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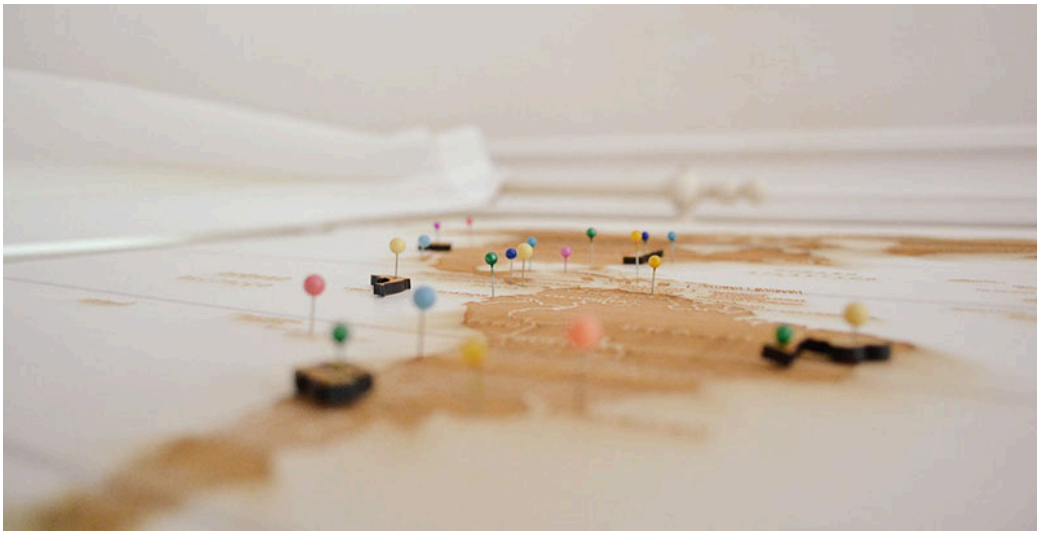
BILBoard November 2018 – Climbing up the Quality Curve



October has been a ghastly month on markets, with almost every asset class having taken a hit. However, without significant deterioration in the fundamentals upon which our risk-on strategy was built, we decided to hunker down and leave our equity overweight as is. However, for fixed income investors, the time is nigh to start preparing for higher rates.

October's correction, which had its roots in the US Tech sector, spread like wildfire through global risk assets. It seems to have been instigated by a host of dovetailing factors, the most prominent being the fear that the US Federal Reserve could act too hawkishly, after the Chairman, Jerome Powell, opined that the Fed was still a long way from reaching the 'neutral' rate (that neither stimulates nor contains growth). Another contributing factor was the idea that corporate earnings have peaked and that the trade war with China is starting to have a tangible negative impact on companies and the economy. These fears were compounded by the laundry list of worries hanging over the world economy: Brexit, Italy's budget gridlock, US mid-terms and the IMF's downward revision of growth expectations.

Firm fundamentals persist

As most of these risks had been on our radar since well before the sell-off, what was essential

for us was to go through macro data with a fine-tooth comb to ensure that some other sands had not shifted, skewing the fundamental outlook that underpins our strategy. Whilst we believe that global growth has reached its peak, we must not confuse a moderation in the pace of growth with a contraction.

Whilst there are some imperfections forming, the US economy is still in a strong growth environment. Third quarter GDP growth came in at 3.5% (annualised) and financial conditions are far from stressed levels. Unemployment is at a mere 3.7%, and the overarching strength of the labour market has fostered a sense of job security, which in turn has allowed consumer confidence to hit an 18-year high. After new home sales dropped for the fourth consecutive month in September (by 5.5%), the Committee expressed some concern with the downward trend in the housing market. Further analysis indicates – at least at this stage – that this is a normal response to decreasing affordability rather than something more sinister. The most recent Case-Shiller Home Price Index shows that home prices continued to increase in October, albeit at a slower pace.

The macro picture in Europe has a lot more white noise. Official data revealed that the eurozone economy grew at a pace of just 0.2% in the third quarter. This was pretty disappointing given the expectations for growth to continue at Q2's pace of 0.4%. There were a few transitory factors such as German car production being hit by new tests, but the key detractor was the fact that Italy registered no growth whatsoever.

Should rising US rates keep you up at night?

Rising rates are not a risk per se, if they move upwards in tandem with growth. On the other hand, a situation in which inflation moves above the Fed's target, forcing the central bank to hike at a faster-thanexpected pace, as fiscal stimulus fades, would be very challenging.

For now, forward inflation expectations have come down on both sides of the Atlantic – more notably in the US, where wages have only now started to show meaningful increases and where capacity utilisation appears to have stabilised at 78%. Without any meaningful rise in inflation for the time being, we expect rates to rise more gradually and our expectations for the US 10-year yield are anchored below 4%.

As the Fed continues along its predefined hiking path, the 2-year yield should rise more rapidly. Investors could either complain about potential yield curve inversion, or about long rates going higher but not about both. Switching from one perspective to the other means investors will never get close to seeing the glass as half-full.

Equities

Rising rates (and yields) threaten the relative attractiveness of equities, but for now, rates are not high enough to pull the rug from under the equity market. Historically, the latter stages of

the cycle have been fruitful for equities, and we maintain our preference for this asset class with a heavy tilt towards the US. Q3 earnings season has underlined the strength of corporate America – S&P 500 earnings growth thus far has been 24.9% YoY, and sales growth of 8.5%. We believe that the selloff was exaggerated (especially given the number of quant strategies which have automatic sell triggers that are activated by changes in momentum and volatility) and we expect a relief rally. Once the blackout period associated with the earnings season is over, buybacks should bring further support to the market. Albeit, as we traverse the later stages of the cycle, volatility will revert to more 'normal' levels (as opposed to the tranquillity that many became accustomed to in 2017).

We still have a lack of enthusiasm for European equities given the myriad of risks that remain.

Fixed income

To prepare for the new reality that higher rates will bring to fixed income, we have started to de-risk by climbing up the quality curve.

We reduced exposure to high-yield bonds and riskier tranches of the investment grade (IG) market, such as corporate hybrids and convertibles, adding core government bonds for ballast against future volatility.

In our lower risk profiles, we are happy to maintain exposure to senior tranches of the IG space in Europe. These instruments held up well during the sell-off, and amongst European corporates, leverage ratios are favourable, as is interest coverage. Hedging costs of 3.4% undermine the attractiveness of US IG for euro-based investors.

Whilst emerging market debt had a relief rally across September and October, we still view this segment as too risky

Conclusion

October was undoubtedly grim, but it is important not to let temporary stock market gyrations reshape one's view of the economy. Whilst it may no longer be stellar, macro data in general is still strong enough to carry the equity market throughout the rest of the year, particularly in the US. However, in fixed income, it is time to start moving up the quality curve in preparation for higher rates and reduced liquidity as quantitative tightening ensues. As Warren Buffet once said, "Only when the tide goes out do you discover who's been swimming naked.

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	26th Sept.	31st Oct.	SAA	26th Sept.	31st Oct.	SAA	26th Sept.	31st Oct.	SAA	26th Sept.	31st Oct.
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% ↑	28%	35%	15% ↑	19%	25%	18% ↑	20%	15%	9% ↑	10%
Emerging Market Debt	10%	10% →	10%	7%	7% →	7%	5%	5% →	5%	3%	3% →	3%
Corporate - Investment Grade	20%	50% ↓	44%	14%	30% ↓	26%	10%	12% ↓	10%	6%	1% ↓	0%
Corporate - High Yield	20%	12.5% ↓	10%	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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