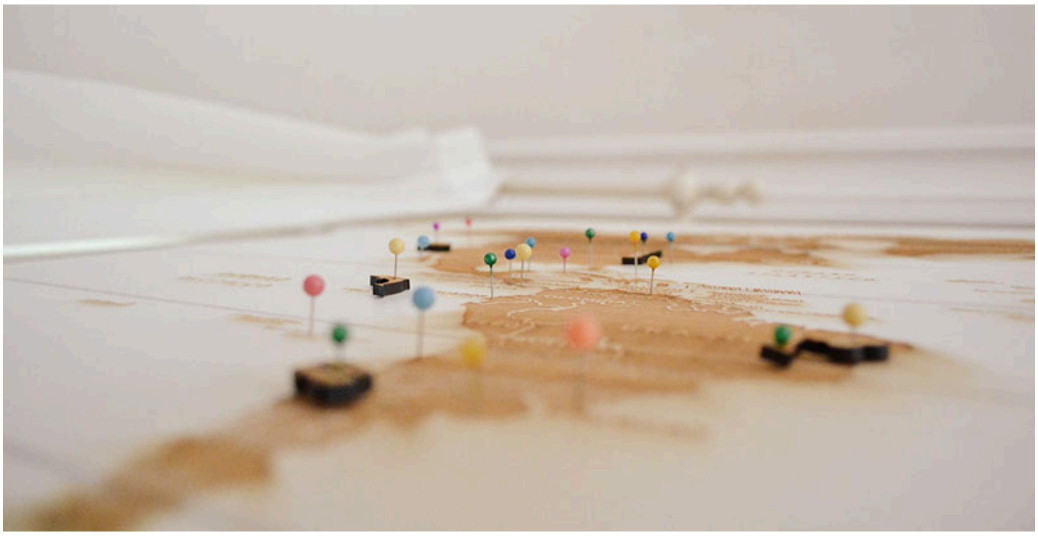
June 19, 2018

BILBoard June / July 2018 – America, the locomotive of global growth



This month we deviate from the script we have been following with regard to our regional equity allocation. For several months, we have carried a European overweight, believing that the continent still had a degree of catch-up to make relative to the US. However, the cocktail of dimming macroeconomic sentiment and re-emerging political risk, laced with trade tensions, is becoming difficult to swallow. We have therefore brought our European overweight down to neutral, whilst increasing our exposure to US equities.

Whilst economic readings have been underwhelming elsewhere, the US continues to confirm its role as the global growth locomotive. Coming in at 2.2%, real GDP growth outpaced expectations of 2% in Q1 2018. This was powered by investment, which should continue to rise on the back of improving capacity utilisation. Labour market dynamics are strong – in May, 223,000 nonfarm payrolls were added, unemployment was 3.8% and there was a better-than-expected boost in wages (2.7% growth year-on- year). Rising wages is normally taken as a signal of more inflation ahead. Steadily rising inflation would confirm the Federal Reserve's forecast for two more rate hikes this year.

Whilst manufacturing PMIs in other regions have continued their retreat from elevated levels, in the US, the figure rose to 58.7 in May (up from 57.3). The European equivalent has fallen from above 60 at the end of 2017 to 55.5 in May; this is strong, but not stellar.

GDP in the euro area expanded by a pallid 0.4% in Q1 2018: the slowest pace since Q3 2016. The European Commission's economic sentiment indicator has slipped, and whilst Macron's victory in the French election was supposed to mark the end of high political risk in the bloc, this seems endless. Uncertainty enshrouds both Spain and Italy, and it is becoming difficult to contend with the lack of homogeneity across member states. We now look to the US, where we have better visibility on the macrocycle, as well as clarity (despite Trump) stemming from a single political decision-making process, rather than 28.

One of Trump's wildcard plays over the month was to extend tariffs on steel and aluminium imports to American allies: Europe, Mexico and Canada. This has already been met with consternation and the threat of retaliation. Should it escalate, a trade war would be detrimental to the EU, which is very much an export-centric economy. In 2017, US-European trade was worth USD 720 billion. Escalation may create friction within the bloc, as Germany has more at stake than other nations given its high trade surplus, which may make Berlin more willing to bend to the US' agenda. Though trade wars remain a clear and present danger to Eurozone growth, we still see a full-blown trade war event as unlikely.

