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April 2019

Global strategy

Slow-motion shifts

If one were to ask the average member of the public what central banks do, then the most likely answer would probably be "to set interest rates" or perhaps "keep inflation under control". However, if one were to ask the same question to someone working in financial markets then the answer is likely to be "it's complicated". Over the last few decades, central bank thinking has been significantly influenced by a very damaging period of high inflation in the mid-1970s, such that a 2% inflation target has been a key central bank policy objective in pursuit of stable prices. However, the period since the financial crisis has been more about avoiding deflation rather than keeping inflation and inflation expectations under control. This has particularly been the case in Europe and Japan, but also to a lesser extent in the United States and the UK.

One of the most important themes over the first quarter was the Federal Reserve's extraordinary shift in tone regarding future rate rises, compared to that of 2018. At the end of September last year the median voting member expected to raise rates three times in 2019, but this was recently reduced to zero. The near-term implications for bond and equity markets are covered in detail below. There is however a broader question of whether the deterioration in economic fundamentals really justified such a dramatic shift, or whether there has been a more fundamental shift in the way the Fed thinks about how the economy operates and what causes inflation.

President Trump has publically criticised the Central Bank and Chair Jerome Powell in particular. Initially, this probably had the opposite of the intended effect i.e. it discouraged the Fed from sounding too dovish in an attempt to prove their independence. However, as markets priced in a materially weaker growth outlook, the Fed either had to react to this or run the risk of being

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blamed for causing a slowdown, which in this era of populism could be very damaging to their credibility, with Washington and the public more widely. Underlying all of this is potentially a subtle shift away from a framework that targets 2% inflation each year to one that tries to make up for previous inflation undershoots and waits to actually see inflation rather than acting preemptively.

That inflation has been "the dog that did not bark" has allowed the goldilocks trade—where investors make money on both bonds and equities—to reassert itself after a very painful fourth quarter last year. If the Fed really is prepared to have a higher tolerance to inflation, then this would be a significant change. The move would likely extend the current economic cycle, which is positive for equities, as they have never made a cycle high more than 12 months before the start of a US recession. It is possible that the deterioration in growth warrants the shift that we have seen and that the Fed has tried to get ahead of the slowdown, rather than react too late. We will know a lot more about how this story develops when the Fed undertakes a strategy review, which is scheduled for June. In the meantime, the market has priced a more optimistic growth outlook, so probably needs to see more stable economic numbers in the second quarter to provide a foundation for stronger growth in the second half of the year.

Fixed income

The Fed folds

With risk assets continuing to ascend and bond yields hitting fresh lows, we have witnessed a first quarter where most investors made money regardless of the asset class they were allocated to. While market participants have known that the US economy was due to weaken as the fiscal stimulus ran its course, it was only at the very start of the fourth quarter that policy makers in the US signaled that they were a long way from neutral (the interest rate that is high enough to contain inflation pressures but not too high as to cause unemployment to rise), prompting markets to expect another three base rate increases over the following twelve months. We of course then witnessed risk assets falling and this episode clearly impacted the Fed's outlook, this was also compounded by the US economy showing firmer signs of economic weakness.

As discussed above, the reason for the magnitude of this pivot is unclear at this stage. Policy markets could be acting pro-actively in an effort to engineer a soft landing, an outcome that no major central bank has been able to successfully accomplish, but if it becomes clear that the economy is in fact stronger than expected then the risks will likely manifest in financial instability i.e. asset price bubbles.

On the economic front, data releases in the US remain mixed, softer yes, but nowhere near recession levels, which makes the massive move lower in US Treasury yields slightly confusing, especially as risk assets seem completely unfazed by any talk of recession. These recent moves have now inverted the yield curve at short maturities with the usually reliable three month versus ten-year curve trading down to -7bps. The bond market now prices in a 70% probability of a cut to the US base rate in 2019 and two full cuts over the next 24 months. In our opinion, this outcome is only likely if policy makers are faced with a full blown

Fixed income

The Fed folds

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recession and with that, credit spreads and equities could be very vulnerable at these levels. Hence, whilst the sun is shining, we have continued to reduce credit risk where appropriate.

