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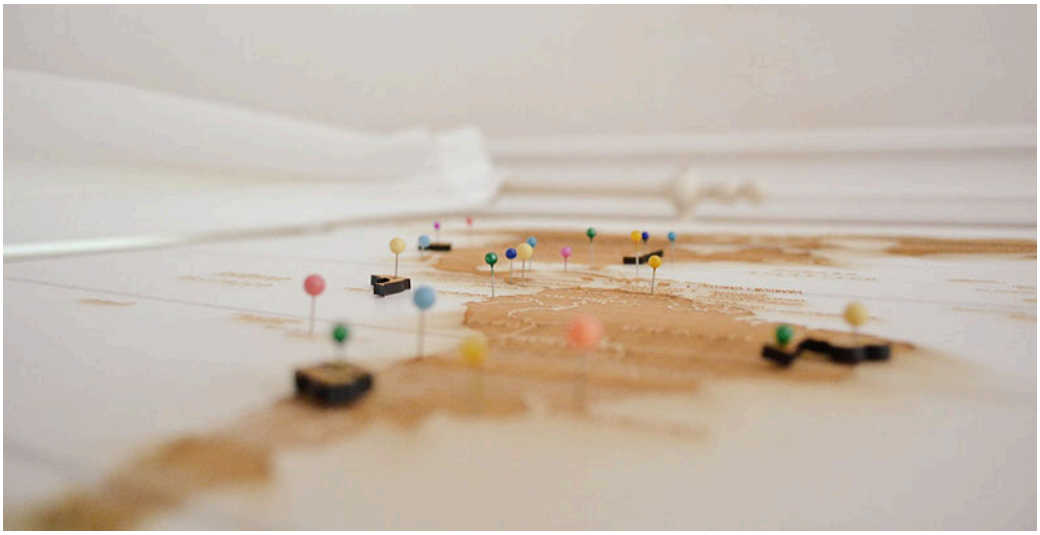
BILBoard September / October 2018 – Economic cycles don't simply die of old age



The business cycle has reached maturity, but it is crucial to differentiate between two very different phenomena: "late-cycle" (where most economists estimate the economy to be) and "end-of-cycle" (which does not appear to be imminent)...

The term "late cycle" is flitting around the financial press quite frequently nowadays as the US economic expansion moves into its tenth year and central banks actively pare back policy largesse. However, for the time being, our key end-of-cycle indicators are not yet emanating warning signs. The business cycle turns very slowly, and while we must prepare for higher rates and plenty more volatility in risky assets, we must do so gradually. We have already begun the process by adding some quality fixed income assets, and for the moment we feel adequately prepared relative to the stage we are at in the cycle, believing that equities still have some room to run.

Often, it's much easier to be doing something, anything, than to be a patient investor. Making constant changes to your portfolio can give an illusion of control, creating the impression that you can affect positive outcomes, even if history disproves this. As the fundamentals that

underpin our bullish outlook for global growth remain intact, our leitmotif this month is consistency and we are maintaining our current allocation, which encapsulates a risk-on strategy and a preference for equities.

The risk of escalating trade tensions still mars the outlook, but our base case is not a full-blown global trade war. Already, we have seen a breakthrough with regard to NAFTA, as Canada has agreed to join the US and Mexico in the new USMCA trade pact. Most concerning is the rift between the US and China, which levied new tariffs on each other in September. Our economists, however, point to reports that China is planning a broad tariff cut, consistent with its long-term strategy of reform and opening up. This, taken together with China's decision to retaliate against US tariffs on $200 billion of Chinese goods with their own, lower tariffs on just $60 billion of US goods, may indicate that China is attempting to de-escalate.

Equity

The lion's share of our equity exposure is allocated to the US, supported by the ongoing health of corporate America, benign financial conditions and strong consumption. Record buyback figures as well as a wave of deal-making by US firms should continue to buoy equities in the near-term. Globally, M&A has hit a record high this year, totalling $3.3 trillion as at the end of September. Midterm elections are likely to bring volatility, but beyond this, we see further upside through 2018. In terms of sectors, we favour Technology and Energy. With regard to the latter, it is expected that the impact of the current emerging market (EM) rout on oil demand will be offset by supply shocks (falling production in Iran, Venezuela, etc.) and that oil prices will stay at current high levels heading into 2019. Normally, the stock price of Energy firms is firmly tethered to the underlying oil price.

We maintain a defensive stance on Europe for the time being. ECB President Mario Draghi sees the economy picking up, which should boost inflation and allow the ECB to proceed with its QE exit sequencing. This, in turn, would signal that fundamentals are strong and that the economy is moving in the right direction, potentially improving investor sentiment. However, for the moment, there is simply too much uncertainty to contend with. Italy remains to be a wild card: the coalition government has set its budget deficit target at 2.4% of GDP – far above the 1.6% requested by technocratic finance minister Giovanni Tria – meaning that Italy risks falling foul of EU fiscal rules. The recent impasse in Salzburg with regard to Brexit negotiations makes European equities even less palatable in the short term.

