HBZ Investment Quarterly

Entering the late cycle

Q3 2018

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Editorial

Dear Reader,

Donald Trump made no secret of his intention to rattle the establishment if elected, however few expected him to take quite such a large and blunt ax to the global trade order. Investors the world over are bound to pay a price, in the short term at least, for his blinkered vision of 'fair trade'. While the strength of the business cycle may limit the immediate damage, darker clouds have started to gather on the horizon: The strength of the USD and higher USD rates have already taken their toll on many emerging-market (EM) assets and could cause market volatility to remain at elevated levels.

That said, it is not yet time to hunker down but it is certainly time to start preparing for any heavy weather that may be in the offing, and this is the theme we have taken for our investment strategy. As global economic expansion moves into the latter part of its cycle, we still favor equities as credit is most at risk at this stage. More generally, investors will have to revisit government bonds as an asset for tougher times.

Asset allocation will matter more than ever as we approach an important cyclical turning point, so we have devoted our Special Topic on page 10 to the concept of the investment cycle – and how things may be different this time around.

Given that the world has become decidedly more complex and less predictable of late, we are especially keen to receive your feedback on this edition of our Investment Quarterly.

Yours sincerely,

Dr. David Wartenweiler, CFA
Chief Investment Officer

The macro backdrop: Headwinds gathering

Political headwinds had been building for some time and have now reached a new peak with US President Trump's full-frontal attack on the fundamentals of global trade. The coming months will show whether the global economy can withstand these and other challenges.

Table 1: Real GDP growth (y/y in %)

	2017E	2018F	2019F	Short-term trend
United States	2.3	2.9	2.4	↗
Eurozone	2.5	2.2	1.9	→
Germany	2.5	2.1	1.9	→
United Kingdom	1.7	1.4	1.6	→
Japan	1.6	1.1	1.0	↗
China	6.9	6.5	6.3	↘
India	6.3	6.6	7.3	→
Russia	1.5	1.8	1.8	→
Brazil	1.0	2.0	2.6	→

Table 2: Consumer price inflation (y/y in %)

	2017E	2018F	2019F	Short-term trend
United States	2.1	2.6	2.3	↗
Eurozone	1.5	1.6	1.6	→
Germany	1.7	1.8	1.8	→
United Kingdom	2.7	2.5	2.1	→
Japan	0.5	1.0	1.0	↗
China	1.6	2.2	2.2	→
India	4.5	3.7	4.7	→
Russia	3.7	2.9	4.0	↗
Brazil	3.4	3.5	4.1	↗

Source: Bloomberg, IMF, HBZ

Key points

- US challenges global trade order
- Populism and lack of structural reforms a threat for Europe
- Most EMs able to handle lower USD liquidity, but growth set to slow

US: Going it alone

The US has opted to go it alone on numerous issues under the Trump administration, and nowhere more prominently than in trade – America has well and truly thrown down the gauntlet with the recent measures taken against China (not to mention a host of long-term allies). While there are good reasons to seek better terms with China, such naked aggression may yet backfire, as the People's Republic is unlikely to cave in to US bullying. For the moment, Trump's biggest asset is the strength of the US economy, which should be able to weather any negative shock arising from a protracted trade war. Nonetheless, the risk of a marked slowdown by 2020 can only increase. His generous tax cuts may prolong the cycle, but record-low unemployment and building inflationary pressure will require sustained monetary tightening. Two further rate increases this year, combined with additional hikes in 2019 and an acceleration in asset disposals, will further constrain monetary stimulus. Ultimately the economy will slow and, more likely than not, take the rest of the world with it.

Reduced ECB support for eurozone growth

Although it will remain above potential for some time yet, eurozone growth began to flag in Q1. Rising populism, widespread opposition to structural reform, and weakening global tailwinds will eventually slow European expansion. Unlike the US Fed, however, the European Central Bank (ECB), which has just committed to keeping rates at present levels at least through the summer of next year, will have limited scope for supporting growth when the need arises next. Unless politicians rise to the challenge, the outlook for the eurozone and the whole continent of Europe will deteriorate.

EMs: Challenged by the US dollar

In aggregate, emerging economies have continued to perform well, but cracks are beginning to show. Withdrawal of USD liquidity has exposed weaker economies (such as Turkey and Argentina) while also complicating matters for others. The strength of the dollar, compounded by higher oil prices, has started to erode domestic consumption – an increasingly important growth driver for economies like China and India. While some economies have room to ease both fiscal and monetary policy, emerging markets as a whole are set to face a period of softer growth.

