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BILBoard May 2019 – It's not game over for growth but there are more snakes than ladders



In the classic board game Snakes and Ladders, players must navigate from the bottom of the board to the top, and the first to do so is declared the winner. Successful players avoid snakes, which send you sliding back down the board, and try to land on ladders which offer a shortcut up towards the finish line. Right now, if the market were a game of snakes and ladders, the board would feature a lot more snakes than ladders for risk assets. On top of that, the ladders would be disproportionately shorter – meaning that the potential upside for risk assets looks contained, whereas the downside could be very steep indeed. For this reason, we have taken more risk off the table and reduced our equity exposure from 'neutral' down to 'underweight'. The proceeds were parked in safe assets, namely US Treasuries and euro amounts in high-quality vehicles with high liquidity.

This move was taken after the most recent 'snake' which sent major indices into the red (the S&P 500 by as much as 2.5%), namely the decision by the US administration to impose further tariffs on Chinese imports (\$200bn of goods had their import levy raised from 10% to 25%). China countered by upping tariffs from 5% to 15% on \$60bn of US goods. What this shows is that a truce is off the cards, and that the game of trade between the US and China is not a quick game of checkers. Rather, it seems that it will be more akin to a calculated, drawn-out, strategic game of chess, with the opponents trying and testing each other at every move. In the absence of a short-term solution, markets will keep yo-yoing. Over the longer term, higher tariffs will have implications for economic growth. A joint study by the Federal Reserve, Princeton and Columbia Universities found that the existing levies have raised costs for US consumers by \$1.4bn a month. Higher prices could dampen the propensity to spend, and private consumption is the backbone of the US economy. At the same time, this could coax inflation upwards, potentially becoming a game changer for monetary policy. For now, the Fed has been locked in a 'wait-and-see' modus, especially with inflation tepid below its 2% target and global uncertainties prevalent. We don't expect a rate move this year, whereas the market is currently pricing a cut. There is a danger that it could be caught off-guard here because – trade war aside – the US economy still looks to be in good shape, having registered growth of 3.2% in Q1. Investment and consumption still serve as pillars of growth and the labour market is ultra-tight: unemployment is at 3.6% - the lowest level since 1969.

The eurozone looks more precarious, with its manufacturing sector (especially in Germany) in deep trouble. Factory orders remain depressed from fluctuating demand (both domestic and foreign). With the various risks dotted across the region, it's a bit of an Indiana Jones-style snake pit.

China churned out decent enough Q1 growth of 6.4%, and the consensus expects the pace to stabilise at around 6.3% this year. Industrial production and domestic consumption are both holding up well, rising 8.5% and 8.7%, respectively, while the PMI is back in expansionary territory above 50. The government is taking a hands-on approach in keeping the economy buoyant – most recently Beijing even bought up Chinese equities following new tariff impositions to limit the damage.

Equities

On

the whole, growth is, and is expected to remain at, comfortable levels, supporting equities. However, that being said, there are not many catalysts that could give stocks a further leg up, and for the next 'ladder' we may have to sit tight until the Q1 earnings season. On the other hand, it seems there is no shortage of risks

– whether it be Brexit, the European elections where populists on the fringes may gain more clout, or the US pursuit of protectionism with both allies and adversaries. This asymmetric risk environment pushed our hand in underweighting equities. Within our downsized universe, we still prefer the US where recession is not considered an imminent risk, where earnings expectations have descended to more realistic levels (consensus sees 4% EPS growth for the S&P 500) and where prices should be supported by a wave of buybacks. Our least-preferred region is Europe. Next to political risks, there is also the prospect that the US section 232 investigation into automotive security could result in tariffs on automotive imports. This could be the final block that topples the shaky Jenga tower that Europe's manufacturing sector is resembling. Furthermore, financials – which make up a significant proportion of the European market – are facing a plethora of problems: money laundering scandals, low rates, low loan demand, and so on.

We are underweight Japan due to its sensitivity to the micro cycle and lacklustre earnings expectations. Further tarnishing the region's allure is the consumption tax hike penned in for October, which will likely put a dent in consumer confidence. We are also underweight emerging markets, which have lost momentum after a good run. The region's fortunes will be heavily influenced by the outcome of trade talks.

In terms of sectors, we are remaining overweight in technology, which drives earnings growth. We are underweight utilities and neutral elsewhere.

Fixed income

After investing the proceeds of our

equity sales in high-quality liquid bonds, our fixed income exposure is now neutral. In this segment of our portfolios, we are still underweight high yield, govies and emerging market bonds, while harbouring an overweight in investment grade corporates. Quality is the leitmotif here, and we further minimised our risk exposure by shifting into instruments with a higher credit rating and trimming exposure to corporate hybrids and subordinated financials. The broader market seems to share this risk

aversion, and even during the recent rally investors have not wholeheartedly jumped back into riskier bonds (as seen in the wide spread between A and BBB-rated bonds). Overall, in investment grade, spreads are sitting around historical averages, and demand is strong. Even without the invisible hand of central banks, new issues have been well absorbed. That being said, no asset class is immune to trade talks, and tensions could cause spreads to widen again, as could an influx of new issues.

All in all, it's not yet 'Game Over' for the global economic growth story. However, the slowdown is real and in motion and with risks abound, we felt it was time to play it safe and bring our exposure to risk assets below neutral.

Current Asset Allocation 13/05/2019	DEFENSIVE		LOW		MEDIUM		HIGH	
	Stance	Change	Stance	Change	Stance	Change	Stance	Change
Global allocation								
Equities	●	→	●	↓	●	↓	●	↓
Bonds	●	→	●	↑	●	↑	●	↑
Cash & Cash Equivalents	●	→	●	→	●	→	●	→
Currencies								
EUR	●	→	●	↓	●	↓	●	↓
USD	●	→	●	↑	●	↑	●	↑
Other	●	→	●	→	●	↑	●	↓
Equities								
Europe	●	→	●	↓	●	↓	●	↓
USA	●	→	●	↓	●	↓	●	↓
Japan	●	→	●	↓	●	↓	●	↓
Emerging Markets	●	→	●	↓	●	↓	●	↓
Bonds								
Government Bonds - Developed	●	→	●	↑	●	↑	●	↑
Corporate - Investment Grade	●	→	●	→	●	→	●	→
Corporate - High Yield	●	→	●	→	●	→	●	→
Emerging Market Debt	●	→	●	→	●	→	●	→
Total return	●	→	●	→	●	→	●	→
Commodities								
Oil	●	→	●	→	●	→	●	→
Gold	●	→	●	→	●	→	●	→

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