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Global strategy

A framework for the big questions

Last month we wrote about the slow-motion shift that we are seeing in the way the Federal Reserve thinks about inflation, and more specifically how they should best fulfill the inflation part of their mandate. Complicating matters for central bankers, and economists more generally, has been the evolving nature of the US economy over time. Three of the most important trends have been: globalisation; financialisation; and a shift away from manufacturing towards services. The combination of these factors has introduced a number of challenges to conventional thinking. Since the Brexit vote and US Presidential election in 2016, globalisation has been covered extensively across a wide range of commentators and media outlets. Financialisation has been the process by which financial institutions and markets have increased in size and influence, and this has been a greater focus since the financial crisis. Lastly, the shift from manufacturing to services is something that is often written about, but the implications of it are still not well understood.

Over the last three decades, economic cycles have been longer, flatter and shallower than they had been previously. The changing structure of the US economy, due to the factors mentioned above, has played a role. The shift from goods and manufacturing to services was a key driver of the "great moderation" thesis which ended abruptly with the financial crisis. However, even including the impact of this period, the volatility of both growth and inflation has fallen substantially. Manufacturing has been declining as a share of the economy since the Second World War, but other factors have also played a role within the manufacturing sector. Better inventory management, driven by technology and global supply chains, has allowed the manufacturing sector to operate in a much more efficient manner, which has helped reduce economic volatility.

Global strategy

A framework for the big questions
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A good example of this was the downturn in the US energy sector in 2014/2015 that did not cause an economy-wide recession, which might not have been the case in the past. Imbalances and capital misallocations tend to cause slowdowns or recessions, however the strength of other sectors, such as software, increased the overall resilience of the economy.

The consequences of these three major shifts are significant and cover a wide range of questions across both economics and financial markets, such as: how powerful is the disinflationary trend from globalisation? Has globalisation peaked? If we are moving into a more inflationary regime, what does this mean for the term-premium in the bond market or price/earnings multiples in the equity market? The aim here isn't necessarily to answer these questions, but the three concurrent forces can help us with a framework for how to think about these questions, which are all very important, particularly given the backdrop of rising trade tensions between the US and China.

Fixed income

Taxi please?

Risk assets continued to plough higher in April, as memories of Q4 volatility fade and easy monetary policy has encouraged market participants to chase yield, leading to excellent risk-adjusted performance given that volatility has been all but non-existent so far in 2019. With credit spreads back to the lows of Q3 2018 and the S&P now at its highest level on record, one would assume that global growth has fully recovered, a trade deal between China and the US had been finalised and Brexit was resolved. Clearly this is not the case, and it is important for us as money managers to maintain our focus on the fundamentals. Whilst we are seeing tentative signs, within some regions, of stabilisation in economic activity, and global growth should accelerate later in the year, risk assets appear to already reflect this optimism and thus with the risk versus reward outlook skewed, we are left with a dilemma. Do we exit the party (market) early when there are plenty of taxis available (liquidity is ample and performance YTD has been superb)?

Focusing in on the fundamentals, the US economy is currently producing mixed data releases which itself is not concerning; economies are fluid and month-to-month data releases can be volatile. Q1 GDP came in at +3.2%, although core GDP was a more subdued +1.5%. Average payroll growth remains strong at around +200k per month. Average wages are growing at a healthy +3% and the housing market has regained momentum. In aggregate, the economy has slowed but remains in decent shape which partially explains why, contrary to the futures market, not one member of the Federal Reserve is officially calling for a base rate cut in 2019. We also maintain the view that core inflation should firm up over the coming months, as a tight employment market and buoyant consumers drive domestic spending, enabling the Federal Reserve to remain on hold for an extended period, and believe that the bar is high for an interest rate cut in the short term.

Fixed income

Taxi please?

