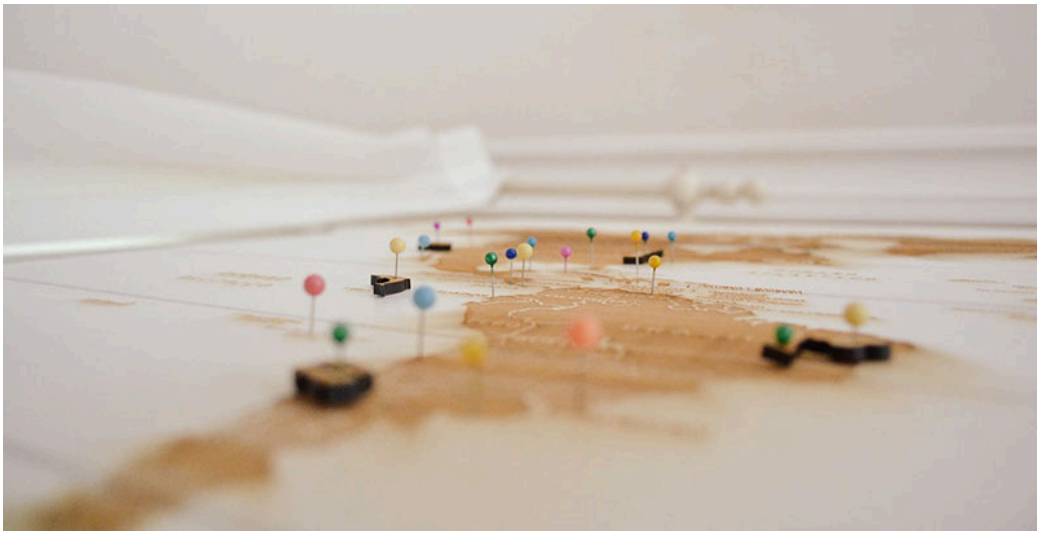
May 21, 2019

BILBoard May 2019 – It's not game over for growth but there are more snakes than ladders



In
the classic board game Snakes and Ladders, players must navigate from the bottom of the board to the top, and the first to do so is declared the winner. Successful players avoid snakes, which send you sliding back down the board, and try to land on ladders which offer a shortcut up towards the finish line. Right now, if the market were a game of snakes and ladders, the board would feature a lot more snakes than ladders for risk assets. On top of that, the ladders would be disproportionately shorter – meaning that the potential upside for risk assets looks contained, whereas the downside could be very steep indeed. For this reason, we have taken more risk off the table and reduced our equity exposure from 'neutral' down to 'underweight'. The proceeds were parked in safe assets, namely US Treasuries and euro amounts in high-quality vehicles with high liquidity.

This move was taken after the most recent 'snake' which sent major indices into the red (the S&P 500 by as much as 2.5%), namely the decision by the US administration to impose further tariffs on Chinese imports ($200bn of goods had their import levy raised from 10% to 25%). China countered by upping tariffs from 5% to 15% on $60bn of US goods. What this shows is that a truce is off the cards, and that the game of trade between the US and China is not a quick game of checkers. Rather, it seems that it will be more akin to a calculated, drawn-out, strategic game of chess, with the opponents trying and testing each other at every move. In the absence of a short-term solution, markets will keep yo-yoing. Over the longer term, higher tariffs will have implications for economic growth. A joint study by the Federal Reserve, Princeton and Columbia Universities found that the existing levies have raised costs for US consumers by $1.4bn a month. Higher prices could dampen the propensity to spend, and private consumption is the backbone of the US economy. At the same time, this could coax inflation upwards, potentially becoming a game changer for monetary policy. For now, the Fed has been locked in a 'wait-and-see' modus, especially with inflation tepid below its 2% target and global uncertainties prevalent. We don't expect a rate move this year, whereas the market is currently pricing a cut. There is a danger that it could be caught off-guard here because – trade war aside – the US economy still looks to be in good shape, having registered growth of 3.2% in Q1. Investment and consumption still serve as pillars of growth and the labour market is ultra-tight: unemployment is at 3.6% - the lowest level since 1969.

The eurozone looks more precarious, with its manufacturing sector (especially in Germany) in deep trouble. Factory orders remain depressed from fluctuating demand (both domestic and foreign). With the various risks dotted across the region, it's a bit of an Indiana Jones-style snake pit.

