MONTHLY HOUSE VIEWS

March 2019

Gliding ahead

Moving on up

Risky assets have rallied further, reversing much of late-2018's market sell-off. Recession fears have receded and the Federal Reserve's (Fed) new dovish tone has shored up investor confidence. The recent oil price rebound has helped ease financial conditions via lower corporate bond yields. Apart from the US, global macro data has been underwhelming while the trade war has begun to dent manufacturing activity. However, investors have shrugged off these factors, pinning their hopes instead on a trade agreement between the US and China and a soft Brexit scenario.

Back to reality!

Despite this investor optimism, global growth is decelerating. All three main economies – the US, China and the eurozone – are expected to print lower data in 2019. Growth in China will be key given its impact on emerging economies as well as on European and US exporters. Analyst expectations for earnings growth in the eurozone still look to optimistic in our view. Nonetheless, we still expect positive earnings growth this year in all three economies.

Riding the momentum

We continue to recommend a neutral position on global equities as central banks seem willing to support credit and growth against a backdrop of tame inflation. The Fed's shift to a neutral stance clearly supports risk appetite – it now looks likely that its planned hikes will be delayed (perhaps cancelled?) and it might even halt the shrinkage in its asset holdings. For now, only a pick-up in US inflation could make the Fed turn more hawkish again. The European Central Bank (ECB) has hinted at new funding measures to help eurozone banks on the back of the current dip in activity and signs of weaker bank lending. However, we remain concerned that the effects of the trade war will linger whatever the outcome of US-China negotiations.

Bottom line

We remain selective on risky assets with a preference for corporate credit and equities, while keeping low exposure to sovereign bonds where valuations are more stretched. We think US and emerging market equities offer the best opportunities. In Europe, we suggest a defensive stance on equities given the cocktail of political and macro risks. We upgrade High Yield corporate bonds in euros to Overweight to benefit from attractive valuations in a low rate environment.

In accordance with the applicable regulation, we inform the reader that this material is qualified as a marketing document.
CA063/FEB/2019

ASSET CLASS VIEWS

The table below presents the latest conclusions of our Global Investment Committee

Asset class	Segment		Strong UW	UW	N	OW	Strong OW	Change since last GIC
EQUITY		**GLOBAL EQUITY**			X			
		United States			X			
		Eurozone		X				
		United Kingdom			X			
		Japan			X			
		Emerging			X			
FIXED INCOME	SOVEREIGN	**GLOBAL RATES**		X				
		U.S. Treasuries		X				
		U.S. Breakeven			X			
		Bunds		X				
		EMU Breakeven			X			
		Gilts			X			
		Gilts Breakeven			X			
		JGBs			X			
		EM Govies ($)			X			
	CORPORATE	**U.S. IG**		X				
		U.S. HY				X		
		EMU IG		X				
		EMU HY				X		+
		UK IG		X				
		UK HY		X				
		Duration USD*		X				
		Duration EUR*		X				
		Duration GBP*		X				
FOREX		**EURUSD**			X			
		USDJPY			X			
		GBPUSD			X			
		EURCHF			X			
		EM FX (vs. USD)			X			
COMDTY		**Brent**				X		
		Copper			X			
		Gold		X				-
ALTERNATIVE		**ALT. STRATEGIES**				X		
		L/S Equity		X				
		Event-Driven				X		
		FI Arbitrage				X		
		Global Macro			X			
		CTAs			X			

	Positioning	*Duration
UW	Underweight	Short
N	Neutral	Benchmark
OW	Overweight	Long

FIXED INCOME

Hunt for yield continues

Muted inflation and dovish central banks have kept a lid on long-term yields so far. However, we continue to recommend short maturity sovereign bonds as risks are tilted towards higher yields. In the US, the gap between short and long-term yields is barely positive and Bunds look expensive, especially after the recent rally. We see better yield pick-up in the eurozone periphery. We reiterate our constructive view on credit – and High Yield (HY) in particular – and have upgraded eurozone HY to Overweight.

