Gilt yields have followed European rates down, hitting a record low of 0.52%. Thirty-year Gilts yield just 1.2%, well below the rate of inflation. Asset/liability guidelines for UK insurers and pension plans ensure continued high demand, and investors have judged that Brexit uncertainties will prevent the Bank of England from tightening policy.

High Yield spreads have narrowed



Source: Macrobond, 18/07/2019

Credit

US. The rather benign macro environment has proved rather supportive for corporate bonds and yield differentials (spreads) over sovereign bonds have narrowed markedly year-to-date. From today's levels, spreads are unlikely to tighten much further but the additional yield pick-up (carry) remains attractive, especially for higher-yielding (HY), lower-quality bonds.

Eurozone. As in the US, euro zone credit has registered strong performance so far this year. Balance-sheet quality is generally better than in the US but spreads are also much narrower. We believe there is little likelihood of an imminent spike in the risk of default. As in the US, our preference is for HY over higher-quality, investment grade (IG) credit.

UK. Given high uncertainty surrounding Brexit, spreads have remained higher in sterling credit, especially for HY issuers. Such companies tend to be smaller than IG issuers and more vulnerable in the event of a disruptive no-deal outcome. As a result, carry looks very attractive but we would caution that a rally is unlikely until we have greater clarity on Brexit.

Emerging debt

We continue to hold emerging market (EM) sovereign bonds. Trade war concerns and slower growth have kept spreads high despite the improvement in macro fundamentals and the hard tilt in dovishness from developed market central banks. Moreover, we expect Chinese stimulus to support growth in the second half. There is still potential for spreads to tighten as yield-seeking investors return to this segment.

Past performance should not be seen as an indication of future performance. Investments may be subject to market fluctuations, and the price and value of investments and the income derived from them can go down as well as up. Your capital may be at risk and you may not get back the amount you invest.

EQUITIES

Supported by the policy mix

After rallying strongly since late December, global equity markets offer less potential upside given loftier valuations. However, we remain sanguine and equities are still our most significant allocation as the asset class is in a strong uptrend, but without the over-bullish sentiment which would be a red flag

US. The Federal Reserve (Fed) has cut interest rates for the first time in a decade in a bid to add "momentum" to decelerating economy. However, given this year's US equity rally has been driven by multiple expansion as earnings growth has slowed after 2018's tax-cut boost, there is less headroom for continued outperformance, particularly as valuations are already approaching expensive. We remain neutral.

Eurozone. The European Central Bank has less room to ease than the Fed, but seems poised to push ahead with looser policy over coming months nevertheless. Euro zone exporters – particularly in Germany – have suffered as the US-China trade war has unfolded and the White House has still not ruled out tariffs on auto imports. Valuations are more attractive than in the US and earnings growth may be slightly higher this year – however, the above-mentioned headwinds may cap any outperformance potential. We remain neutral.

UK. UK equity markets are facing an environment of continuing Brexit uncertainty, weakening domestic economic sentiment – evident in both manufacturing and services purchasing managers indices – and slowing profit growth. However, with an uncertain Brexit outcome and weak profit growth, attractive valuations and historically high dividends are perhaps overlooked by investors, especially in a low-yield investment landscape.

Indeed, UK equities are trading at 12.4x their forward estimated earnings, roughly in line with long-term averages. That makes them considerably cheaper than US or European equity markets, which both are trading above their respective averages. Moreover, UK equities are offering a dividend yield of about 4.5% which is above its historic average, and well above that of competing equity markets. It is also significantly higher than the yield on offer from competing asset classes, such as UK government bonds, where the 10-year yield is a relatively paltry 0.52%.

Finally, the global nature of the UK equity index insulates the index somewhat from domestic geopolitical concerns – roughly 70% of revenues of the 100 largest publicly listed UK companies are generated abroad. However, those geopolitical concerns have perhaps unduly generated negative sentiment.

Should Sterling weaken further, the repatriated profits of its globally-oriented companies will grow, a clear positive. On the other hand, should Sterling appreciate markedly on a possible "Brexit" deal or similar, the market reaction may also be positive given resolution of a key source of instability. In any event, evidence suggest geopolitics is a poor determinant for long-term investment decisions, and long-term investors should focus on the valuations. We are Overweight.

Japan. Despite its many attractions – cheap valuations, improved corporate governance, central bank purchase programme – we expect Japan to continue to underperform. The government is likely to push ahead with the planned VAT hike this autumn, running the risk of provoking a recession. Moreover, the yen is modestly undervalued and prized as a safe haven. Any rise in currency will be to the detriment of the country's large export complex.

Emerging Markets. Emerging market equities have kept pace with their developed market peers, with the singular exception of the US. In the near term, US-China tensions and sluggish trade are likely to keep it that way. This being said, China has embarked on a stimulus programme targeting the private sector which promises an improved outlook for next year. However, valuations are not particularly attractive in comparison to history and slowing GDP growth means underwhelming corporate earnings – we remain Underweight.

CURRENCIES

Little to go for

As global interest and GDP growth rates begin to converge in the second half, we see little reason for sizeable swings in currencies. The big exception to this view is Sterling, which is subject to extreme swings given the twists and turns of Brexit.

