HBZ Investment Quarterly

Into overtime?

Q3 2019

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Editorial

Dear Reader,

While 2019 kicked off in stellar fashion, the second quarter proved challenging for investors. The main trigger for the more volatile market environment was the lingering trade dispute between the US and China. Moreover, the early signs of a renewed uptick in global activity, which we had noted in our previous edition three months ago, faded in the period under review. Indeed, momentum slowed to the point where major central banks, spearheaded by the US Fed, started to signal a return to easier monetary policy in the coming months.

Our recommendation to adopt a more defensive investment strategy has proved sound, given the increased uncertainty. At this point, we continue to recommend lightening up on equities and improving the quality of fixed-income investments in order to strengthen the robustness of portfolios. Although we still believe the risk of recession — global or otherwise — is small, we would advise adding more high-quality bonds as a hedge against lower growth as well as gold to benefit from a weaker US dollar.

The depressed level of global yields is causing more and more investors to venture into the less familiar territory of low-rated bonds. In our Special Topic we address some of the risks associated with this asset segment and outline ways of mitigating them.

We hope you will enjoy reading our short commentary and wish you a successful summer quarter.

Yours sincerely,

Dr. David Wartenweiler, CFA
Chief Investment Officer

The macro backdrop: Lower rates, lower growth?

The aggressive US stance on trade has pushed global growth to the brink of stagnation. Central banks, led by the US Fed, are once again expected to save the day. The upshot will be lower rates – but quite possibly also lower growth, if uncertainty persists.

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

	2018E	2019F	2020F	Short-term trend
United States	2.9	2.5	1.8	↘
Eurozone	1.8	1.2	1.3	↗
Germany	1.5	0.8	1.2	↗
United Kingdom	1.4	1.4	1.4	↗
Japan	0.7	0.7	0.4	↗
China	6.6	6.2	6.0	→
India	7.4	7.0	7.0	↗
Russia	1.8	1.4	1.7	↗
Brazil	1.2	1.0	2.1	↗

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

	2018E	2019F	2020F	Short-term trend
United States	2.4	1.8	2.1	→
Eurozone	1.7	1.3	1.4	→
Germany	1.9	1.5	1.5	↘
United Kingdom	2.5	1.9	2.0	↘
Japan	1.0	0.7	1.1	↘
China	2.1	2.3	2.3	→
India	4.1	3.7	3.8	↗
Russia	2.9	4.9	4.0	↘
Brazil	3.7	3.9	3.9	↘

Source: Bloomberg, IMF, HBZ

Key points

- US likely to start cutting rates soon
- ECB to support faltering eurozone growth
- Strategic concerns may delay comprehensive solution of Sino-US trade dispute

Is Fed policy going into reverse?

Inflation which has on average remained stubbornly below target since 2012 and mounting risks to growth could force the hands of a reluctant US Federal Reserve. A rate cut may come as early as the next FOMC meeting scheduled for 31 July. In cutting rates, the Fed would be taking out some insurance, as it were, against a further worsening of the global growth outlook — despite the fact that many question the need for easier monetary conditions in an economy running at some 5% nominal annual growth. Still, inflation is not expected to begin accelerating any time soon and the Fed itself will be exerting renewed downward pressure on longer-term yields when it resumes buying US Treasuries in Q4. A lower policy rate would go some way towards remedying the partial inversion of the yield curve, which has many market participants worried about a recession even though most forecasters continue to attach a low probability to such an outcome.

Downside risk to European growth

Given the importance of its traded sector, global trade tensions have hit Europe particularly hard. Reasonably robust domestic demand has prevented a further slide in economic activity so far, but risks remain to the downside. The ECB has already signaled its determination to provide whatever support is needed to sustain the expansion. In the coming quarters, the ECB is thus likely to take its key rate deeper into negative territory, and it may also resume its asset purchase program. The weaker, southern eurozone economies (including Italy) would be the winners in such a scenario.

