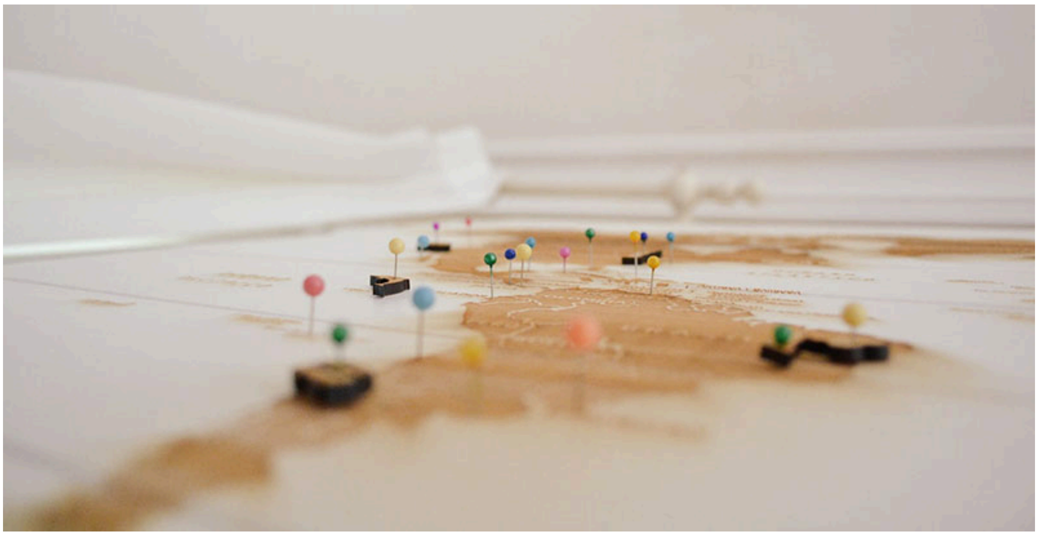
March 22, 2018

BILBoard March / April 2018 – Higher US rates on the horizon



Robust economic growth has increased confidence amongst Federal Reserve (Fed) officials that the US economy is ready for higher interest rates. Because interest rates affect almost every asset class in some way, rising rates have important implications for portfolio construction

The global growth story valiantly persists, though the scope for more positive economic surprises is lower. In the US, strength is visible across various data points, particularly the manufacturing PMI which surged to 60.80 in February. With the economy so strong, we expect the US 10-year yield to drift higher, reaching somewhere between 3 and 3.5%, before year-end. However, what is key is that this ascension is expected to be smooth, allowing for a continuation of equity market strength. A sudden spurt could derail markets.

After the Eurozone recorded GDP growth of 2.7% in 2017 (the fastest pace in a decade), economic momentum has paused for breath, but this has not affected our positive growth outlook. Thus far in 2018, inflation has dipped to 1.2% but the ECB forecasts that it will tick upwards from here on out. However, it is not expected to reach the 2% target until beyond

2020.

In response to resounding economic strength, central banks are rolling up their sleeves with regards to reducing monetary stimulus. Incoming Fed Chairman Jerome Powell's somewhat hawkish congressional testimony, coupled with continued economic strength, has led the market to add an additional hike to its expectations for 2018. In total, the market consensus is for three hikes, with a fourth now seen as decidedly more probable. Inflation, on the whole, still remains low. Headline PCE inflation (the Fed's preferred measure) is at 1.7%, lifted by the housing sector. This indicates that US economic conditions are still running closer to "just right" than "too hot", for now.

To avoid falling behind the curve, the Fed is seeking to raise rates, albeit gradually, so as to keep the economy from overheating without impeding economic expansion. If the Fed stays consistent in its actions and focuses on the macro picture, we don't see any reason to fear higher rates. The danger comes when markets anticipate that the Fed will hike too aggressively.

Elsewhere, at its March policy meeting, the ECB began to rotate its forward guidance, dropping its pledge to increase its bond-buying if needed. The German Bund, which was 0.7% at the time of print, is expected to yield 0.9% before year-end. That being said, the market expects that it will be more than a year before the ECB hikes rates. In Japan, the government confirmed Kuroda as the Bank of Japan Governor for a further five years. He has said that the bank would consider an exit from its ultra-easy monetary policy if it met its inflation target in 2020.