We recommend short maturity sovereign bonds

Prefer short-dated bonds

Since early 2019, yields on 10-year US Treasuries have traded in a narrow range between 2.55% and 2.80%. The minutes from the Federal Reserve (Fed) January meeting outlined a patient approach to monetary policy given the uncertain outlook. We nevertheless expect US 10-year yields to creep up towards 3.00% as growth remains sustained and market measures of inflation expectations ("break-evens") are rising. We still prefer short-dated bonds which offer almost the same yields as 10-year bonds but with far less interest rate risk.

Bund valuations are expensive after the recent rally

In the eurozone, core bond yields have been pushed lower by weak macro data, lingering political risks and a scarcity of high quality liquid assets. The 10-year Bund yield is hovering around 10bps, the lowest since late 2016, but we think it is unlikely to fall much further. At current levels, yields are unattractive and bonds overly sensitive to rate moves. However, there is perhaps better value in peripheral bonds – the risk-reward is attractive in a low interest rate environment. We prefer Spanish bonds to Italy as Spain boasts a lower debt burden and stronger growth.

UK Brexit risk lingers

We still hold sovereign bonds ("gilts") for diversification, particularly as the probability of a no-deal Brexit is relatively low. The Bank of England (BoE) should keep interest rates on hold given the slide in growth momentum, which should support gilt valuations.

Constructive view on corporate bonds

Still prefer US HY

The yield differential (or "spread") between Treasuries and US corporate bonds ("credit") has narrowed thanks to higher oil prices and solid macro data. Default rates are expected to stay below historical averages and stable corporate bond issuance bodes well for US HY. Based on our Fed policy projections and spread forecasts, HY remains attractive relative to Investment Grade (IG) – HY delivers an extra 300bps of yield at current levels. We believe corporate credit is appealing – recession risk remains remote and corporates have been able to lock in attractive borrowing rates over the past few years.

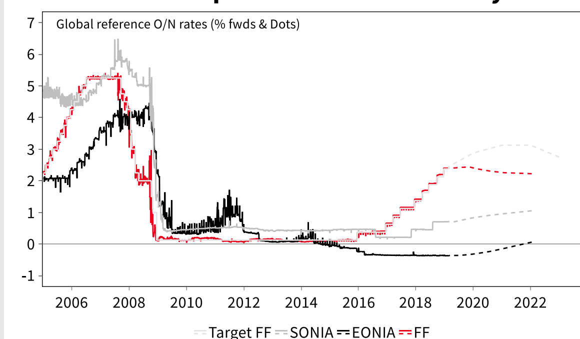
EMU HY upgraded to Overweight

In the eurozone, spreads widened steadily in 2018 as investors demanded better compensation for credit risk. HY spreads more than doubled and now offer an opportunity to rebuild positions. Despite ending Quantitative Easing (QE), the European Central Bank (ECB) seems keen to support credit growth, which should help keep default risk in check this year. The hunt for yield will encourage investors to prefer corporate bonds to sovereigns. We upgrade HY to Overweight.

Brexit uncertainty will continue to weigh.

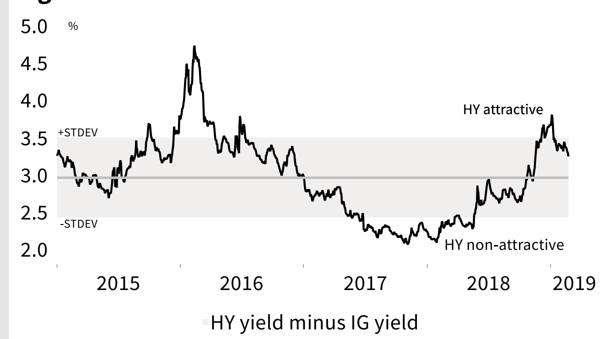
We maintain a defensive stance on UK credit despite attractive valuations. Brexit uncertainty should continue to weigh on corporates in the short run, keeping spreads relatively high and volatile.