Trade conflicts and global growth

The unresolved trade dispute with China is emblematic of the US administration's hardened stance on trade, but it also contains an important strategic dimension which could stand in the way of a comprehensive solution in the short term. This said, the US presidential elections are already looming large and candidate Trump can ill afford an all-out trade war if he is to stand a chance of being elected for a second term. The uncertainties associated with these spats will continue to impede global growth, and in particular the growth of many emerging markets whose economies are highly leveraged on the assumption of ongoing, trade-driven global expansion. Lower US rates and a lower USD will only partially offset the potential decline in activity.

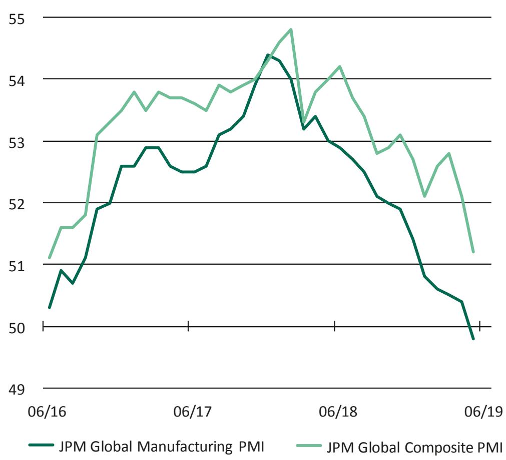
Investment strategy: Thinking about protection

After a blistering start to the year, asset returns in Q2 were much more pedestrian as the US-China trade spat briefly wreaked havoc on financial markets in May. While they may have recovered some poise in the intervening period, there is no guarantee that this will last — whether or not the Fed decides to ease.

Adding hedging positions

If there is one lesson to be learned from the drawdown in May, it is that investors have become extremely edgy and that the next big tumble is never far away. Also, considering the shallow and extended nature of the cycle, we recommend adding some form of protection to portfolios. The traditional hedge — US Treasuries — may not be particularly attractive at the moment, but should markets retreat on a sustained basis, longer-dated notes and bonds will generate sizeable positive returns, not least thanks to their high convexity in a low-rate environment. Other investment-grade (mainly corporate) bonds can also help improve the downside properties of a portfolio. However, the rapid rise in BBB issuance calls for heightened vigilance when selecting assets and strongly supports the case for actively managed collective instruments to build up the required exposure. Lower US interest rates and limited upside to the US dollar have improved the outlook for emerging-market sovereigns which can add further diversification and yield. Equity investors should consider taking profit on some of their exposure and allocate assets to hedge fund-type strategies such as equity long/short or market neutral. While lower USD yields once again reduce the attractiveness of cash, they also remove a major headwind for gold which remains an effective diversifier of portfolio risk in uncertain times.

Chart 1: Global manufacturing PMI has dipped into contraction territory (diffusion index — 0-100)



Source: Bloomberg, HBZ

Our positioning

We maintained our underweight in equities, which served us well during the tumultuous weeks in May. Moving forward, we will gradually trim our exposure further, having benefited from the latest rebound. Conversely, we will add to our Treasury holdings and have already extended the maturity of our corporate and EM exposure at the expense of investments in short-duration bonds.

What to watch

In times of uncertainty it is easy to get distracted by daily news flow. Mindful of this, we will continue to be guided by our customary sign-posts – signals from the global purchasing manager indices (leading indicators) and corporate results, which will shortly begin to flood in for the quarter just ended. Naturally, we will also be keeping a close watch on political and geopolitical risks, notably US trade policy and Iran.