China churned out decent enough Q1 growth of 6.4%, and the consensus expects the pace to stabilise at around 6.3% this year. Industrial production and domestic consumption are both holding up well, rising 8.5% and 8.7%, respectively, whille the PMI is back in expansionary territory above 50. The government is taking a hands-on approach in keeping the economy buoyant – most recently Beijing even bought up Chinese equities following new tariff impositions to limit the damage.

Equities

On
the whole, growth is, and is expected to remain at, comfortable levels,
supporting equities. However, that being said, there are not many catalysts
that could give stocks a further leg up, and for the next 'ladder' we may have
to sit tight until the Q1 earnings season. On the other hand, it seems there is no shortage of
risks
– whether it be Brexit, the European elections where populists on the
fringes may gain more clout, or the US pursuit of protectionism with both
allies and adversaries. This asymmetric risk environment pushed our hand in underweighting
equities. Within our downsized universe, we still prefer the US where recession
is not considered an imminent risk, where earnings expectations have descended
to more realistic levels (consensus sees 4% EPS growth for the S&P 500) and
where prices should be supported by a wave of buybacks. Our least-preferred
region is Europe. Next to political risks, there is also the prospect that the
US section 232 investigation into automotive security could result in tariffs
on automotive imports. This could be the final block that topples the shaky Jenga
tower that Europe's manufacturing sector is resembling. Furthermore, financials – which make
up a significant
proportion of the European market – are facing a plethora of problems: money laundering
scandals, low rates, low loan demand, and so on.

We are underweight Japan due to its
sensitivity to the micro cycle and lacklustre earnings expectations. Further
tarnishing the region's allure is the consumption tax hike penned in for
October, which will likely put a dent in consumer confidence. We are also underweight
emerging markets, which have lost momentum after a good run. The region's fortunes
will be heavily influenced by the outcome of trade talks.

In terms of sectors, we are remaining overweight
in technology, which drives earnings growth. We are underweight utilities and
neutral elsewhere.

Fixed income

After investing the proceeds of our

equity sales in high-quality liquid bonds, our fixed income exposure is now neutral. In this segment of our portfolios, we are still underweight high yield, govies and emerging market bonds, while harbouring an overweight in investment grade corporates. Quality is the leitmotif here, and we further minimised our risk exposure by shifting into instruments with a higher credit rating and trimming exposure to corporate hybrids and subordinated financials. The broader market seems to share this risk
aversion, and even during the recent rally investors have not wholeheartedly jumped back into riskier bonds (as seen in the wide spread between A and BBB-rated bonds). Overall, in investment grade, spreads are sitting around historical averages, and demand is strong. Even without the invisible hand of central banks, new issues have been well absorbed. That being said, no asset class is immune to trade talks, and tensions could cause spreads to widen again, as could an influx of new issues.

All in all, it's not yet 'Game Over' for the global economic growth story. However, the slowdown is real and in motion and with risks abound, we felt it was time to play it safe and bring our exposure to risk assets below neutral.

Current Asset Allocation 13/05/2019	DEFENSIVE		LOW		MEDIUM		HIGH	
	Stance	Change	Stance	Change	Stance	Change	Stance	Change
Global allocation								
Equities	🟡	→	🔴	↓	🔴	↓	🔴	↓
Bonds	🟡	→	🟢	↑	🟡	↑	🟡	↑
Cash & Cash Equivalents	🟡	→	🟢	→	🟢	→	🟢	→
Currencies								
EUR	🔴	→	🔴	↓	🔴	↓	🔴	↓
USD	🟡	→	🟢	↑	🟢	↑	🟢	↑
Other	🟡	→	🔴	→	🔴	↑	🔴	↓
Equities								
Europe	🟡	→	🔴	↓	🔴	↓	🔴	↓
USA	🟡	→	🟢	↓	🟢	↓	🟢	↓
Japan	🟡	→	🔴	↓	🔴	↓	🔴	↓
Emerging Markets	🟡	→	🔴	↓	🔴	↓	🔴	↓
Bonds								
Government Bonds - Developed	🔴	→	🔴	↑	🟢	↑	🟢	↑
Corporate - Investment Grade	🟢	→	🟢	→	🟢	→	🔴	→
Corporate - High Yield	🔴	→	🔴	→	🔴	→	🔴	→
Emerging Market Debt	🔴	→	🔴	→	🔴	→	🔴	→
Total return	🟡	→	🟢	→	🟡	→	🟡	→
Commodities								
Oil	🟡	→	🟡	→	🟡	→	🟡	→
Gold	🟡	→	🟡	→	🟡	→	🟡	→

French version

German version

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 ı L-2953 Luxembourg ı RCS Luxembourg B-6307 ı Tel. +352 4590 6699 ı www.bil.com.