Markets do not expect a Fed rate hike this year



Sources: Macrobond, Bloomberg, data as of 02/2019

High Yield at an attractive level



Sources: Macrobond, Bloomberg, data as of 02/2019

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EQUITIES

Time for patience

Rising hopes of a US-China trade agreement and a soft Brexit deal continue to lift investor sentiment. The dovish stance recently adopted by major central banks, easier funding conditions, and Chinese stimulus measures are all supportive for equities. However, economic uncertainty remains high, global manufacturing activity is decelerating, and trade growth continues to slow. We maintain a neutral view on global equities.

Stay cautious on eurozone equities

US: "Don't fight the Federal Reserve (Fed)"

The Fed's change in policy stance helped trigger the sharp rebound in equities from the late-December lows. Meanwhile, constructive US-China trade talks have lifted investor sentiment, even if the terms of any deal are still highly uncertain. The Fed's pause in monetary policy and easier funding conditions are clear positives for equity markets. However, corporate profit growth will decelerate this year – sales growth is slowing, the impact from last year's tax cuts is fading and rising wages are eroding historically-high margins. In addition, valuation is not attractive and thus we prefer to wait for a better entry point.

Eurozone: a wall of worries

Eurozone fiscal policy is being eased and there is talk of new long-term refinancing support for bank lending, two supportive factors for stocks. However, equities are vulnerable to slowing global trade and to a weakening regional economy where manufacturing activity is declining rapidly. In addition, political uncertainty is high, banking sector weakness is a source of concern and trade tensions persist despite the push to reach a US-China agreement. And European car manufacturers would be badly hit if the US were to impose auto tariffs. In this context, earnings-per-share (EPS) should continue to grow at a sluggish pace this year – current consensus expectations still seem too optimistic and are likely to be cut in coming months.

Economic uncertainties remain elevated

UK – in the hands of Brexit

Large British companies generate a significant share of revenues overseas, making them highly sensitive to the Brexit outcome – a soft deal would strengthen sterling, to the detriment of foreign earnings. The market should remain volatile but appealing valuations and a high dividend yield argue for a sanguine view.

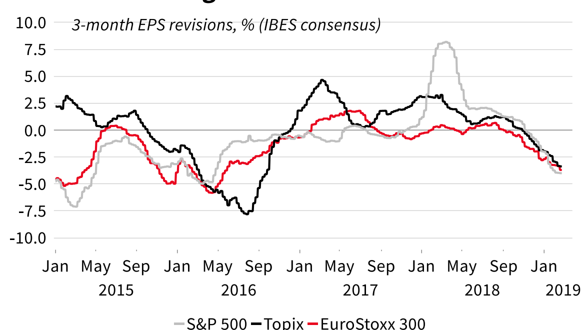
Japan: good fundamentals but cyclical headwinds

Despite solid domestic demand, the global slowdown could penalise this cyclical market and profit growth is expected to be lacklustre in coming months. This should outweigh positives from structural reforms, improved corporate governance and profitability, and attractive valuations.

Emerging markets: out of the bargain basement

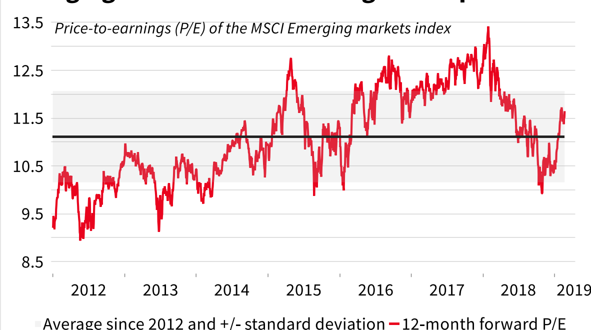
The environment for emerging markets has improved over the past few months as a more dovish Fed and a peaking dollar have eased pressures. Also, most central banks are now less restrictive, currencies have stabilised, and capital inflows are recovering. However, valuations are no longer a bargain and emerging equities remain vulnerable to any disappointment in US-China negotiations. We intend to increase our exposure from our current Neutral stance if economic momentum improves.