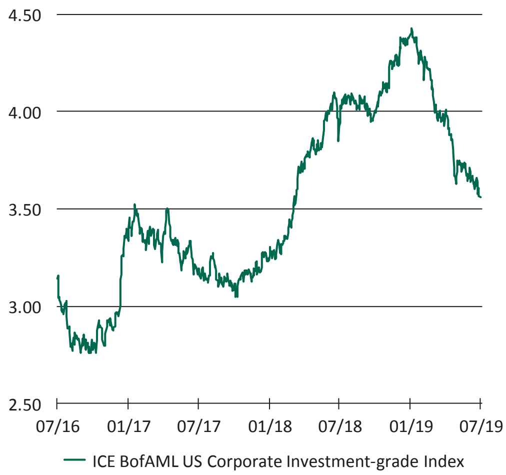
Key points

- Add hedging positions to portfolios
- Some profit taking on equities warranted
- US trade policy remains major risk to global markets

Fixed income: More moderate returns

Most fixed-income segments rallied considerably during the first half of the year, and going forward we expect only moderate additional returns. We see most value in emerging markets but recommend holding some high-quality bonds as portfolio stabilizers.

Chart 2: Investment-grade yield have declined since the beginning of the year (% p.a.)



Source: Bloomberg, HBZ

Key points

- EM bonds still benefiting from search for yield
- Higher-quality bonds act as portfolio stabilizers
- Time to exit senior loans

Investment-grade with more moderate returns

Investment-grade bonds benefited from the substantial drop in US Treasury yields, which pushed USD investment-grade yield to just over 3%. Looking ahead, we have not been able to identify catalysts for persistently strong performance in this asset class as spreads are likely to trend sideways. If trade tensions continue to de-escalate following the G20 meeting and growth slows only modestly, Treasury yields could temporarily back up over the coming months; this would represent a headwind, causing prices to fall and leaving short-term total return at a lower level.

EM corporate bonds – for risk-takers only

EM bonds posted impressive returns this year on the back of narrowing credit spreads and falling US Treasury yields. Accommodative central bank policies around the world, stabilizing global growth and firm commodity prices should continue to underpin EM credit, for which valuations remain fair. While the yield level here is lower than it was some months ago, it remains higher than in other fixed-income markets and this asset class will continue to benefit from investors hunting for yield. The main risks are a renewed escalation in Sino-US trade tensions or a materially softer growth outlook for emerging economies. Within EM, we favor sovereign or quasi-sovereign USD bonds even if we expect lower returns in the coming months. EM corporate bonds offer more attractive yields but they are a risky and volatile asset class and hence only appropriate for investors with a high-risk tolerance; selection and diversification are key and an investment in this segment should only be transacted via well-diversified, actively managed funds. Since the cycle is advanced and the next economic slowdown is bound to come at some point, we advise investors with substantial EM or corporate high-yield exposure to hold some quality bonds as well; these will provide some portfolio stability in the event of a pronounced market downturn.

Lower rates negative for loans

Senior loans, which are typically arranged by banks for non-investment-grade companies, have a floating rate, earning LIBOR plus a spread. They performed well in a market of rising rates, however rate cuts would erode their carry. The current positive market environment offers a good opportunity to scale back such positions.

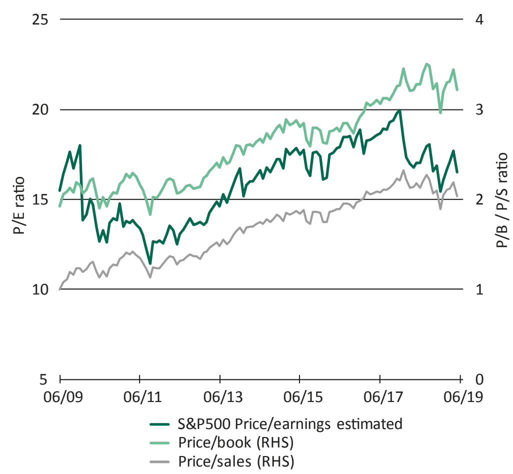
Equities: Is the sky the limit?

The resilience of global equity markets is nothing short of astounding, and the outlook for lower policy rates could keep this late-cycle bull market going for some time yet. We would nevertheless caution against chasing after rallies that lack strong fundamental support.