Outside of the US, we are seeing some signs of green shoots in Asia, but continue to see weaker data in Europe. Germany in particular has seen a severe manufacturing slowdown which has led to ten-year Bund yields falling into negative territory for the first time since 2016. This has had implications for global bond yields, explaining some of the recent rally in US Treasuries, as the US remains one of few sovereign's with a positive real yield. In the globalised economy, a potential recovery in Asia should in time support the economies of Europe and the US. If we do see stabilisation in growth and inflation outlooks, then running an underweight interest rate risk position would enable investors to avoid capital losses in their portfolios as yields rise.

Given our preference for the US to avoid a recession this year, we have taken this opportunity, with ten-year US Treasuries at 2.41%, to reduce exposure to the long end of the curve in appropriate mandates. In addition, we also used the recent weakness in inflation expectations to increase our TIPS (Treasury Inflation Protected Securities) positions. The Fed's recent dovish pivot was in part due to sticky inflation expectations (PCE inflation remains below 2%), in spite of buoyant employment and wages trending higher. If they are successful in resetting expectations portfolios should benefit, especially if monetary policy does turn out to be too easy for the US economy.

Equities

A strong recovery

Investors in equity markets could breathe a sigh of relief in the first quarter, as a broad based recovery has brought global markets within striking distance of all-time highs. The MSCI World continued the "V" shaped recovery pattern during the first quarter of 2019 – returning 12.5%. Recent risk asset performance has been driven by a battle between global growth and monetary policy stances. In the fourth quarter of 2018, global growth had clearly slowed and the Fed seemingly had a hawkish tone, which sent equities close to bear market territory. Fast forward three months, the Fed has turned dovish, and growth expectations have fallen so much that the market could be underpricing a recovery.

Absent an earnings recession, this is clearly an environment in which equities can perform well – evidenced by the strong returns during Q1. The Fed has hit the pause button on further rate hikes in the short-term, inflation is not running rampant anywhere in the world, global earnings expectations call for 4.5% growth in 2019, and valuations are far from stretched. Despite solid single digit growth in expected earnings, it is often the change in expectations that is more important. While bottom up European (ex UK) earnings are expected to grow 6.8% in 2019, which leads all global regions, only 3 months ago that same figure was 9.2%. Similar decreases can be seen in the US and Asia. Earnings expectations have been hit by higher input costs, wages and commodity costs, as well as slower top line revenue growth.

The other important factor worth examining at the moment is the disconnect between bond and equity markets. Inversion has occurred at specific points on the yield curve, which have