Investment strategy: Thinking ahead

The global investment environment has become distinctly more challenging, with a pugnacious US president, a stronger USD, and higher US rates to consider. Our preference for equities remains unchanged for the present but we recommend cutting back in the credit space.

Follow the Fed?

While our macro concerns, as set out on the previous page, look more to the medium term, the time to revisit some of the assumptions underlying our investment strategy is now. We have no doubt that key secular trends, such as the rise of emerging markets and the dominance of technology, are here to stay. However, we believe investors are soon likely to face serious cyclical challenges. With the normalization of the USD yield curve well under way, focus is shifting back to US treasuries (which we had been disregarding – with good reason – for some time). We already have exposure to inflation-protected securities and now we need to consider nominal bonds as well. The basic parameters are clear enough: While much of the Fed's anticipated tightening is already priced in, at least for maturities longer than one year, currently high levels of uncertainty argue against taking on too much duration risk. The current spread between 5- and 10-year rates is historically low – and we believe that any normalization would widen it, at the expense of the long end. For these reasons, we would anchor any treasury exposure at this point. The perennial question of corporate bonds vs. equities will also need revisiting but currently we are maintaining our particular preference for US equities – Trump's trade policy notwithstanding.

Chart 1: US treasuries 10-to-5-year spread at record low (in %)

Source: Bloomberg, HBZ

Current positioning

We have positioned our portfolios for the late cycle with a preference for equities relative to corporate bonds and retain our overweight in US equities due to the earnings outlook, tax-cut-induced share buy-backs, and sector composition (large weight in IT and a robust financial sector). We are planning to further cut our credit exposure in favor of more government bonds.

What to watch

Given its potential to trigger market volatility and economic dislocation, the US-China trade dispute is top of our watch list. Higher inflation could additionally complicate matters for central banks globally, and it is important to bear in mind that any further, unexpected tightening could come at a delicate moment in the cycle. We will also closely follow the US earnings season, which we expect to deliver another set of strong results, while the political situation in Europe and the US mid-term elections will likewise merit close attention.

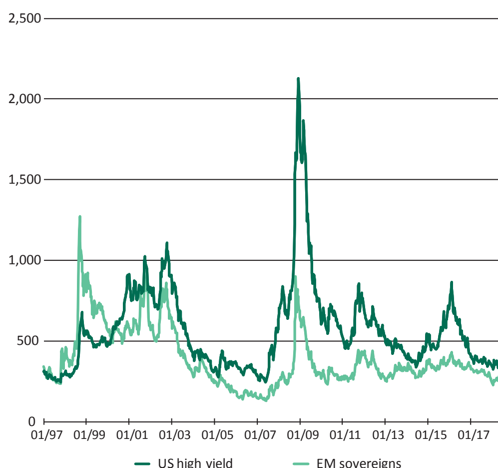
Key points

- Time to revisit US treasuries
- Preference for equities at this stage of the cycle
- Scale back credit exposure

Fixed income: Credit has passed its peak

Fixed-income assets are by most standards expensive, and current spreads and fundamentals would suggest that the credit cycle has started to turn. Senior loans, US mortgage-backed securities and (after the recent sell-off) some EM sovereign bonds are among the few pockets of relative value left.

Chart 2: EM sovereign and US high-yield spreads over US treasuries (in basis points)



Source: ICE Index, Bloomberg

Expensive credit markets

Investment-grade (IG) corporate bonds have not had a good year, with most of the setbacks inflicted by a combination of rising US treasury yields and wider credit spreads. In the absence of any catalyst that might push spreads back to the lows witnessed at the beginning of 2018, we expect a further widening of credit spreads over the remainder of the year, while the macro backdrop is also likely to continue to lift US treasury yields; returns on IG bonds are thus set to be meagre at best. High-yield bonds have performed better, but we feel the time has come to sell: spreads are tight and can only widen over the coming months. In the non-IG space, we prefer senior loans whose floating-rate characteristics make them more resilient to rising bond yields.

Relative preference for EM sovereigns

Hard-currency EM sovereign bonds have cheapened significantly in the wake of their USD-induced sell-off. With much negative news already priced in, their spreads are now on a par with those of high-yield bonds. This is unusual, as EM sovereign bonds are typically IG-rated and should thus trade more tightly. There is evidence (including rates, generally good fundamentals, and stable commodity prices) to suggest some spread compression on EM sovereign bonds over the coming months. While the valuations of many EM sovereign bonds remain attractive, we believe that near-term volatility is set to continue and would thus advise investors to build up positions in selected countries only. With an IMF program in place that is likely to keep the country away from the bond market, Argentina continues to look attractive. Equally, we expect Pakistan's next government to return to the IMF, which should be positive for bonds. Following pledges of support from three neighbouring countries, we see value in Bahrain. However we are more cautious about Turkey, where we expect the election results to both prolong the political status quo and perpetuate the country's economic problems. We would also counsel caution for most local-currency EM bonds, even though most currencies and bonds have corrected considerably.