Highly resilient bull market

The ongoing equity bull market has proved exceptionally robust. Neither the sell-off in early 2018, nor the meltdown in the second half of that year, nor yet the sharp drop in May 2019 have been able to break its spirit. This uncanny resilience has its roots in the unconventional monetary policy regime that was established during the 2008 recession and has been in place ever since. Depressed yields brought on by this regime have literally forced investors requiring a certain level of return to pile into equities. The mediocre performance of equity markets in the second quarter of this year is unlikely to change this situation, especially since the Fed has recently signaled its willingness to revert to easier monetary policy. But is it worth chasing any rally? Much depends on the fundamentals. With most valuation metrics above their long-term averages, earnings must be consistently sound to justify an explicitly bullish stance. Market expectations for the Q2 earnings season are not overly demanding — indeed a moderate contraction of some 2.7% y/y is currently being projected — but various trade and geopolitical issues as well as the global industrial slowdown present substantial risks. Moreover, earnings weakness is not just a US phenomenon; the profits of European companies are also expected to grow at a snail's pace — some 4% in 2019.

Chart 3: S&P 500 valuation metrics continue to trend higher



Source: Bloomberg, HBZ

More defensive positioning

Not being invested in equities could prove costly but so could trying to ride this rally until the bitter end. We therefore recommend two courses of action: We favor a below-benchmark asset allocation, as this will allow investors to continue participating in upmarkets but will reduce potential drawdown *ex ante;* and as regards sector and regional positioning, we suggest adopting a more defensive exposure. For a USD-based investor this means maintaining sizeable exposure to the US and making low-level allocations to more defensive international markets like Japan, Switzerland and — yes, despite all the Brexit chatter — the UK. We would also reduce the cyclical tilt in portfolios and rebalance towards more defensive growth sectors such as health care. We continue to favor IT as a secular growth play, but here too we prefer stocks with more defensive characteristics (e.g. IT services). Trade tensions between the US and China have shown quite how acute the supply chain risks of many IT manufacturers are; we therefore recommend underweighting this sub-sector.

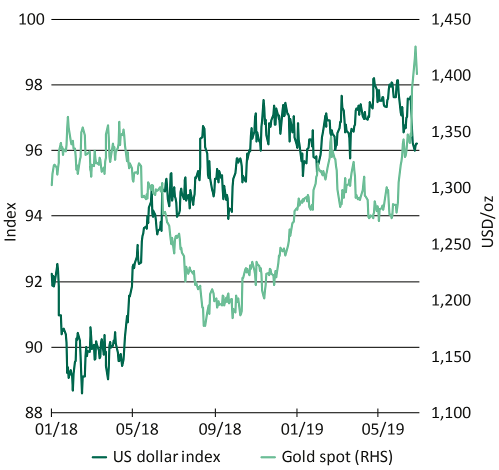
Key points

- Equity markets show remarkable resilience
- Q2 earnings next test
- More defensive positioning advised

Commodities and FX: Wither the US dollar?

The US dollar has lost some of its appeal as US rates appear to have gone into reverse. However, relative to other currencies, this downside appears to be limited. We prefer to look to commodities for alternatives and continue to favor gold.

Chart 4: Weaker US dollar, higher gold price



Source: Bloomberg, HBZ

USD topping out

The latest shift in the Fed's language and the likely shift in its monetary policy stance have stopped the USD's rise in its tracks. However, we do not expect a sustained dollar bear market as long as the US economy continues to outperform its developed-market peers and the greenback's yield advantage remains material. In fact, the likely lowering of ECB rates will ensure that any upside for the EUR will be capped while upside for the GBP from its current (and arguably attractive) levels will be limited by the dense fog of Brexit. Should global growth take a turn for the worse, demand for the USD could actually resurface quickly, further limiting any downside; even lower yields are therefore unlikely to undermine its safe-haven status. Given slowing global growth momentum, EM currencies will struggle to make real headway against the USD. For many of them, the fortunes of the Chinese renminbi will be crucial. Many Asian central banks continue to manage their exchange rates relative to the CNY in order to keep their economies competitive. With many other EM currencies their yield advantage can be deceptive since high yields typically mask weak fundamentals, which would undoubtedly be laid bare in a softer global environment.

