Butterfield

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December 2019

Global strategy

How much longer can US outperformance last?

One of the features of the past decade has been the strong performance of the US economy and US financial markets relative to the rest of the world. Looking at the drivers of the outperformance of US equities, around half has been due to faster sales-per-share growth, a third has been due to faster growth in US corporate profit margins, with the rest due to relative valuation (price/earnings ratio) expansion in favour of the US. Strong sales growth in the US has been driven primarily by the Technology, Consumer Discretionary and Healthcare sectors, which are three of the largest market sectors.

The US is home to a number of the largest technology companies in the world, with the sector compromising around 23% of the US market index, compared to 6% in Europe, 12% in Japan and 15% in Asia excluding Japan. While global growth has exhibited a number of mini-cycles over recent years, the technology sector has been exposed to favourable structural and cyclical themes. Semiconductor companies and hardware companies have benefitted from the proliferation of digital devices in our everyday lives, such as the rise of the smartphone, while software-exposed companies have been well placed to benefit from trends in cloud based technology, cashless payments, online retailing and online advertising.

That investors have been prepared to pay a premium for companies with faster revenue growth and higher profit margins is hardly surprising, however the question is how sustainable are these trends relative to those in other market sectors? The investment banks and independent research providers that we follow are currently in the process of releasing their outlooks for 2020. One of the common calls for the year ahead is that it is time to favour international equities over US equities. International equities tend to have more exposure to cyclical sectors such as financials, energy, materials and industrials, so would be expected to outperform in a period of stronger growth. We have seen recent signs that global manufacturing has bottomed, so the outlook is certainly brighter than it was in late summer.

Global strategy

How much longer can US outperformance last?

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China has become an increasingly important country in terms of global growth and global exporters, so whether growth there has stabilised will be a key factor for global growth, and therefore regional equity dispersion. The US economy is relatively closed compared to others, such as Europe and a number of Emerging Markets, so this is another reason that the US tends to be more insulated when growth is weak. Looking under the surface of the slowdown in China shows that previously weak areas of semiconductors and autos have started to recover, whereas the previously strong construction sector is now showing signs of weakness. China continues to balance contrasting objectives of managing debt levels and managing a growth slowdown, so this is something that we are watching closely.

Overall, lower interest rates have been relatively quick to support growth in the US due to the sensitivity of the housing market and the equity market. The transmission mechanism outside of the US is less direct, so if we see compelling evidence that growth outside of the US has turned sustainability then we will look to increase exposure to more cyclical regions outside of the US. In the meantime, we would like to wish all of our readers a very happy Holiday Season.

Fixed income

Taking some insurance

With no Federal Reserve policy decision this month, and only the meeting minutes from October to digest, markets were solely focused on economic data and the almost daily tweets on the status of the US-China "phase one" trade deal. As we stated in our commentary last month, given the significant bid for safe haven assets, which did not match the signals from leading economic indicators, we felt like we had reached peak pessimism. Given the movements in risk assets, which rallied during November, the market clearly feels that this is the case. We do however still need to be mindful of upcoming events.

The outcome of the UK election is likely to impact markets first, closely followed by a decision as to whether the next round of US tariffs on China will be enacted. Both of these immediate events could be particularly bullish or bearish for asset prices, so it is important that we correctly measure how much pessimism remains embedded into asset prices. Spoiler alert: US credit markets remain vulnerable, closely followed, for very different reasons, by long-dated UK Gilts, German Bunds and US Treasuries.

After so many months of weak data releases, it was a welcome relief to finally see some stabilisation in Europe, where manufacturing activity appears to have found a floor. US data also continues to exceed expectations and these positive improvements have helped to nudge the global manufacturing PMI back above the important 50 threshold. Although, we still await confirmation of this improvement via commodity prices, which are subdued. These events helped to boost global bond yields pushing the 10 year US Treasury up to a high of 1.94%, from 1.69% at the start of the month, steepening the curve in the process. In addition, with Japan and the UK both set to enact large fiscal stimulus programmes next year, and Germany under pressure to follow suit, the stage is being set for a 2020 rebound in global activity. The world's major central banks are likely to allow their economies to "run hot", keeping interest rates low for some time, as growth and inflation is desperately needs to erode debt levels and to pacify the uptick in populist movements that are rising around the world.