Value in US mortgage-backed securities (MBS)

The US housing sector will be shored up by strong demand in the near future, so we continue to expect MBS to perform well, at least in relative terms, due to their yield pick-up and moderate duration risk.

Key points

- Credit remains expensive
- Relative value in EM USD sovereign bonds
- US MBS still attractive

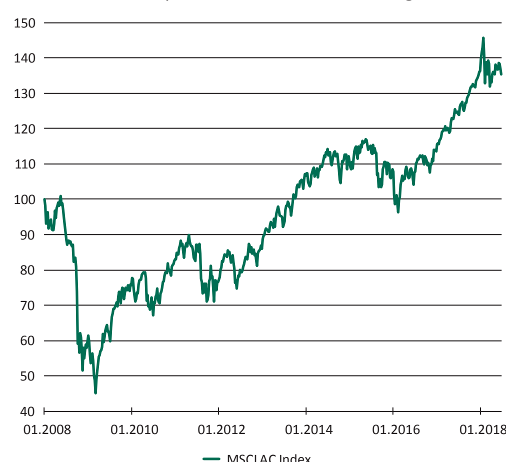
Equities: No floating on air

Global equities have struggled to surpass the highs achieved in February 2018. Given the many headwinds facing financial markets, with monetary stimulus being withdrawn and rising tension over global trade sapping much of the positive impact of lower US tax rates, this comes as no surprise.

Earnings to the rescue

US earnings trends are undoubtedly still robust, with growth of around 25% y/y in Q1 2018 led by cyclical stocks such as IT, industrials, and energy. Hampered by their interest rate sensitivity, defensive sectors have shown no convincing signs of growth, while fears of a trade war with China, compounded by the increasingly restrictive policies adopted by the Fed (and, in due course, the ECB), have put a damper on investor sentiment. Equities have been trending sideways for several months now and are set to remain range-bound until geopolitical and trade-related concerns dissipate. A fully-fledged trade war would be a disaster for IT and industrial stocks, not to mention emerging markets. EM equities have already suffered heavy outflows; this, in turn, has contributed to their substantial underperformance relative to developed markets – and the gap continues to widen. Having survived recent market gyrations relatively unscathed, otherwise attractive IT stocks could be at risk, as their vast supply chains in Asia make them particularly vulnerable to any trade restrictions. On a positive note, reduced tax expenditure will lift US corporate earnings and investment spending over the coming quarters.

Chart 3: Global equities below their recent highs



Source: Bloomberg, HBZ

Where do we go from here?

Should the (admittedly unlikely) worst-case scenario come to pass, equity investors will be left with precious few places to hide. While defensive sectors would probably benefit (not least as they are oversold and inexpensive relative to cyclicals), tilting portfolios towards these at this point is not advisable: bond yields are unlikely to move significantly lower unless the economy deteriorates considerably. With the possible exception of a bear-flattening of the US yield curve, leading indicators do not currently point in this direction. A bumpy late-stage upswing is more likely than this scenario – possibly even exceeding the most recent highs – as and when there is a lull in negative news. In such a case, a tilt towards growth stocks from various sectors would still be recommended. Earnings will be paramount in such circumstances; further more, investors should be cautious about breaking growth trends while keeping an eye out for unfavorable company outlooks, which are more likely in the future. As ever, a well-balanced, high-quality portfolio will prove the best defense against pronounced drawdowns.

Key points

- Earnings growth still solid
- Equities facing various headwinds
- Growth tilt remains appropriate

Commodities and FX: Challenging times

Most commodities and FX crosses suffered negative returns in the second quarter, with only energy prices rallying during this period as the USD continued to appreciate (principally at the expense of EM currencies).

Chart 4: Commodities stay at depressed levels (100 = 01.2008)

Source: Bloomberg, HBZ

Commodities: Downside risks

With the notable exception of the energy complex, returns of commodities were a lackluster in the last three months. Broad commodity indices plummeted in June, along with other risk assets, but overshot on the downside as they hit lows last seen in February. Concerns about a trade war, declining US Fed stimulus, deleveraging of the Chinese economy, and slowing global growth momentum all conspired to create headwinds for most commodities. The strengthening USD has further compounded this negative trend. Despite a prevailing risk-off sentiment, gold was down some 5%, mirroring the stronger USD. Metal prices were largely flat. Any future price increases in this space will be dependent on economic momentum picking up again over the next few months but global demand for industrial metals is likely to take a hit if economic pressure on EM markets – especially China – increases. Over the same period, oil prices experienced near double-digit increases as the production cuts by OPEC and its oil-producing allies appear to have achieved their stated goal of reducing the inventory overhang on global oil markets.

