Butterfield

Global strategy
What about Europe?

Fixed income
Taking stock

Equities
Another good month

Global asset allocation

Investment Views

March 2019

Global strategy

What about Europe?

It is unsurprising that recent news flow has been dominated by the US and China given that they are the two largest economies in the world and have been embroiled in a very public trade negotiation. Some commentators have even described global growth today as a function of China's growth cycle and the US monetary policy cycle. On this basis, it feels like Europe has almost become the forgotten region. It is true that Europe's share of global GDP has declined significantly over the last few decades - down to 16.5% - but this is partly due to the rise of emerging market economies. However, Europe remains one of the world's largest trading areas, has a population of 741 million and the euro is used for 35% of global payments.

The Eurozone economy had a disappointing year last year. After participating in the synchronised economic growth in 2017, growth weakened due to a number of factors and dashed hopes that Europe may again become a meaningful contributor to global growth. The region is particularly exposed to global trade, so the slowdown is partly due to weaker growth in China. Add to this the uncertainty around Brexit, Italy's struggle to get their budget approved by the European Union and political protests in France, and it doesn't make for a rosy outlook. Stepping back a little, the demographic profile is less favourable than the US, so adding a cyclical slowdown to a structurally fragile Eurozone does make it a challenging environment for investors.

To its credit, the European Central Bank (ECB) has followed up on its promise at the height of the euro-crisis in 2012 to "do whatever it takes to preserve the euro". They have made use of a wide array of monetary policy tools and we have seen a range of asset purchase programmes to help support the sovereign, financial and corporate sectors. However, any analysis of Europe has to include the issue that the Eurozone is not an optimal currency union. The right interest rate for Germany is not the same as the right interest rate for Italy and, without floating currencies as the usual adjustment mechanism, it forces other adjustments and imbalances on the region.

Global strategy

What about Europe?
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Overall, it's disappointing that the Eurozone weakened so abruptly in 2018, even as interest rates remained very low and credit conditions remained supportive of growth. Last year really highlighted how reliant Europe is on demand from other countries, most notably China, and how fragile the region is to any external shocks. The one country with ample capacity to increase demand is Germany, so the pressure on them to raise domestic demand by boosting government spending is only going to increase. With political risk rising, measures to boost growth are much needed, and without meaningful fiscal stimulus the ECB's options remain very limited.

Fixed income

Taking stock

Risk assets continued to appreciate in February, with most asset classes returning to levels last seen at the start of Q4 2018. It appears the volatility that has consumed financial markets looks to have passed for now. Although, recent market behaviour has highlighted how important central bank policies have become and also how mindful the central banks are to tightening financial conditions. This point was made in recently released data for December, when amidst the weakness in global risk assets the Bank of China quietly eased monetary policy by US$200 billion, reversing four months of tightening by the Federal Reserve and effectively calling the bottom for corporate credit.

Economic data in the US is clearly weakening, with various indicators now showing signs of a reduction in output. However, the noise from the US government shutdown in January continues to distort the picture, with more reliable measurements not available until next month. With the American consumer in excellent health driving solid domestic spending, aided by US mortgage rates falling by 40 basis points since November, risks of an imminent recession look overstated. We are also seeing encouraging signs of a turnaround in China, driven by Chinese policy makers who have enacted various easing measures in order to stabilise economic growth, which may be finally bearing fruit. These potential green shoots should help to alleviate any negative trends building in the US and also provide a much needed boost to Europe.

With a newly dovish Federal Reserve anchoring base rates at the short end of the US Treasury curve, two year yields have declined ending the month at 2.52%. The market believes the tightening cycle is over and the partial inversion of the US Treasury curve from two-five years also suggests a recession is forthcoming over the next 24 months. In contrast to this bearish setup in the US rates market, credit spreads have tightened considerably, oil has surged back to $57 per barrel, inflation expectations have rebounded and volatility indices have fallen substantially. This differential is unlikely to last and, if the US economy can avoid a meaningful slowdown, global yields should be pressured upwards. Furthermore, with UK Gilts now especially vulnerable given

Fixed income

Taking stock
(continued)

that the Brexit end game is potentially upon us and the Bank of England is eager to raise interest rates on a positive outcome.

We largely continued with our investment theme from last month, taking stock of current portfolio positioning and, where needed, de-risking portfolios via the reduction of corporate bond exposures. So far this year, credit spreads have rallied very strongly, which has driven returns via our overweight position in the asset class. However, given the magnitude of the rally, we have failed to see any significant sell-off in US Treasury yields which traditionally accompany this sort of move. This has led to a market anomaly where we have captured strong performance due to corporate spread tightening but have not given back any of this alpha to higher yields in US Treasuries. We have, therefore, taken profits on long credit, where appropriate, and switched to shorter-dated investment grade credit or US Treasuries. While we are biased to reducing risk, we do still favour a modest overweight to corporate bonds, due primarily to the easier monetary policy outlook and potential for stabilisation in global growth, which would provide a backstop to risk assets in 2019.