We are maintaining our EM equity exposure, at least as a tactical play until the US midterms, and deem the risk of financial contagion Economic cycles don't simply die of old age The business cycle has reached maturity, but it is crucial to differentiate between two very different phenomena: "late-cycle" (where most economists estimate the economy to be) and "end-of-cycle" (which does not appear to be imminent)... to be low. As mentioned, uncertainty around trade is likely to persist, but a lot of this is already priced in within the EM space.

Fixed income

US 10-year government bond yields managed to break 3% without retreating in September. Until now, yields had been suppressed by US pension fund demand, but higher wage inflation earlier in the month and generally better macro prospects encouraged the move up. We are keeping limited exposure to high quality government bonds (Bunds/US Treasuries) for downside protection, but are fundamentally negative on govies on the whole, as we seek to take on as little interest rate risk as possible. For the moment, the 'least worst' place to park money in fixed income is European Investment Grade (IG). Yields have improved, reaching their highest levels in two years, while duration has fallen slightly. Europe is far behind in the credit cycle and most European companies are still on a deleveraging cycle, a fact reflected in stronger balance sheets. Corporate hybrids are particularly interesting. Simultaneously, hedging costs make US IG unattractive for EUR-based portfolios.

Currency

The EUR jumped recently when Draghi said inflation was "relatively vigorous", and investors bet on a faster pace of interest rate hikes over the next two years. Comments were played down by Peter Praet (the ECB Chief Economist), but despite the "good cop, bad cop" routine, we are still broadly positive on the single currency. There is more pressure on the ECB to change its policy, and clearer forward guidance should push EUR higher.

Conclusion

We are entering uncharted waters as global central banks actively pare back loose policy, attempting to engineer a soft landing. Further down the line, quantitative tightening will surely generate volatility, but we must consider that this could also create opportunities. For now, the cycle is ageing gracefully, allowing us to gradually tee up our portfolios for the next stage, responding to the cues that data, central banks and markets provide along the way.

Strategic Asset Allocation (SAA) & Tactical Asset Allocation (TAA) by risk profile and asset class

	Defensive			Low			Medium			High		
	Bonds: 100%			Equities: 15% - 45% Bonds: 55% - 85%			Equities: 25% - 75% Bonds: 25% - 75%			Equities: 40% - 100% Bonds: 0% - 60%		
Asset Classes	SAA	29th August	26th Sept.	SAA	29th August	26th Sept.	SAA	29th August	26th Sept.	SAA	29th August	26th Sept.
Equities				30%	35%	→ 35%	50%	60%	→ 60%	70%	85%	→ 85%
Bonds	100%	100%	→ 100%	70%	65%	→ 65%	50%	40%	→ 40%	30%	15%	→ 15%
Equity Allocation												
USA				9%	15%	→ 15%	15%	27%	→ 27%	21%	36%	→ 36%
Europe				15%	12%	→ 12%	25%	20%	→ 20%	35%	30%	→ 30%
Japan				3%	3%	→ 3%	5%	5%	→ 5%	7%	7%	→ 7%
Emerging Markets				3%	5%	→ 5%	5%	8%	→ 8%	7%	12%	→ 12%
Bond Allocation												
Government Bonds - Developed	50%	19.5%	→ 19.5%	35%	15%	→ 15%	25%	18%	→ 18%	15%	9%	→ 9%
Emerging Market Debt	10%	10%	→ 10%	7%	7%	→ 7%	5%	5%	→ 5%	3%	3%	→ 3%
Corporate - Investment Grade	20%	50%	→ 50%	14%	30%	→ 30%	10%	12%	→ 12%	6%	1%	→ 1%
Corporate - High Yield	20%	12.5%	→ 12.5%	14%	8%	→ 8%	10%	5%	→ 5%	6%	2%	→ 2%
Total return	0%	8%	→ 8%	0%	5%	→ 5%	0%	0%	→ 0%	0%	0%	→ 0%
Currency												
EUR	100%	95%	→ 95%	85%	83%	→ 83%	75%	72%	→ 72%	65%	61%	→ 61%
Other FX	0%	0%	→ 0%	6%	5%	→ 5%	10%	8%	→ 8%	14%	12%	→ 12%
USD	0%	5%	→ 5%	9%	12%	→ 12%	15%	20%	→ 20%	21%	27%	→ 27%
Commodities												
Oil				0%	0%	→ 0%	0%	0%	→ 0%	0%	0%	→ 0%
Gold				0%	0%	→ 0%	0%	0%	→ 0%	0%	0%	→ 0%

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