Butterfield

Global strategy
Light at the end of the tunnel

Fixed income
Peak pessimism

Equities
Cyclical stocks start to outperform

Global asset allocation

Investment Views

November 2019

Global strategy

Light at the end of the tunnel

This year can be characterised as one where global central banks have acted decisively in an attempt to offset a global slowdown in economic growth. The Federal Reserve has cut interest rates three times, the European Central Bank has cut the deposit rate and the Bank of England has hinted that it would consider cutting rates if the Brexit headwinds do not lift. Of the 57 institutions monitored by Bloomberg, more than half have cut borrowing costs this year. The slowdown in global growth started last year and the re-escalation of the trade war in May came at a time when growth was fragile, but starting to show signs of stabilisation. However, the trade war has hit corporate confidence and caused investors to assess whether lower interest rates would be sufficient to offset weakness caused by geopolitics.

Equity markets had a very strong start to the year and bounced back quickly from the weakness in the fourth quarter of last year, then, remained largely range bound as we progressed through the summer. The good news is that October heralded a wave of optimism across markets that a combination of thawing trade tensions and lower interest rates would be enough to stabilise global growth and get global manufacturing growing again. The trade war rhetoric has ebbed and flowed over the year, but as we get closer to an election year, the market has understandably taken Trump's recent statement touting a "very substantial phase one deal" as an encouraging sign. More tariffs on imports from China are scheduled to take effect in December, but the prospect of an initial deal raises the likelihood that these tariffs get shelved. Furthermore, Trump has hinted that current tariffs may be scaled back, depending on the progress of the current negotiations.

This shift in optimism came at a time when investor positioning had a very defensive tilt to it; the bond market was pricing in an elevated probability of a US recession, many cyclical stocks were underperforming defensive stocks and small cap stocks were underperforming large caps. We have therefore seen some notable rotations under the surface of markets recently as investors have moved to more pro-cyclical positioning; further detail on bond and equity markets is provided below.

Global strategy

Light at the end of the tunnel

(continued)

The evidence that global growth really has turned the corner is still only tentative, but in any case we would expect markets to run ahead of economic data. The extent to which the slowdown in manufacturing will spill over into the service sectors of the economy has been a key question, but evidence from resilient global labour markets suggests that the overall picture isn't as bad as some of the hardest hit sectors, such as automobiles and technology hardware, would suggest. One of the interesting divergences has been that consumer confidence remains high but corporate confidence has weakened. The labour market is really the key to this relationship and the signs are that a healthy employment market will support consumers and business confidence will eventually follow if the US and China can reach a trade truce.

Fixed income

Peak pessimism

The Federal Reserve recently lowered borrowing costs by 25bps to a range of 1.50-1.75%, delivering in line with market expectations. The probability of this move rose to 95% the day before the meeting, so it is therefore not surprising that markets did not move very much on the news. Our thoughts on central banks capitulating to market pressure are already well known (they probably shouldn't), but even we acknowledge the secondary effects that not delivering can have on market and consumer confidence. So at this delicate time, when global growth appears to be turning a corner, and some resolution on trade is upon us, we concede it was probably prudent for the Federal Reserve not to disappoint the bond and equity markets. The question is now: will markets push the Federal Reserve for more? Possibly not; the yield curve has steepened since August in what may be a sign that monetary policy has reached an optimum level, which would imply that economic data has returned as the main driver of policy moves.

What was also significant in our view was the formal expansion of the Federal Reserve's balance sheet, primarily designed to tackle the regulatory imposed stress in the repo markets and the implication that the series of "insurance" rate cuts delivered so far this year may have run their course. On the balance sheet the level of recent expansion is very large and goes beyond the natural growth rate of money supply, so much so that the Fed is buying around 96% of treasury issuance over the next 8 month. U.S. Treasury bills are the primary purchasing instrument, but short dated coupon bearing US Treasury bonds will clearly also feel an impact of a non-price sensitive buyer entering the market in size.

With policy makers clearly moving to a more neutral stance, and largely data dependent, the prospect of further interest rate cuts are diminishing and very short term interest rates are likely to remain range bound. So without an obvious trigger for a move in either direction, a neutral duration allocation for short dated mandates seems appropriate and we will look for an entry point next month to lock in some insurance of our own now that the Federal Reserve thinks that they have enough.