Downward earnings revisions across the board



Sources: Macrobond, Datastream, 20/02/2019

Emerging valuations are no longer cheap



Sources: Macrobond, Datastream, 20/02/2019

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CURRENCIES & ALTERNATIVES

FX: Steady as she goes

Central banks are on hold, keeping cross-currency exchange rates in check. It would take surprises (a no-deal Brexit hit to sterling) or market shocks (safe-haven buying of the yen) to break currencies out of current ranges. The euro should remain range bound versus dollar. Stimulus measures in China and steady demand should prop up cyclical commodities (oil, copper). Hedge funds could face higher volatility and we prefer those strategies which perform best in turbulent markets.

Currencies: little further upside for the dollar

Dollar rally petering out

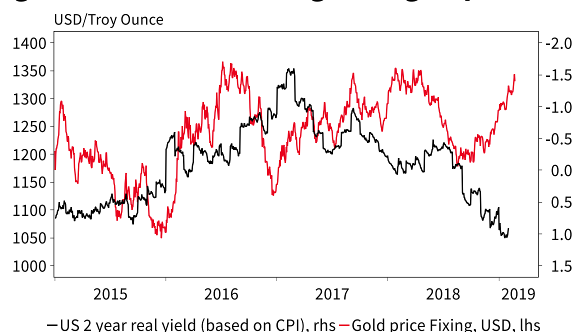
The Federal Reserve (Fed) has paused its policy normalisation, implying that interest rate gaps with other major currencies could stabilise as growth differentials narrow this year. Markets face looming dollar headwinds, such as widening twin deficits, and Russian and Chinese moves to diversify away from the USD for both trade settlement and official reserves. In addition, long dollar positions on futures markets are stretched. Although political risks may bolster the dollar near term, the catalysts for a further leg up are missing. We expect the dollar index to trade range bound in the months ahead.

Moving in concert

We see limited downside risks for the euro against the USD at current levels. The European Central Bank (ECB) has hinted at easing measures, but these should be mostly designed to ease funding conditions to boost growth. Cheap valuations and the eurozone's large current account surpluses are also supportive. However, there are persistent headwinds – macro data have been disappointing and political risks endure.

Sterling's fate is driven by market sentiment on Brexit. We expect a soft-Brexit outcome, and hence a modest uptick in the pound, though possibly after the March 29 deadline if it is extended.

Higher real rates set to drag down gold price



Source: Macrobond, 22/02/2019

A late cycle bounce in commodities

Rebound in oil prices should continue

After plunging in Q4 2018, oil prices are now recovering thanks to the Fed's softer tone, improving market sentiment and production cutbacks by OPEC and its allies. We still see upside potential in the short run as global oil demand is trending upwards, the rise in US shale oil output has stalled, and production in Iran and Venezuela has contracted. We expect oil prices to trade in a $65-70 range later this year given supply/demand dynamics.

Gold prices set to consolidate

The recent gold rally seems overdone. Although the rally was sparked by late-2018 risk aversion, it has continued despite improving sentiment. US real rates (that is, net of muted inflation) have crept up, increasing the opportunity cost of holding gold, a non-yielding asset. We think a correction is possible as gold has been trading close to $1350/oz, its high over the past three years. Our target remains at $1250.

Copper requires some patience

Copper inventories are low, geopolitical risks should fade as US-China trade discussions advance and Chinese imports of copper ore have increased – all supportive factors for prices. Chinese stimulus measures are already reflected in accelerating credit growth and increases in infrastructure spending are expected – prices should pick up later this year.

Hedge funds: Overweight, but be selective

Prefer Merger and Fixed-Income Arbitrage

Hedge funds can help in unstable market conditions, but selectivity is key. Several strategies suffered drawdowns in 2018 (Long/Short Equity, Special Situations, CTAs or trend-followers), while others proved more resilient (Merger Arbitrage, Fixed Income Arbitrage, Global Macro). We prefer strategies which hold their own in bear markets, such as Merger Arbitrage, or which do well in times of higher equity volatility, such as Fixed-Income Arbitrage. The Global Macro segment is attractive but, given wide disparities in strategy, careful selection is key. Finally, we stay defensive on L/S Equity strategies with a long market bias.

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