

October 12, 2018

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 Bonds:	55% - 45 55% - 85			Equities Bonds:	: 25% - 75 25% - 75			Equities Bonds:	: 40% - 10 0% - 609		
Asset Classes	SAA	29th August	26 th Sept.	SAA	29th August	26	th Sept.	SAA	29th August	26	th Sept.	SAA	29th August	26	⇔ 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%

Download the pdf version here

Download the pdf version here (in French)

<u>Download the pdf version here</u> (in German)

Disclaimer

All financial data and/or economic information released by this Publication (the "Publication"); (the "Data" or the "Financial data and/or economic information"), are provided for information purposes only, without warranty of any kind, including without limitation the warranties of merchantability, fitness for a particular purpose or warranties and non-infringement of any patent, intellectual property or proprietary rights of any party, and are not intended for trading purposes. Banque Internationale à Luxembourg SA (the "Bank") does not guarantee expressly or impliedly, the sequence, accuracy, adequacy, legality, completeness, reliability, usefulness or timeless of any Data. All Financial data and/or economic information provided may be delayed or may contain errors or be incomplete. This disclaimer applies to both isolated and aggregate uses of the Data. All Data is provided on an "as is" basis. None of the Financial data and/or economic information contained on this Publication constitutes a solicitation, offer, opinion, or recommendation, a guarantee of results, nor a solicitation by the Bank of an offer to buy or sell any security, products and services mentioned into it or to make investments. Moreover, none of the Financial data and/or economic information contained on this Publication provides legal, tax accounting, financial or investment advice or services regarding the profitability or suitability of any security or investment. This Publication has not been prepared with the aim to take an investor's particular investment objectives, financial position or needs into account. It is up to the investor himself to consider whether the Data contained herein this Publication is appropriate to his needs, financial position and objectives or to seek professional independent advice before making an investment decision based upon the Data. No investment decision whatsoever may result from solely reading this document. In order to read and understand the Financial data and/or economic information included in this document, you will need to have knowledge and experience of financial markets. If this is not the case, please contact your relationship manager. This Publication is prepared by the Bank and is based on data available to the public and upon information from sources believed to be reliable and accurate, taken from stock exchanges and third parties. The Bank, including its parent,- subsidiary or affiliate entities, agents, directors, officers, employees, representatives or suppliers, shall not, directly or indirectly, be liable, in any way, for any: inaccuracies or errors in or omissions from the Financial data and/or economic information, including but not limited to financial data regardless of the cause of such or for any investment decision made, action taken, or action not taken of whatever nature in reliance upon any Data provided herein, nor for any loss or damage, direct or indirect, special or consequential, arising from any use of this Publication or of its content. This Publication is only valid at the moment of its editing, unless otherwise specified. All Financial data and/or economic information contained herein can also quickly become out-of- date. All Data is subject to change without notice and may not be incorporated in any new version of this Publication. The Bank has no obligation to update this Publication upon the availability of new data, the occurrence of new events and/or other evolutions. Before making an investment decision, the investor must read carefully the terms and conditions of the documentation relating to the specific products or services. Past performance is no guarantee of future performance. Products or services described in this Publication may not be available in all countries and may be subject to restrictions in some persons or in some countries. No part of this Publication may be reproduced, distributed, modified, linked to or used for any public or commercial purpose without the prior written consent of the Bank. In any case, all Financial data and/or economic information provided on this Publication are not intended for use by, or distribution to, any person or entity in any jurisdiction or country where such use or distribution would be contrary to law and/or regulation. If you have obtained this Publication from a source other than the Bank website, be aware that electronic documentation can be altered subsequent to original distribution.

As economic conditions are subject to change, the information and opinions presented in this outlook are current only as of the date indicated in the matrix or the publication date. This publication is based on data available to the public and upon information that is considered as reliable. Even if particular attention has been paid to its content, no guarantee, warranty or representation is given to the accuracy or completeness thereof. Banque Internationale à Luxembourg cannot be held liable or responsible with respect to the information expressed herein. This document has been prepared only for information purposes and does not constitute an offer or invitation to make investments. It is up to investors themselves to consider whether the information contained herein is appropriate to their needs and objectives or to seek advice before making an investment decision based upon this information. Banque Internationale à Luxembourg accepts no liability whatsoever for any investment decisions of whatever nature by the user of this publication, which are in any way based on this publication, nor for any loss or damage arising from any use of this publication or its content. This publication, prepared by Banque Internationale à Luxembourg (BIL), may not be copied or duplicated in any form whatsoever or redistributed without the prior written consent of BIL 69, route d'Esch I L-2953 Luxembourg I RCS Luxembourg B-6307 I Tel. +352 4590 6699 I www bil com