FX: USD on the move

The US dollar has continued to appreciate against most currencies since mid-February, although the economic outlook is casting some doubt on the greenback's upward trajectory, and any material bounce-back in global activity indicators in particular could leave the USD rally overextended, especially against the majors. By the same token, its interest rate differential against the rest of the world is still high, keeping the currency relatively supported. As a result, EM currencies have been depreciating across the board – in some cases massively so. The Argentine peso has dropped some 20%, thanks to the strength of the USD, balance of payments issue and Argentina's appeal to the IMF. Brazilian real, South African rand and the Turkish lira have also suffered significant setbacks, with country-specific issues and international outflows propelling the sale of these currencies. At this juncture investors appear to be in two minds: while some are assuming that EM currencies are oversold, others are expecting high-yield EM currencies to underperform, as they believe the USD will continue to attract an increasingly large share of global flows to finance the widening US current account and fiscal deficits.

Key points

- Weaker commodity and FX performance
- Risk of oil supply disruptions
- USD supported but upside limited

Key markets: Deadlines and deals

Political priorities have delayed important decisions in Pakistan and the UK. While the upcoming elections should focus minds in Pakistan, the impending Brexit deadline has proven a lasting distraction to British politicians. The UAE continues to surf on a wave of pricey oil – for as long as it lasts!

Pakistan: To the elections and beyond

Pakistan will go to the polls on 25 July, a historic occasion marking the second consecutive peaceful, constitutional transition of power. Irrespective of the outcome, however, the country is facing a clear challenge: it must stabilize its external accounts without slowing down the economy. Another IMF program looks inevitable, but this will come with numerous strings attached and further initiatives will be required to offset the conditions imposed. One such has been the recently completed tax amnesty which has brought considerable amounts of hitherto untaxed assets out into the open. Additional Chinese support may prove another, helping at least to roll over existing liabilities, and the currency may have to weaken further. Ultimately, though, lifting the long-term growth prospects of the economy will require substantial improvements in governance. The stock market is likely to bounce once the political landscape becomes clearer and the IMF is back on board, but any rally may prove short-lived if the new government fails to instill confidence early in its tenure.

Chart 5: GBP rattled by Brexit

Source: Bloomberg, HBZ

UAE: Oil to the rescue

Activity indicators continue to point upwards in the UAE and even more so in Dubai; the higher oil price has clearly started to lift spirits in the Gulf, and neither the latest OPEC decision nor ongoing political tensions are expected to dampen the recovery. Any measures taken to keep global growth on track are likely to prove advantageous to the UAE, and indeed to this whole region whose fortunes are so evidently intertwined with those of oil.

UK: Deal or no deal?

Having announced early in her tenure that 'Brexit means Brexit', Prime Minister May recently reiterated her preference for no deal over a bad deal, once again raising the prospect of a UK cut adrift from the European Union with no institutional follow-on arrangement in place. With less than a year to go, time is clearly running out. In the meantime, the Bank of England has signaled an appetite for tightening monetary policy earlier than expected as the economy appears to be recovering from an unduly soft first quarter. While this may help to shore up the GBP, the currency – and with it, the rest of the UK's asset markets – will continue to trade on the ebb and flow of Brexit news.

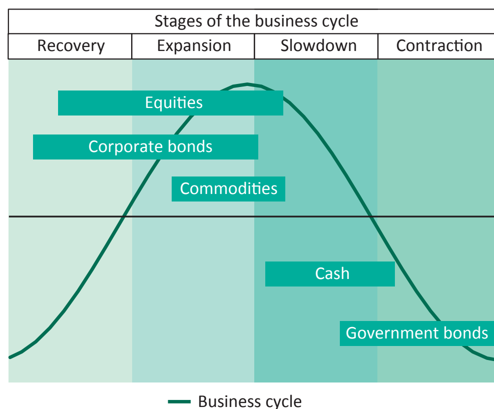
Key points

- Pakistan will need the IMF and other confidence-building measures
- Oil lifts UAE economy
- Brexit risks remain high for GBP

Special topic: The investment cycle revisited

The investment cycle is a well-established, generic representation of market patterns that can be used to guide the asset allocation process. Its key assumption is that asset prices move in cycles, much like the economy. An approach of this kind still has its uses today.