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Outside the US, with economic activity in Asia showing signs of life, the stage is being set for a global growth rebound later in 2019, which should validate the recent performance of risk assets and pressure government bond yields upwards. However, global yields are very likely to remain depressed for the foreseeable future, which means that we are unlikely to see a rapid rise in US borrowing rates. This should allow a window of opportunity for the US Treasury to cheaply fund a badly needed US infrastructure programme before the election.

As we referenced last month, we have stepped up the reduction of credit risk within portfolios, leaving current positioning slightly overweight versus benchmarks, as duration-adjusted credit spreads remain very tight relative to history, with higher rated credit quality issuers, in the AAA-A space in particular, trading at very rich levels. With further tightening of credit spreads in April, we now prefer using our corporate credit allocation solely for select BBB issuers as spread compensation remains attractive and where the potential for capital gains, if risk assets melt up, is much greater. In addition, given that the market continues to price in a cut in the US base rate, floating rate notes, which benefit when rates rise, are now extremely good value versus their fixed counterparts and we have also increased allocations there.

Revisiting the question in our opening paragraph, historically late business cycle returns are much greater within Equities than Fixed Income credit, so is a portfolio's risk allocation better spent within another asset class? At these valuations possibly; although there are still low-risk opportunities for mandates with flexibility, and we continue to believe that US Treasuries remain the best risk off hedge globally. Despite ballooning fiscal deficits and erratic Presidential policy, we maintain a preference over similar-rated government debt due to heightened policy uncertainty and favourable real yields, and therefore an allocation to Fixed Income should remain a core feature of a multi-asset portfolio.

Equities

Here come the IPOs

The global MSCI World equity index finished April at all-time highs, returning 3.5%; adding to already lofty returns in the first quarter. On a year-to-date basis, the MSCI World has returned 16.5%; bouncing back after a painful last three months of 2018. In client meetings held in early 2019, we were reiterating our view that the equity market remains on solid footing, and thus we were increasing our exposure to the asset class back to our neutral allocations, where appropriate. Currently, after such a strong move higher, we have taken profits in portfolios, where appropriate, and trimmed exposure back to portfolio's neutral allocation. Portfolio rebalancing has historically been a very good way of managing volatility and maximising risk-adjusted returns.

This month, instead of diving deeper into what drove equity markets, we thought it would be interesting to examine what is happening in the Initial Public Offering (IPO) market, and why investors' appetites for IPOs describe current market sentiment. If you have watched any financials news or read the Wall Street Journal or Financial Times recently, you would have noticed a lot of chatter around several hot IPOs hitting the market. Tech darling Lyft beat rival Uber to market with a multi-billion dollar IPO in late March, with investors bidding shares of the company up 9% initially. Many "Unicorn" startups, those companies valued at $1B or more, are tentatively scheduled to go public over the next seven months of 2019 –Palantir, Pinterest, WeWork, and AirBnb just to name a few. The most recent "Unicorn" to go public was Beyond Meat, a company that creates plant-based meat substitutes that has benefitted from a more health conscious consumer. Beyond Meat raised $241 million in its IPO, with shares increasing 163% on its debut. With such strong performance, one

Equities

Here come the IPOs
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would assume that Beyond Meat is a highly profitable company with profits on an upward trajectory. In actuality, Beyond Meat has never made a profit, losing $24M in 2016, and $30M in 2017. Investors buying shares are more interested in the size of the market that Beyond Meat operates within, and the massive growth in revenue that Beyond has shown.

It is not rare that a company lists an IPO with no earnings to date and high valuations; Lyft and Uber have never made a profit and have both managed to sell shares recently. Beyond is valued over 40 times on a price-to-sales basis; more like a high flying technology company than a food producer. The demand for the IPOs is another sign that we are late-cycle and we are watching sentiment closely for signals of froth in global equity markets. Extremely bullish sentiment is a contrarian indicator for us in the short run, although market fundamentals remain strong and markets tend to overshoot fundamentals particularly at the end of the cycle.

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 Industrials
– Underweight	Fixed interest	US$ interest rate risk Sterling £ interest rate risk Government debt		Communication services Utilities Consumer discretionary

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