Equities

Even if concerns over Fed policy and tighter financial conditions have dominated markets in the short-term, economic activity and earnings data continue to evidence above-trend growth. Earnings are one of the most powerful drivers of stock market performance over time and the corporate earnings picture continues to be quite healthy. We do expect higher volatility as the Fed goes ahead with its hiking cycle, but maintain an equity overweight as we do not see any specific signs of complacency. In the US, we favour cyclical sectors such as IT and Financials. We also favour select Energy names, as the sector's performance has lagged the increase in oil price.

As well as cyclical sectors, we also maintain exposure to cyclical regions, namely Europe. While the temporary respite in economic momentum is likely to bring difficulties for equities in the shortterm, over a longer timeframe the reflation theme is supportive of a European tilt; Europe has historically been a key beneficiary of rising US yields. In particular, we are overweight on European Financials who should see their bottom lines improve in tandem with rising rates.

Emerging Markets (EM) continue to benefit from the global growth story, but we are monitoring the developments surrounding US import tariffs and any retaliation. At the moment, it seems that the risk of a global trade war is contained, but EMs would take a hit if this was to materialise.

Fixed Income

Bond markets offer few places to run to, and even fewer places to hide.

In 2018, we expect to see a dramatic increase in US bond supply as the government seeks to finance its budget deficit. At the same time, the Fed will be reducing its holdings. Unless floods of new buyers emerge, long rates will move higher and credit spreads will widen.

Rising rates are detrimental to fixed income, making us even more reluctant on this asset class. Expectations for a rise in rates compel us to lower our overall duration by reducing some of our exposure to Emerging Market hard currency debt.

When stronger-than-expected US wage data pushed up US yields at the beginning of February, yields on hard currency EM bonds went up hand-in-hand with them, and prices fell. In light of further yield increases on the horizon, the attractiveness of this segment comes under pressure.

We are maintaining local currency EM debt positions as this asset class is not driven by US rates and thus provides some diversification, while supportive fundamentals paint this segment as an interesting investment case on its own. These instruments are currently yielding around 6%.

With regards to our investment grade holdings, we also intend to use any temporary decrease in rates as an opportunity to rebalance in a way that reduces duration.

Inevitably, rates are headed north. As long as this happens gradually, we do not see any reason for investors to get spooked. In fact, with a nuanced portfolio of asset classes which benefit from rising rates – for example cyclical equities - investors can position themselves to benefit from the final leg of the cycle which has typically brought quite handsome returns.

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	Feb. TAA	March TAA	SAA	Feb. TAA	March TAA	SAA	Feb. TAA	March TAA	SAA	Feb. TAA	March TAA
Equities				30%	36%	→ 36%	50%	65%	→ 65%	70%	90%	→ 90%
Bonds	100%	100%	→ 100%	70%	64%	→ 64%	50%	35%	→ 35%	30%	10%	→ 10%
Equity Allocation												
USA				9%	12%	→ 12%	15%	22%	→ 22%	21%	30%	→ 30%
Europe				15%	18%	→ 18%	25%	30%	→ 30%	35%	41%	→ 41%
Japan				3%	3%	→ 3%	5%	5%	→ 5%	7%	7%	→ 7%
Emerging Markets				3%	3%	→ 3%	5%	8%	→ 8%	7%	12%	→ 12%
Bond Allocation												
Government Bonds - Developed	50%	12.5%	→ 12.5%	35%	8%	→ 8%	25%	5%	→ 5%	15%	0%	→ 0%
Emerging Market Debt	10%	25%	↓ 17%	7%	16%	↓ 11%	5%	10%	→ 10%	3%	5%	→ 5%
Corporate - Investment Grade	20%	50%	→ 50%	14%	32%	→ 32%	10%	15%	→ 15%	6%	3%	→ 3%
Corporate - High Yield	20%	12.5%	→ 12.5%	14%	8%	→ 8%	10%	5%	→ 5%	6%	2%	→ 2%
Total return	0%	0%	↑ 8%	0%	0%	↑ 5%	0%	0%	→ 0%	0%	0%	→ 0%
Currency												
EUR	100%	95%	→ 95%	85%	88%	→ 88%	75%	80%	→ 80%	65%	72%	→ 72%
Non-EUR	0%	5%	→ 5%	15%	12%	→ 12%	25%	20%	→ 20%	35%	28%	→ 28%
Commodities												
Oil				0%	0%	→ 0%	0%	0%	→ 0%	0%	0%	→ 0%
Gold				0%	0%	→ 0%	0%	0%	→ 0%	0%	0%	→ 0%

[Download the pdf version here]

[Download the pdf version here] (in French)