Dollar Index. The dollar has had a number of key supports in recent years. Interest rates are higher than elsewhere, growth has been more robust and the depth and quality of US capital markets continues to attract portfolio flows. Despite all these positives, the Dollar Index – which measures its international value against peers – has been tracking sideways since late last year. This reflects the fact that the dollar is now expensive and already well-represented in reserves and portfolios. Shrinking differentials in rates and growth could begin to erode some of its strength.

EURUSD. There remain numerous headwinds in Europe, from Brexit to ballooning budget deficits in Europe, from potential US auto tariffs to rising political divergences between EU members. Moreover, euro zone exporters have struggled in recent quarters, slowing growth across the region and prompting the central bank to prepare the ground for looser policy. However, the ECB has much less room to ease than the Fed and the euro is rather undervalued against the dollar. All in all, we see range-bound trading for now.

GBPUSD. Sterling is trading at historically low levels (£1 = ca. $1.21) and is significantly undervalued versus the US dollar on most measures of purchasing power parity, a proxy for "fair value". However, the currency is clearly not trading on fundamentals, and volatility levels in Sterling are above that of some notable emerging markets. The biggest driver in the short-run is the market perception of three broad possibilities: A) Hard Brexit (i.e. no deal); B) Soft Brexit (i.e. a deal); or C) some other outcome (e.g. a general election or a delay).

It is impossible to know which one of the three options is more likely at this stage, though the market is rife with speculation and the currency is highly sensitive to news flow. Evidence suggests attempting to divine geopolitical outcomes, or subsequent market moves, is largely a fruitless pursuit. Our approach is to ensure we are comfortable with risks to globally oriented, multi-asset, Sterling-referenced portfolios. Should further Sterling weakness occur, these strategies should benefit. Should Sterling strengthen, globally oriented strategies should face a currency drag; thus we "hedged" part of the non-Sterling exposure earlier in the year and may do so again should Sterling fall further.

USDJPY. The Bank of Japan will find it difficult to match Fed policy easing, meaning a shrinking interest rate differential which could bolster the yen. Moreover, the yen is modestly undervalued and also prized as a safe haven in times of trouble. A VAT-hike induced recession could exert some downward pressure, but this is likely to be short-lived.

EM currencies. They have shown notable resilience lately, despite slowing economies and trade war worries. Over recent years, many emerging economies have ditched their explicit pegs to the dollar, bringing greater monetary policy flexibility along with freer-floating currencies. However, recent rate cuts – South Korea, Indonesia and South Africa all eased on July 18 – mean the EM currency index could remain low against the dollar.

USDCNY. A slowing domestic economy and trade war headwinds has led the renminbi to weaken beyond the psychologically important CNY 7 versus the US dollar. However, the authorities will be keen to stem capital outflow risks and also to promote increased use of the CNY for trade settlement. This means a delicate balancing act which is likely to see the CNY trade sideways in coming months.

ALTERNATIVES

Useful diversification

While gold has rallied by about 15% thus far this year and is trading at a six-year high, the commodity has been a crisis hedge for thousands of years. We have increased positions as we seek increased protection in multi-asset portfolios. We also like hedge funds which employ low volatility strategies and hold their own in bear markets, such as Merger Arbitrage.

Commodities

OPEC+ seek to support oil prices

The Organisation of Petroleum Exporting Countries (OPEC) and major allies such as Russia decided in late June to keep output limits in place for another 9 months, reducing production by 1.2 million barrels per day (mb/d). These quotas are designed to keep oil prices high, especially as output disruptions in Venezuela and US-imposed sanctions on Iran have already removed some 2mb/d from global supply over the last twelve months.

However, in recent years US oil production has surged ever higher, from 8.9mb/d in January 2017 to 12.2mb/d in June this year making the US the world's single largest source of oil. There are some signs of reduced investment in exploration and production – the number of oil rigs is down from 880 last autumn to 780 at present – but so far US output has remained resilient.

We still expect Brent prices to be around today's level, between $60 and $70, over the next twelve months.

Gold

After a 15% rally this year, gold prices have reached $1,480, the highest since 2013. A number of factors have contributed to this move:

- With trade wars and Brexit just two of a number of risks that have spoked of late, safe-havens have become sought-after;
- around 70% of developed world bonds are trading with negative real yields making non-yielding assets like gold more attractive, as does the Fed's dovish shift towards lower rates;
- demand has been robust – so far this year, gold-backed funds have seen 108 tonnes (t) of inflows, central banks have bought 247t and traders have held long positions of 369t on average; and
- gold supply has stagnated so far this year with only modest growth from mine production.

These underpin our decision to increase our positions to gold. However, our primary motivation in multi-asset portfolios to diversify away from equity risk, particularly as government bonds – the first avenue of diversification –are increasingly expensive.

Hedge funds

Hedge funds: Prefer Merger Arbitrage type strategies

Hedge funds can help in unstable market conditions, but selectivity is key. We prefer strategies which hold their own in bear markets, such as Merger Arbitrage. These strategies provide relatively safe, uncorrelated sources of returns from equities, our most significant allocation across balanced and growth multi-asset strategies. These investments have been a positive contributor of returns – and lowered risk – especially during a volatile Q4 2018.

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