May 30, 2018

BILBoard May / June 2018 – Sticking to the script



Into the second quarter, our long-term thesis for higher rates and healthy equity performance remains unchanged. As our base case plays out, we hold our tactical allocation steady in order to continue taking sap from the global expansion, while cushioning our portfolios from rising rates where possible.

All is relatively calm in terms of the macroeconomic landscape. Growth readings and PMI figures have come off the boil, receding from elevated levels, but the world economy is still expanding. Though inflation dynamics are building, signs of overheating are not present. This, coupled with the fact that markets are still highly liquid, leaves us without any compelling reason to de-risk at this stage. At its May meeting, our investment committee therefore voted to maintain our current allocation with a tactical overweight in equities.

It is however acknowledged that equity markets face heightened volatility compared to the abnormal tranquillity of 2017. Already, the first quarter of 2018 has been a tale of two halves with January delivering some of the best monthly equity returns in years, quickly superseded by a correction of roughly 10%. But volatility is part and parcel of equity investing, and thus far we have been able to use it to our advantage; for example, in February the tactical correction was taken as an opportunity to add to our exposure. We are poised to take advantage of similar

opportunities that may arise in the months ahead.

Equities

Our equity strategy is centred around the US and Europe. In the US, GDP growth outpaced expectations of 2% in Q1, coming in at 2.3%, with corporate investment growing at a robust pace of 7.3%. As we have entered the later stages of the US cycle, our analysts produced a special report delving into the financial health of American corporates and consumers. Looking at data on debt and delinquency rates, no warning signals are flashing red at this stage in terms of credit.

Q1 earnings-per-share growth on the S&P500 came in at a staggering 24% (with the majority of names having reported). Not only is earnings growth strong, top lines and profit margins are also rising at a good pace – a true sign of corporate health. As firms begin putting the cash saved from Trump's $1.5 billion tax cuts to work, we believe that the US market can hum along through summer. It is unlikely that such stellar earnings results will be repeated in Q2, but if figures can meet analyst expectations, this alone should be enough to keep markets supported. We maintain selective overweights in pro-cyclical sectors as well as in energy names – a bet that continues to perform as the oil price rallies (WTI recently went above $70 per barrel).

Europe has had a slow start to 2018 but the European Central Bank (ECB) has emphasised that it does not believe this to be a portent of worse to come. Indeed, temporary factors such as extreme weather, French labour strikes, and capacity constraints in supply chains have weighed on sentiment and it seems that the region's stream of disappointing data may now have run its course. While 2017 was the pinnacle for European growth, hitting a decade high of 2.4%, the outlook for 2018 is still robust with the Bloomberg consensus forecasting 2.3% growth. In light of this, and a softer euro, the equity market may still be tracking an upswing. We favour financial names which benefit from rising rates and industrials. We do however note that while the US-China trade dispute prevails, European equities which rely quite heavily on exports are likely to experience bouts of volatility. We have diversified into mid-cap names which conduct more business within Europe as a buffer.

Fixed Income

What is more concerning to us than a normalisation in volatility on equity markets is the harsh reality facing fixed income markets. As the 10th anniversary of the credit crunch approaches, central banks are sticking to *their* scripts in terms of gradually withdrawing ultra-accommodative monetary policies that propped up major economies after the crisis. Thus, bond yields which have been artificially suppressed are on the rise, which will erode value (price and yield are inversely correlated). This makes us reluctant on the majority of fixed income assets. By the end

of 2018, our analysts see the US 10-year Treasury around the 3.1% level and the Bund at around 0.9%. In anticipation of rising rates, there has already been a general repricing of risk, seen mainly in higher beta instruments such as high-yield and corporate hybrids.

In Europe, QE continues according to plan and the ECB is expected to communicate tapering intentions in June or July. A likely scenario is that QE will be extended into December. Investors in investment grade (IG) corporates continue to enjoy the huge stimulus while it lasts and spreads have been relaxed; month-to-date, European IG spreads have only widened by 1 basis point. However, down the line when tapering becomes a reality, this will change. We are maintaining exposure to convertible bonds, added in February, in order to benefit from their equity-like features.

Geopolitical tensions were highlighted as a rising risk by the investment committee. To name but a few, there is the trade war rhetoric, the Iran nuclear deal, an incoming populist government in Italy... all of which could have wider political ramifications. However, empirically speaking, geopolitical events are unlikely to single-handedly ignite a bear market. Nevertheless, these risks will undoubtedly generate volatility.

So, what is important to remember is that 2018 doesn't promise a rose garden. Along with the sunshine, there is going to be a little rain sometimes – this is something that may have been forgotten after 2017 – the Goldilocks year when everything was 'just right', with the maximum drawback on the S&P 500 having been a mere 3%. But if you can stand the pullbacks that are an inherent feature of equity markets and stick to the script despite short-term fluctuations and noise, over the longer term, fundamentals imply that there is still value left in stocks.

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	Apr. TAA	May TAA	SAA	Apr. TAA	May TAA	SAA	Apr. TAA	May TAA	SAA	Apr. TAA	May TAA
Equities				30%	36%	→ 36%	50%	65%	→ 65%	70%	90%	→ 90%
Bonds	100%	100%	→ 100%	70%	64%	→ 64%	50%	35%	→ 35%	30%	10%	→ 10%
Equity Allocation												
USA				9%	12%	→ 12%	15%	22%	→ 22%	21%	30%	→ 30%
Europe				15%	18%	→ 18%	25%	30%	→ 30%	35%	41%	→ 41%
Japan				3%	3%	→ 3%	5%	5%	→ 5%	7%	7%	→ 7%
Emerging Markets				3%	3%	→ 3%	5%	8%	→ 8%	7%	12%	→ 12%
Bond Allocation												
Government Bonds - Developed	50%	12.5%	→ 12.5%	35%	8%	→ 8%	25%	5%	→ 5%	15%	0%	→ 0%
Emerging Market Debt	10%	17%	→ 17%	7%	11%	→ 11%	5%	10%	→ 10%	3%	5%	→ 5%
Corporate - Investment Grade	20%	50%	→ 50%	14%	32%	→ 32%	10%	15%	→ 15%	6%	3%	→ 3%
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%	88%	→ 88%	75%	80%	→ 80%	65%	72%	→ 72%
Non-EUR	0%	5%	→ 5%	15%	12%	→ 12%	25%	20%	→ 20%	35%	28%	→ 28%
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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