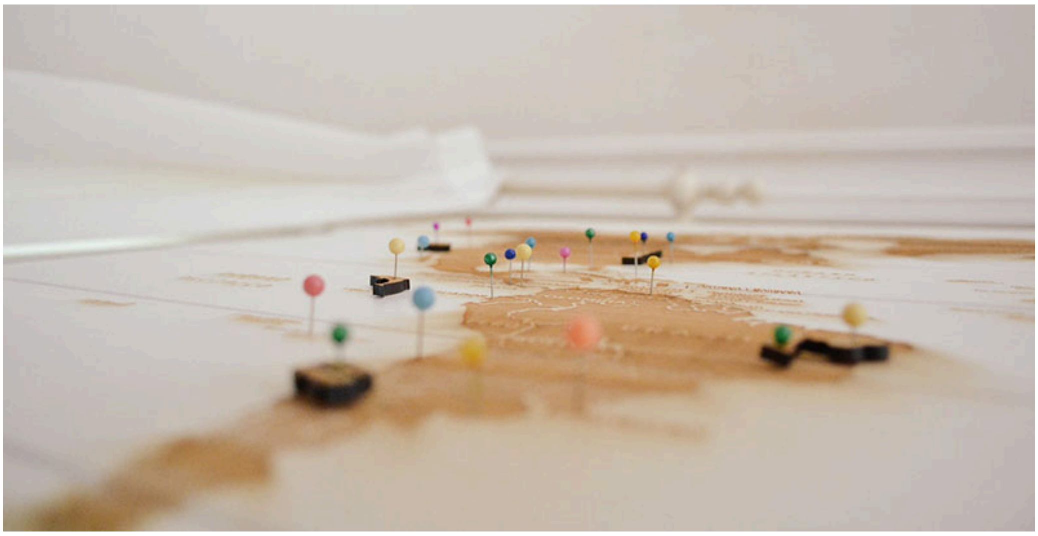
September 13, 2018

BILBoard August / September 2018 – Summer shakeout leaves Emerging Markets attractively valued



Hoping that the dust will settle after the summer correction, we believe EM equities offer value in a world where good value is hard to come by. We are taking the opportunity presented by lower valuations to re-enter the market, and see enough long-term value to accept the volatility that could potentially play out in the coming months.

Despite decent fundamentals and continued global growth, in 2018, EM assets fell out of favour with investors: yields shot upwards, currencies plummeted and equities fell into correction territory. This was instigated by a stream of protectionist trade policies emanating from the White House and a stronger dollar, but was compounded by unique idiosyncratic risks (Turkey, Argentina, Venezuela...). Heading into the summer months, when liquidity is typically tighter (making stock prices more sensitive to noise), we de-risked our portfolios by reducing our positioning in EM and European equities. In doing so, we avoided the summer bloodbath that later ensued in EM assets. However, EMs are now starting to look attractive, especially EM equities, whose prices appear to have fallen out of sync with fundamentals.

Equity

Amidst the summer rout, a chasm has developed between the unrelenting US equity market and other global indices. We expect it to close before long, especially as EMs – which are hovering some 20% below their January peaks – play catch-up. The price reactions seen across EM equities this year do not square with analyst expectations for earnings, implying that the outlook for EM stocks may be brighter than current valuations suggest.

Recent developments have allayed at least some fears for EM investors: China has taken action to put a floor under its sinking currency (a move commended by US Treasury Secretary Steven Mnuchin) and the US has reached a preliminary trade deal with Mexico. Additional de-escalation in trade tensions would likely reignite sentiment. Even so, it's worth noting that 30% of the MSCI EM index is made up of IT (a sector somewhat insulated against traditional trade tariffs). Undoubtedly, the risks are still high within this mercurial asset class, but current valuations and solid global growth act to balance these, and it seems that EMs have priced in enough negative news relative to incoming data for the time being.

Alongside our EM exposure, we also continue to be overweight the seemingly bulletproof US equity market, which is basking in the afterglow off the Republican fiscal stimulus package. Trump's protectionist push has not, for the time being, acted to the detriment of American manufacturers, who may even have received a boost from policy – as indicated by the ISM manufacturing index, which surged to a 14-year high in August.

US companies are surpassing high expectations with flying colours: EPS growth on the S&P 500 tallied in at 25.3% for Q2 (the second-highest earnings growth since Q3 2010 (34.1%) and sales growth at 9.5%. Following the blockbuster earnings season, US indices have skipped from new high to new high and record buybacks should support equities from a supply/demand perspective moving forward. Year-to-date, buyback authorisations have reached $754 billion, as firms put the cash garnered from tax cuts to work. Corroborating the case for US equities is the fact that American consumers are exhibiting their highest confidence levels in 18 years. As this confidence translates into looser purse strings, corporate America's collective bottom line should receive an additional boost.