Equities

As macroeconomic sentiment fades in Europe, we are pivoting our equity allocation towards the US, where we see more opportunity and less risk. Corporate earnings, politics and growth readings all favour the US at this point in time. Excluding the tax impact, the S&P 500 is still expected to produce low-teens earnings growth in 2018 (all-in consensus including the tax benefit is 20%). In conjunction with this, we foresee continued strength coming from dividends, buybacks, and M&A activity. If Americans investing in Europe become fatigued by the steady stream of menacing headlines and start bringing their dollars home, this would be supportive in terms of flows. Our sectoral preferences continue to be Financials and Energy. America, the locomotive of global growth This month we deviate from the script we have been following with regard to our regional equity allocation. For several months, we have carried a European overweight, believing that the continent still had a degree of catch-up to make relative to the US. However, the cocktail of dimming macroeconomic sentiment and re-emerging political risk, laced with trade tensions, is becoming difficult to swallow. We have therefore brought our European overweight down to neutral, whilst increasing our exposure to US equities.

The Euro Stoxx 50 index has had a tough year. With the majority of European companies operating in 'old-world industries' (unlike in the US, where large IT firms dominate), Europe is particularly sensitive to global trade, and the fear of a trade war has taken its toll. After having maintained a conviction on European banks in recent months as a play on rising rates, we now believe that this sector is subject to too much exogenous noise. As we have witnessed, European bank balance sheets are sensitive to global political and financial concerns (from Italy and Spain, and to a lesser extent from Turkey, Argentina and other areas), while profitability is still questionable (as demonstrated by recent news flows related to the Deutsche Bank). The investment committee therefore decided to remove exposure. In doing so, Spanish exposure was also taken down, as many of our banking positions had been taken via the IBEX index.

Fixed Income

Rising rates make us reluctant towards government bonds. We see the 10-year Treasury at 3.1% in Q4 2018, and the Bund at 0.9%. There is a growing feeling amongst investors that finding value in today's fixed income market as akin to finding a needle in a haystack. This is why we continue to favour convertible bonds (added in February), which offer equity-like features. We also have a nuanced selection of European investment grade bonds in our portfolios, as the hunt for yield is still prevalent in Europe, thus providing some support. However, the music may end soon when the ECB draws the line on its mass quantitative easing programme that buys EUR 30 billion worth of bonds per month. The ECB's chief economist Peter Praet has said that the June ECB meeting will be 'instrumental' in defining the end of QE.

This raises concerns, especially for peripheral bonds, which have been buoyed by abundant central bank support. Even after Italian bonds sold off amidst political turbulence, their yields are still suppressed by the invisible hand of the ECB. We did, however, manage to profit from the sell-off in a short-term tactical trade at the height of the Italian drama.

From a portfolio management point of view, the time seemed right to go where the grass is greenest – that is, US equities. Fading macroeconomic data in Europe raises the question: if Europe were a store, would its stock be on sale, offering buyers a discount for a limited time only? Or is it more like an 'everyday low prices' establishment, where stock will always be cheaper, but for valid reasons? Incoming data makes us lean towards the latter. The US, on the other hand, is more like a high quality department store. Amidst trade war talk, political risks and slowing global growth, we prefer to have more quality stocks that should be better at weathering 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	May TAA	June TAA	SAA	May TAA	June TAA	SAA	May TAA	June TAA	SAA	May TAA	June 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%	↑ 15%	15%	22%	↑ 27%	21%	30%	↑ 36%
Europe				15%	18%	↓ 15%	25%	30%	↓ 25%	35%	41%	↓ 35%
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%	17%	→ 17%	7%	11%	→ 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%	8%	→ 8%	0%	5%	→ 5%	0%	0%	→ 0%	0%	0%	→ 0%
Currency												
EUR	100%	95%	→ 95%	85%	88%	↓ 85%	75%	80%	↓ 75%	65%	72%	↓ 66%
Non-EUR	0%	5%	→ 5%	15%	12%	↑ 15%	25%	20%	↑ 25%	35%	28%	↑ 34%
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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