Fixed income

Peak pessimism

(continued)

Economic data releases during October were mixed, with better than expected numbers from Europe and Japan, although coming from a very depressed base, with continued strength in the core consumer in the US offsetting the weaker survey based "soft" data. This dynamic was seen in the advanced Q3 US GDP reading which showed +1.9% annualised growth (vs +1.6% expected) and consumer spending again compensating for weak capital expenditures and exports. The unemployment rate remains at just 3.5%, consumer confidence at 20 year highs and wages growing at a solid 3% – very far from the doom priced into US bond markets. Global growth indicators are also building some positive momentum with continued improvements in leading indicators and stabilisation in others. This coupled with monetary and fiscal stimulus, and the potential reduction in policy uncertainty, prompts us to ponder have we hit peak pessimism? If so, fixed income markets could be in for a bout of interest rate volatility to rival the taper tantrum back in 2019, and we are proactively positioning ourselves accordingly.

Portfolio positioning is largely the same as last month with a sizeable US Treasury allocation, split between nominal and inflation protected bonds which we still view as cheap given the potential for a growth rebound, complemented by US conventional agency mortgage backed securities (in appropriate portfolios) and a very targeted allocation to investment grade credit. Within the investment grade credit bucket very little value can now be found in AAA-A rated companies, as duration adjusted corporate credit spreads are now below the levels of early 2018, and thus, we prefer the BBB space where spreads remain mildly attractive on a risk adjusted basis.

Going forward, the probability of an increase in corporate bond volatility has been dampened by the actions of the major global central banks. However, we still prefer to remain defensive overall as market sentiment has turned very sharply bullish - driven by the prospect of a deal which has not yet been signed - therefore there is a risk of a short-term pull back in risk assets on any disappointment. In addition, if we assume a partial trade deal is signed this year, credit spreads have very little room to rally further and a large allocation would simply be adding volatility to portfolios at this point for little additional yield. Balancing these outlooks, we can make a case for maintaining credit risk, as opposed to our strategy year to date of an outright reduction, but still remain reluctant to increase risk with the pace of leverage and duration increases we are seeing across corporates.

Equities

Cyclical stocks start to outperform

Global equity markets continued to climb to all-time highs despite significant flows out of the asset class. The headline MSCI World index increased 2.5% as cyclicals outperformed, and overtook defensives during October. US equity mutual funds and ETFs have seen a combined $100 billion of outflows so far in 2019, relative to inflows of $800 billion into US fixed income and cash holdings. Equities have more than held their own despite these outflows as investors have bid up equity valuations amid heightened levels of share buybacks driven by a historically low corporate interest expense. Underlying the headline index, global ex-US equities posted strong performance for the month. Japanese equities, 4.9% return, emerging markets equities, 4.2% return, and European equities, 3.2% return, all outperformed as the cyclical recovery took shape.

We have kept a close eye on the most recent corporate earnings season to determine how various economic and geopolitical factors are affecting the health of global corporations. It is evident that global growth is decelerating, but what is a little less clear is whether the economy is slowing organically, or has the deterioration of global trade hurt the expansion, and thus internationally exposed businesses. What is most likely is some combination of an organic slowdown and a drag from slowing global trade is at play.

Consensus analyst estimates at the beginning of the reporting season pointed to a 5.5% fall in the level of earnings relative to the third quarter of 2018. By the end of October, the majority of S&P 500 companies have reported, with their earnings faring better than estimates in aggregate, showing a 2.3% decline in earnings on 4% growth in revenue. All sectors reported higher than expected earnings figures, led by technology companies, which came in 4.9% above consensus estimates. The healthcare sector, a long standing overweight in our discretionary portfolios, showed strong top and bottom line growth, propelling companies