With regard to the European equity market, we are reluctant to increase our holdings. It is true that the eurozone economy stabilized in Q2, with GDP growth revised upward to 0.4%; but at the same time, risks are no less abundant. Turkey is the third-biggest contributor to the EU trade surplus, weaknesses remain in the banking system, uncertainty surrounds Italian politics as the coalition seems to be on a collision course with the EU over its budget, and Brexit is still an elephant in the room... Spare capacity is almost non-existent in Germany and Holland, and is concentrated in peripheral countries. This accentuates the challenges faced by the ECB when withdrawing accommodative policy from a set of nations operating at different stages in the cycle.

Fixed income

As the global central bank collective pares back loose monetary policy, higher rates and rising yields are on the cards. Because higher yields equate to lower prices for bonds, the fixed income market offers few places to run, and even fewer places to hide. However, we see European Investment Grade (IG) bonds, especially corporate hybrids, as the best option for investors looking for yield. Europe is far behind the US in the credit cycle and most European corporates are still in de-leveraging mode. This translates to stronger balance sheets, and we are seeing credit rating agencies award European corporates with more upgrades than downgrades. It is true that compelling yields can also be found in the US IG space, but for euro-based portfolios, hedging costs of roughly 3% erode much of the upside. Investors in European IG should not expect significant spread tightening, but can benefit from the yield, as well as from diversification into an asset class in which risk is contained. For an additional layer of protection in the event of a downturn, we have a small selection of sovereign government bonds (Bunds/US Treasuries).

Summary

Certainly, the investment landscape has been difficult to navigate this year, with risk coming from almost every angle. But at the heart of the matter, the fundamentals which underpinned our bullish outlook for global growth remain intact, and give us confidence in our equity overweight. We will not promise an easier ride through the second half of the year, as midterm elections and trade tensions will likely keep investors on their toes. However, with the economy still in an expansionary phase, it seems that equity investors can still achieve some upside if they're prepared to ride out the volatility.

Strategic Asset Allocation (SAA) & Tactical Asset Allocation (TAA) by risk profile and asset class

	Defensive			Low			Medium			High		
	Bonds: 100%			Equities: 15% - 45% Bonds: 55% - 85%			Equities: 25% - 75% Bonds: 25% - 75%			Equities: 40% - 100% Bonds: 0% - 60%		
Asset Classes	SAA	8th August	29th August	SAA	8th August	29th August	SAA	8th August	29th August	SAA	8th August	29th August
Equities				30%	33%	↑ 35%	50%	57%	↑ 60%	70%	80%	↑ 85%
Bonds	100%	100%	→ 100%	70%	67%	↓ 65%	50%	43%	↓ 40%	30%	20%	↓ 15%
Equity Allocation												
USA				9%	15%	→ 15%	15%	27%	→ 27%	21%	36%	→ 36%
Europe				15%	12%	→ 12%	25%	20%	→ 20%	35%	30%	→ 30%
Japan				3%	3%	→ 3%	5%	5%	→ 5%	7%	7%	→ 7%
Emerging Markets				3%	3%	↑ 5%	5%	5%	↑ 8%	7%	7%	↑ 12%
Bond Allocation												
Government Bonds - Developed	50%	19.5%	→ 19.5%	35%	15%	→ 15%	25%	18%	→ 18%	15%	9%	→ 9%
Emerging Market Debt	10%	10%	→ 10%	7%	7%	→ 7%	5%	5%	→ 5%	3%	3%	→ 3%
Corporate - Investment Grade	20%	50%	→ 50%	14%	32%	↓ 30%	10%	15%	↓ 12%	6%	6%	↓ 1%
Corporate - High Yield	20%	12.5%	→ 12.5%	14%	8%	→ 8%	10%	5%	→ 5%	6%	2%	→ 2%
Total return	0%	8%	→ 8%	0%	5%	→ 5%	0%	0%	→ 0%	0%	0%	→ 0%
Currency												
EUR	100%	95%	→ 95%	85%	85%	↓ 83%	75%	75%	↓ 72%	65%	66%	↓ 61%
Other FX	0%	0%	→ 0%	6%	3%	↑ 5%	10%	5%	↑ 8%	14%	7%	↑ 12%
Non-EUR	0%	5%	→ 5%	9%	12%	→ 12%	15%	20%	→ 20%	21%	27%	→ 27%
Commodities												
Oil				0%	0%	→ 0%	0%	0%	→ 0%	0%	0%	→ 0%
Gold				0%	0%	→ 0%	0%	0%	→ 0%	0%	0%	→ 0%

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