Chart 6: Stylized investment cycle



Source: BoAML, HBZ

Key points

- Asset prices move in cycles just like the economy
- Rotation in and out of assets makes sense even for long-term investors
- Yields may fall less in next downturn

Position in cycle and financial assets

The business cycle is a well-understood feature of a market economy. While individual cycles may vary in length, due to factors as diverse as the weather, productivity or politics, economic activity levels tend to ebb and flow in line with inflation and interest rates. Financial asset prices will reflect these changes and, as the economy's principal discounting mechanism, should in fact even anticipate them. We all know markets can get it wrong, of course, but they also tend to correct quickly once incoming data confirms a different trend.

Rotation in asset allocation

Interest rates are the key driver of the asset cycle. Changes in the discount factor have a significant impact on valuations, and this is where central banks enter the fray – their attempts to control inflation involve adjustments to key rates that eventually impact prices of financial assets (with the current ongoing turmoil in emerging markets a timely illustration of this process). Investors alter the weightings in their portfolios according to their individual expectations of the path of interest rates and their anticipated impact on activity and valuations. As economics and financial analysis are not exact sciences, however, investors may often arrive at highly divergent conclusions.

Will it be different this time around?

Most investors would nonetheless agree that we currently find ourselves in an advanced stage of the cycle, which should favor equities and commodities over bonds. The central question is whether the script will play out for the last stage of the cycle as it has in the past, when rotating into cash and defensive equities has usually paid off; or will the unwinding of the massive monetary experiment embarked upon in the wake of the Great Financial Crisis mean that it will all be different this time around? One important difference may yet be the reaction of the bond market. Cash is usually king during the initial phase of a downturn, at least until central banks react, at which point value shifts to the bond market. However, with long-term yields already historically low, a shrinking US Fed balance sheet and a fast-expanding US budget deficit could counteract the natural decline of bond yields during an economic slowdown. In such circumstances, yields may actually fall less than under regular conditions, reducing the attraction of duration and keeping investors bunched up in the front and middle of the curve.

Market data summary

As of 2 July 2018

Equity indices	Last	-3M %	YTD %	-3Y %
MSCI World USD	5'954.1	3.1	0.4	26.8
S&P 500	2'718.4	5.3	1.7	30.9
EuroStoxx 50	3'395.6	1.0	-3.1	-2.0
FTSE 100	7'636.9	8.2	-0.7	15.2
SMI	8'609.3	-1.5	-8.2	-3.9
Nikkei	21'862.2	2.2	-4.0	6.5
MSCI EM USD	486.7	-7.9	-6.7	17.8
Sensex 30	35'200.9	5.9	3.4	26.0
KSE 100	41'934.0	-8.3	3.6	19.2
Hang Seng	28'955.1	-3.8	-3.2	10.2
Russia RTS	1'154.2	-6.5	0.0	23.8
Brazil Bovespa	72'762.5	-14.1	-4.8	37.0

Bond indices	Last	-3M %	YTD %	-3Y %
Citi US gov	1'459.72	0.0	-1.0	3.3
CIti US Corp	2'114.65	-1.1	-3.2	9.5
CIti US HY	996.75	1.2	0.3	16.2
Citi Euro gov	232.04	-0.6	0.5	7.2
CIti Euro Corp	236.98	0.0	-0.4	7.2
CIti EM Sov	781.58	-3.7	-5.7	12.5
DB EM Local USD	156.18	-9.3	-6.4	3.7

Currencies vs USD	Last	-3M %	YTD %	-3Y %
DXY	94.47	5.3	2.9	-1.4
EUR	1.17	-5.3	-3.0	4.9
CHF	0.99	-3.7	-1.8	-4.8
GBP	1.32	-6.1	-2.5	-15.6
JPY	110.76	-4.2	1.8	11.2
AUD	0.74	-3.7	-5.5	-3.3
CAD	1.31	-2.0	-4.6	-4.8
ZAR	13.73	-13.7	-9.9	-10.8
INR	68.47	-5.0	-6.9	-7.4
PKR	121.74	-4.9	-9.0	-16.3
Gold oz	1'255.37	-6.7	-4.4	7.2

Interest rates	3M interbank %	10YR government %
USD	2.34	2.85
EUR	-0.32	0.30
GBP	0.67	1.28
CHF	-0.73	-0.06
JPY	-0.05	0.03
AUD	2.96	2.60
CAD	1.17	2.17
ZAR	6.96	8.72

For your notes

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