Our portfolio positioning, as detailed in previous commentary, is largely unchanged in terms of risk assets. We continue to

Fixed income

Taking some insurance

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avoid expensive credit, but at the same time, improving global growth indicators and the massive increase in global liquidity, keeps us from dialing back credit exposure to underweight. Portfolios have ample amounts of dry powder and we feel that this remains appropriate given rich valuations. Throughout 2019 we have been fairly aggressive in terms of reducing credit risk in dollar mandates. While, we did not see the level of volatility that we expected, this did not impact performance significantly as corporate spreads were tight, so the forgone income was minimal. When we do finally witness a bout of nervousness in credit markets, we will move swiftly to add exposure back, but will remain biased towards companies with solid balance sheets as we attempt to maximize risk adjusted returns going forward.

In terms of duration positioning, we did make a major change to our core view. At the start of the month, the bond market sharply priced out almost all remaining base rate cuts, indicating that it agreed with the Federal Reserve in that the "insurance cuts" that have so far been delivered will likely be enough to steer the economy away from a recession. We agree with this assessment and continue to expect a rebound in global growth over the coming months. While this is a positive outcome, we do not expect the Federal Reserve to raise rates over the next 12 months to counter this improvement in the economy and expect yields to only rise very slowly thereafter. Given this backdrop, coupled with the Federal Reserve purchasing $60bn per month in US Treasury Bills (effectively capping short-dated yields), investor positioning remaining neutral and global interest rates likely to stay very low, there is no compelling reason to remain underweight to short-dated USD duration. While it is not our base case outcome that the Federal Reserve resumes rate cuts in 2020, we believe that now is time, especially given the unwind in pessimism, to add some insurance to portfolios as protection in case of lower interest rates. We have therefore moved USD short duration positioning to neutral in early November, locking attractive yields in the process. We retain our underweight duration positioning across longer-dated parts of the yield curve.

Equities

Solid fundamentals underpin equity gains

Global equity markets continued to climb higher during November, increasing 2.8%; the highest return since June. The month of November followed a familiar pattern in which US equities, returning 3.6%, outperformed the rest of the world, while Emerging Market equities actually fell in dollar terms. Unsurprisingly, given the difference in sector weights, the sectors with the highest weight towards the US outperformed; mainly Technology and Health Care showed the highest returns. The global Technology sector is tilted towards the US more than any other sector; 85% of the sector is allocated to the US which propelled the sector to a 5.4% return for the month. The return profile for November displays a cyclical bias with Industrials also performing quite well, and those sectors with a higher-than-average interest rate sensitivity underperformed. Utilities and Real Estate underperformed the other nine sectors and were the only sectors with a negative return. However the impact on the broader market was held back due to the relatively small market capitalisation of those two combined sectors.

Over the last 12 months, the MSCI World has outpaced our expectations, despite various bouts of volatility in December, May, and August. As we near the end of the calendar year, it is a great time to take a step back and reevaluate the fundamentals underpinning the market. On the valuation front, equities are certainly more expensive than recent history, but recent economic and geopolitical trends seem to have reduced tail risk outcomes. On the earnings front, bottom-up growth expectations have typically been overly optimistic, only to be revised lower over time. Having said that, expectations have been cut so far that too much pessimism may exist, which is a positive contrarian factor.

