Butterfield

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Global strategy

Crisis, Japan or neither?

Anyone following the news cycle over the last few months would be forgiven for thinking that the world is devoid of any good news. Whether it is the trade war and deteriorating relationship between the US and China, ongoing Brexit melodrama, stagnating Eurozone economy, political tensions in Hong Kong, or another financial panic in Argentina, the headlines suggest an increasingly uncertain environment. Of course, many column inch writers are incentivised to portray events as an imminent crisis, and in some instances this is justified; when the Argentinian peso loses a quarter of its value versus the US dollar and the authorities impose capital controls on businesses, it is fair enough to report this as a crisis situation. But not everything that is bad is a crisis.

Historically, the bond market has been better at providing insights to the future than the equity market. One of the challenges so far this year is that the unambiguously downbeat "message" from the bond market is in contrast with stronger performance from equities. One of the ways to reconcile these two perspectives is that the growth outlook isn't quite as strong as previously hoped, but that ultimately lower interest rates will work to support growth. Over the last year the 5 year Treasury bond yield has fallen from around 3% to 1.5%; this has led to an increase in suggestions that the world is "turning Japanese".

Twenty years ago the Bank of Japan cut interest rates to zero and has since never managed to raise them back above 1%. The rate cuts were in response to a significant asset price and credit boom, which collapsed in the early 1990s. In short, the deflationary impact of this period and subsequent lack of any inflationary pressures has stayed with Japan much longer than almost all economists thought was possible. The consensus has distanced the post financial crisis period in the US with the Japan

Global strategy

Crisis, Japan or neither?

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experience, and for many good reasons. Japan was very slow to respond to its financial crisis, and it took many years for bad loans in the system to be acknowledged and dealt with. In contrast the US was very quick to recapitalise the banking system and deliver extraordinary monetary policy support in the form of quantitative easing.

Europe on the other hand, was much slower to respond to risks in their financial system and was also more reluctant to provide monetary support than the US. On this count we can say that the risk of Europe "turning Japanese" is higher than the probability in the US. This is indeed what the bond market is pricing, with yields in much of Europe already negative, which is actually more extreme than the situation in Japan.

One of the slower moving themes is demographics; Japan has a weak demographic profile and the working age population is actually falling. This is not a positive for growth, and lower growth leads to lower risk free bond yields. Again here, the experience in Europe is more reminiscent of Japan. In Europe the current UN forecast is for annual population growth of -0.5% over the next 27 years, however, this is not the case in the US, where population growth is expected to be +0.5%.

One of the interesting aspects of this whole debate is that real growth in Japan, when adjusted for the working age population, has actually been strong, more so than the US and Europe over the last 20 years. Comparisons between Europe and Japan are far more convincing than with the US, and as such it is dangerous to assume that inflation in the US will be dormant forever. This means that, contrary to the President's exclamations, the authorities in Europe have a lot more work to do to avoid the Japan scenario than the US. In any case, "turning Japanese" does not suggest an imminent crisis, and is not necessarily even a bad outcome. The most convincing message from financial markets today is perhaps not that there is an imminent crisis, or that economies are "turning Japanese", but just that longer term global growth isn't going to be quite as strong as previously thought.

Fixed income

Momentum is king

The month of August always feels a little odd as small news items can move asset prices in a disproportionate manner. However, August just gave us all another good reminder of what happens when illiquid markets meet a President Trump tweet. Fixed income assets performed extremely well, in fact the best monthly return for the aggregate US bond market since Q4 2008! Whilst this level of performance is great news for any investors with a fixed income allocation, this month's move wasn't healthy. Yes risk assets sold off slightly and credit spreads contemplated rising, but there was no major market stress or event that justified a move in the 30 year US Treasury from 2.52% down to 1.96%. US economic data surprised to the upside and gauges, such as the Atlanta Fed GDP and Chicago Fed National Activity index, both maintained levels consistent with 2% trend growth in the US. So what gives? Momentum. Difficult to foresee but obvious once established; add in the absence of humans, given the holiday season and, much like Christmas eve, machines were given a free run to drive yields lower with some anxious mortgage hedgers reluctantly joining the party as rates plummeted.

Aside from the behavior of global bond markets, other asset classes have been mostly subdued with energy prices treading water, credit spreads as mentioned above, mostly flat, and currency markets barely moving month on month. However, gold and to a greater extent silver, have seen massive appreciation helped by much lower real interest rates across the world and renewed interest in risk-off hedges given black swan risk; Hong Kong for example, is arguably the highest since the financial crisis. We would expect this trend to continue as high quality government bonds, given their valuations, carry risk of capital loss if yields now rise and are heavily skewing the risk/return profile of some balance portfolio mandates.