Equities

A strong recovery
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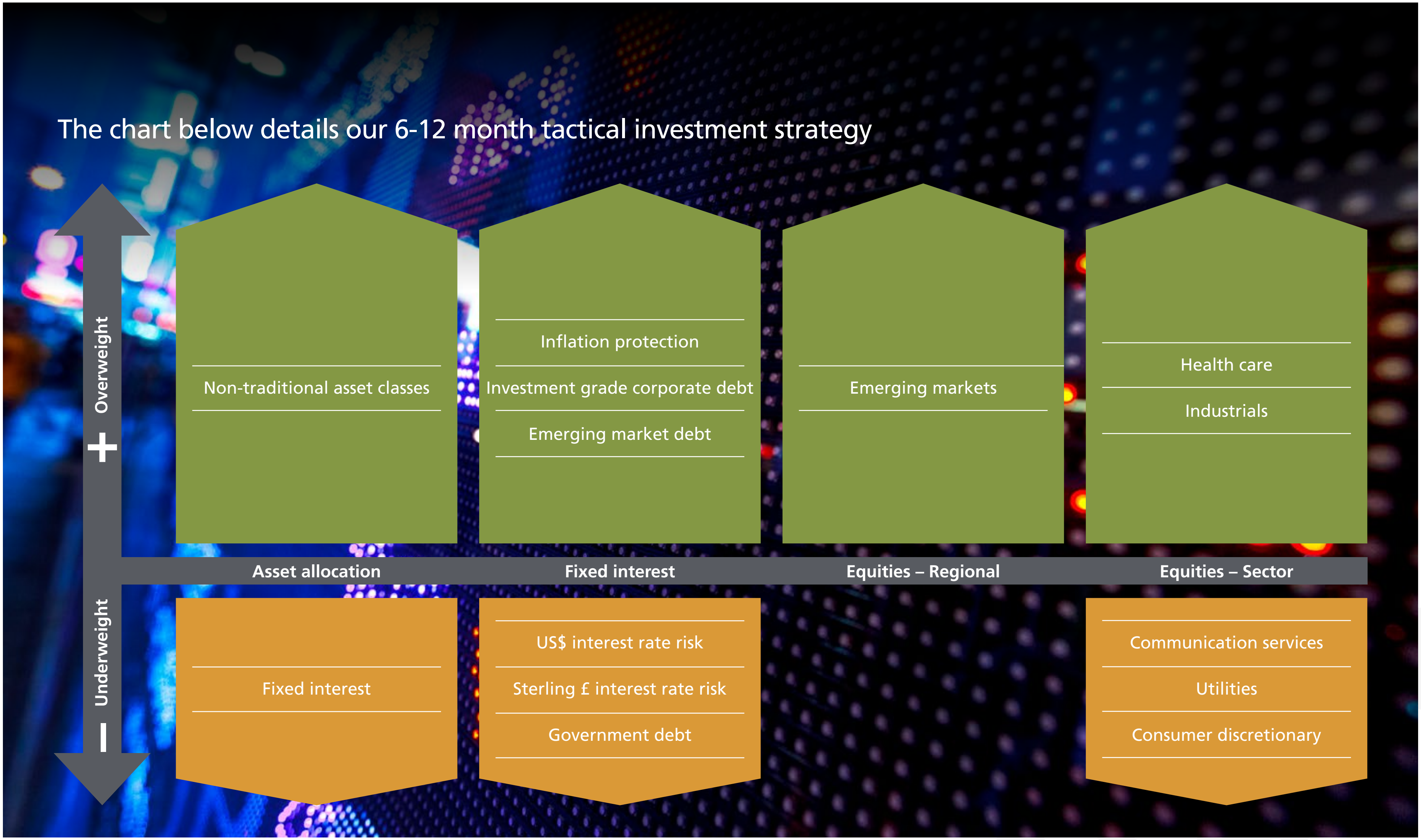
historically had strong predictive power towards recessions. While we are aware of the relationship between yield curve inversion and amount of time until the occurrence of recessions, and thus a fall in equity prices – the yield curve inversion is only one factor in determining whether equity markets will fall and when that fall will actually begin. Equity markets have continued to climb higher and have ignored the signals that are flashing red in the bond market, both the inversion and levels of yields. Meanwhile, the message from corporate credit spreads is much more supportive.

At a regional level, the dispersion of returns is similar to that of 2017 and the first half of 2018. North America has posted the strongest gains, with all other regions underperforming the headline MSCI World. The rationale for North American outperformance has been the region's reliance on the technology sector relative to Europe's reliance on the financial sector. Technology is the largest sector in US equity markets and has been the strongest performing sector in 2019, while financials, the largest sector in Europe, has struggled thus far in 2019. Despite the financial sector's poor relative performance, absolute returns have been solid in all 11 global sectors. It is however important to examine what equity markets have done over the past 6 months – a broad based quasi bear market followed by a strong recovery. The financial press loves large market moves, but they are uncomfortable for us as investors. If we were to combine the "bad" (Q4 2018) and the "good" (Q1 2019), global equity markets have fallen slightly over the past six months, with the outlook for equities mildly positive for the rest of 2019.

Global asset allocation



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