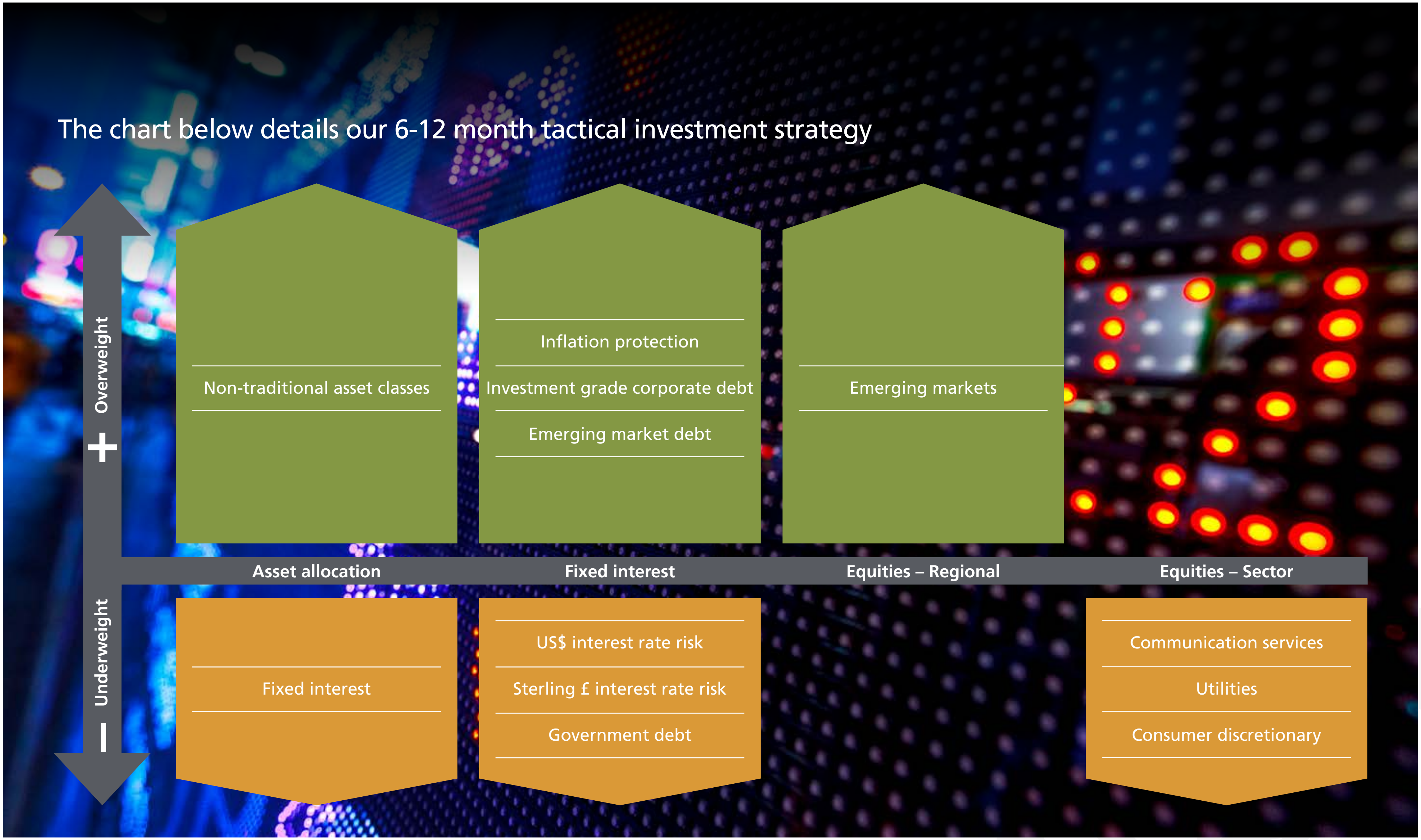
Equities

Cyclical stocks start to outperform
(continued)

in the sector to better relative performance. Outside of healthcare, those companies with the highest international exposure posted the slowest year-over-year earnings growth. Drilling down a level, those companies with the highest exposure to China unsurprisingly posted lower earnings growth than their more domestically focused peers. However, there may be some light at the end of the tunnel as analysts are no longer cutting estimates most for companies with the highest international exposure.

As discussed above, the fundamentals underlying the healthcare sector are strong, and the sector has been a solid performer since we initiated the overweight allocation versus benchmark. The defensive nature of the healthcare sector can sometimes be overshadowed by political overtures, especially around US elections. Our long-term thinking that aging populations will benefit the broader healthcare sector has not changed. However, we have decided to trim the sector weight back to neutral in a bid to reduce the overall portfolio's exposure to exogenous forces, political or otherwise.

Global asset allocation



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