Fixed income

Momentum is king

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Economic data releases during August should have supported higher bond yields, with positive surprises across all major regions, which make recent bond yield moves even more puzzling. U.S. Q2 GDP at the second reading was downgraded a tad to +2% but with solid consumer spending under the hood. Also wage gains remain elevated and inflation stable. As we reiterated last month, this is not the usual backdrop for large base rate cuts – confidence, growth and inflation all need to be much weaker, in our opinion, for the Federal Reserve to follow through with the additional -90 basis points of base rate cuts currently priced into the futures market over the next 12 months, although we expect the next policy meeting in the US will almost certainly deliver a 25bps cut in the base rate, with the market assigning only a low 7% probability of a larger move.

Although markets have been buffeted by negative sentiment of late, there are some positive signs emerging. Italy looks likely to gain a more market friendly government and China is displaying signs of de-escalation in the trade war rhetoric. US corporates are issuing bonds again (in record amounts) with demand meeting supply even as yields hit new lows and we would expect this run of issuance to continue given ultra-low borrowing costs. Ultimately, although global growth has slowed in 2019, monetary policy by most of the major central banks has moved to counter this with lower base rates and another round of ECB QE imminent. In addition, fiscal stimulus also looks likely to be enacted soon. Together this should at the very least stabilize activity and lead a recovery in coming months.

We entered August maintaining our defensive stance after reducing allocations to corporate bonds, but with our core underweight interest rate risk positioning intact. However, we tactically increased duration, in some accounts, at the start of the month as we witness momentum building in order to mitigate the impact of a sharp move down in yields, as well as adding some black swan protection given the headlines on Hong Kong and Brexit. Strategically we continue to believe current bond yields are expensive versus the underlying level of economic activity and inflation, therefore we will look to unwind this over the coming weeks if we see signs of stretched positioning.

Equities

August volatility

August saw some relatively wild swings in global equity markets. The MSCI World index fell early in the month, saw more ups and downs mid-month, and then climbed late, to finish August with a total return of -2.05%. Volatility clearly jumped in August and the VIX index, which is a measure of expected volatility in US equities, jumped to levels we have not experienced since late in 2018. Over the past several years, we have seen the VIX index at depressed levels during the majority of trading periods, primarily due to global central bank policy. However, the index has recently seen spikes due to a poor macroeconomic data release or tweet. There were few places to hide during the increased volatility during August; all global regions were negative with Asian and emerging markets struggling the most.

When portfolio managers expect spikes in future volatility, a tendency exists to hold "defensive" assets, whether in a portfolio context or within a given asset class. In the equity asset class, achieving a "defensive" tilt entails holding companies whose earnings are less likely to be affected by swings in economic growth, along with companies that are attractively valued on fundamental fronts. This, in theory appears straight-forward. However, implementing a "defensive" tilt in portfolios is not always that easy. Going overweight the value factor in global equities is an example of why this does not always prove effective. Global value stocks are typically those companies that have higher dividend yields and more attractive valuations relative to the entire market. The MSCI World Value index has struggled coming out of the global financial crisis relative to the broader market and relative to the MSCI World Growth index.

Equities

August volatility

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In August, during heightened volatility, the Value index fell over -3% while the Growth index fell just under -1%. Why didn't safer, more defensive assets, outperform when the market fell? The answer lies in the makeup of the index itself. Two of the three largest sectors of the MSCI World value index are financials and energy. Financial and energy were the two worst performers during August, and are the two worst performers over the past 12 months. The more "defensive" sectors such as telecoms, utilities, or health care have performed well recently, but make up a relatively small portion of the value index due to expensive valuations.

Our focus recently has been reducing risk at the margins while still maintaining market weightings or above market weightings to those sectors we view as having persistent earnings growth and/or attractive valuations. We have begun to reduce our exposure to the global industrials sector. Industrial sector performance has held up relatively well despite slowing global trade, however we believe that the sector's performance will better track certain indicators that point to a struggling manufacturing environment. We are conscious of the allocations to cyclical sectors in our equity portfolios, but remain overweight counter-cyclical health care, and are increasing weights to other counter-cyclical sectors at the margin, while trying to avoid those companies that are expensive and lacking high levels of growth.

Global asset allocation

The chart below details our 6-12 month tactical investment strategy

	Asset allocation	Fixed interest	Equities – Regional	Equities – Sector
+ Overweight	Non-traditional asset classes	Inflation protection Investment grade corporate debt Emerging market debt	Emerging markets	Health care
– Underweight	Fixed interest	US$ interest rate risk Sterling £ interest rate risk Government debt		Communication services Utilities Consumer discretionary

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