Equities

Another good month

Global equity markets continued to shake off the concerns that precipitated the correction in late 2018, and added to the gains experienced in January. The MSCI World increased 3.0% in February, following a robust 7.8% gain in January. At a sector level, Technology and Industrials, a portfolio overweight, led markets higher. The returns of both sectors were broad based, which differs from 2017 and 2018 when certain groups of securities, think "FANG", dominated market cap weighted indices. Cyclically exposed sectors outperformed their more defensive peers during February; not surprising given the risk-on nature of the rally. Defensive (and interest rate sensitive) sectors including Real Estate, Telecom, Consumer Staples, and Utilities all underperformed in the month. Surprisingly to some, Consumer Discretionary underperformed as Retailers and Auto manufacturers struggled in a difficult environment for both. Our discretionary portfolios have been underweight Consumer Discretionary for some time now, as there are structural and regulatory issues for much of the sector; themes that are currently playing out and affecting individual company-level performance.

In a vacuum, most investors would be content with a double-digit gain in equities in any year (let alone in the first two months of the year), however, the see-saw nature of markets over the past five months have forced investors to reassess their short-term expectations. How should we, and our clients, view markets for the remainder of 2019? Our thinking is shaped by quantitative factors, such as earnings growth and equity multiples, as well as qualitative factors, such as the potential impact of fiscal policy or emotion. In late 2018, the MSCI World's forward looking multiple had troughed to levels not seen in several years as the velocity of selling increased.

Equities

Another good month

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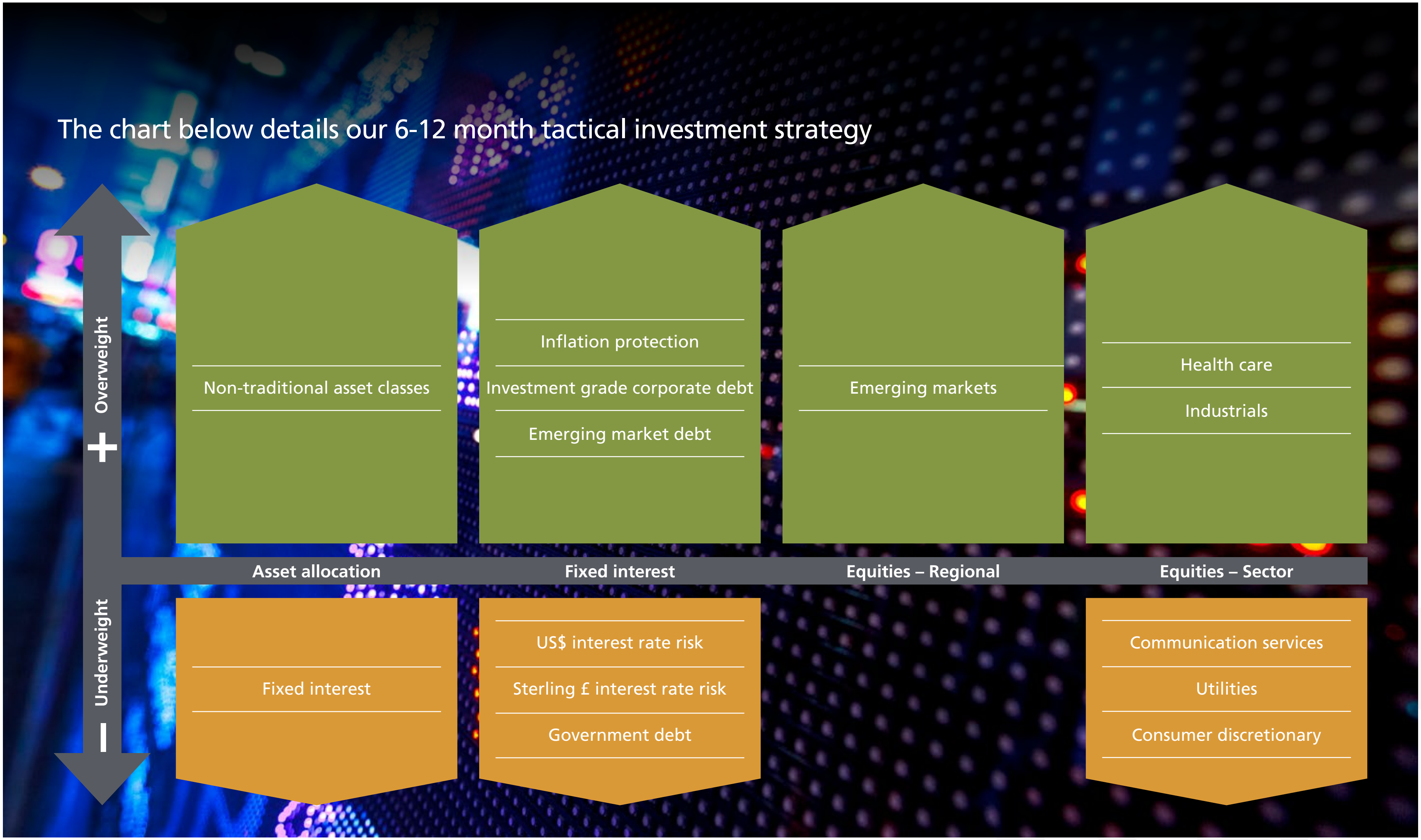
At that point, we wrote about beginning the year with a neutral stance towards the asset class, which meant adding to equities, where appropriate, in late December or early January. Fast forward several months: the market has increased 11%, whilst expectations for global earnings growth have steadily fallen and valuations are no longer as attractive as late 2018. We reiterate our neutral stance towards equities, yet it is difficult to envision the market vaulting to September 2018 highs in a straight line. There will be bumps along the way, however we do believe that equity markets will be higher in 12 months' time. It is important at this time to temper expectations and again reassess portfolio positioning and trim certain positions to take gains where appropriate.

Global asset allocation



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