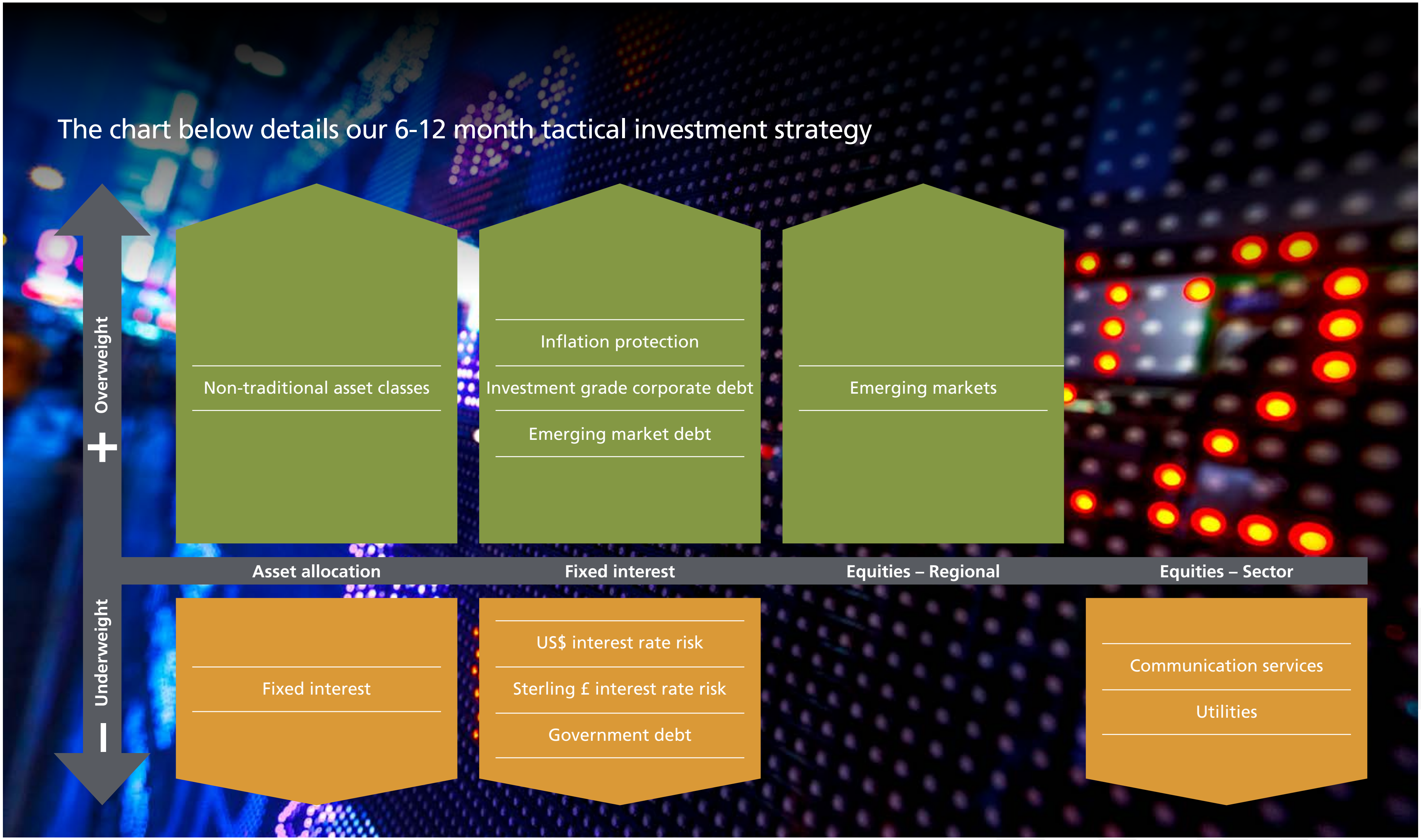
Long-term (5-year) global bottom-up earnings growth expectations currently stand at 7.9% per annum. At the beginning of 2018 that same figure was 12.1%, significantly

Equities

Solid fundamentals underpin equity gains *(continued)*

higher and more optimistic than today's estimates. The global growth outlook, given the levels of government debt yields, does not paint a rosy picture, but we do think that the consensus earnings outlook sets a low bar for equities, and thus puts a floor under global markets. Relative to early 2018, the Federal Reserve is much more accommodative with monetary policy, and there appears to be more clarity on the trade war, although many questions remain. On balance, we are much more comfortable remaining fully invested in multi-asset portfolios than we were over the summer. The high valuations are a product of easier monetary policy and a better outlook on trade, while low earnings growth expectations provide ample room for upside outperformance, despite subdued levels of forecasted total returns.

Global asset allocation



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