Gold lustrous again

We see gold as the most attractive, real alternative to the USD. It is a hard asset with limited supply and tends to hold its own in times of lower USD yields and heightened market uncertainty. The stars were aligned for gold late in Q2 and the metal duly surged to a new five-year high. Since US yields are generally expected to fall, gold should enjoy substantial support going forward. Overall, other commodities did not fare as well, as fundamental concerns eclipsed the positive effect of a weaker USD. One of the major exceptions was the traded front contract for iron ore traded in Dalian (China), which soared over 40% on temporary supply constraints. Over the course of the quarter, global oil prices retreated in response to ample supply and slowing global growth. However, OPEC's output discipline and the tensions between the US and Iran will guarantee Brent fairly strong support around USD50/bbl. Moreover, US shale producers are highly price sensitive and will throttle their production quickly should WTI fall below a similar level.

Key points

- USD topping out
- Gold is best alternative
- Oil range-bound with support at USD50/bbl (Brent)

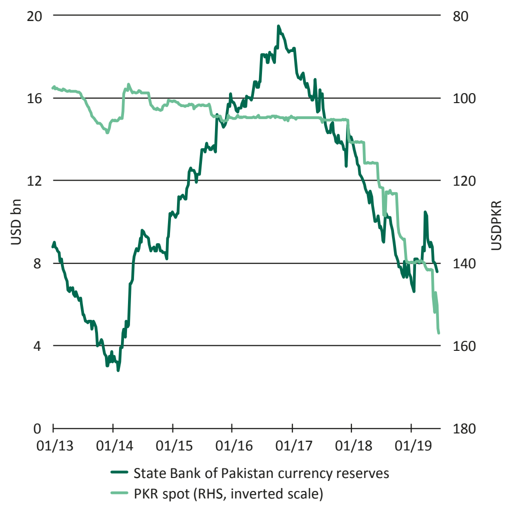
Key markets: Still in limbo

The IMF deal is certainly welcome news for Pakistan, however much remains to be done and the country is not yet on a genuinely sure footing. The cyclical outlook has improved for the UAE while the UK remains stuck in the Brexit rabbit hole.

Pakistan: A deal at last

After an excruciatingly long negotiation, in early May Pakistan finally agreed an Extended Fund Facility with the IMF of approximately USD 6 billion over the next three years. While this was a welcome development, an inordinate amount of time and effort has been squandered, leading to a much sharper drop in economic activity than expected. On a brighter note, the agreement with the IMF, once duly approved by the board, will open the way for additional funding from other multilateral institutions. Growth is nonetheless set to remain woefully low in 2019. Additional headwinds will come from an austerity budget adopted in June which focuses on consolidation rather than growth. In accordance with IMF requirements, the government will also seek to improve tax collection, which remains among the lowest in the world. Another IMF demand is the adoption of a market-based exchange rate mechanism for the PKR. Given weak fundamentals, the currency faces further downside having already shed some 11% of its value this year alone. No wonder the State Bank is determined to contain capital outflows. Against this backdrop, the stock market will clearly continue to struggle; it may be cheap, but it is also out of favor.

Chart 5: Pakistan — dwindling reserves, plummenting PKR



Source: Bloomberg, HBZ

UAE: Cyclical uptick

The latest activity indicators confirm that growth should pick up this year, aided by the three-year stimulus package adopted late in 2018 and easier monetary conditions in line with lower USD rates. The ongoing real estate slump and weak regional growth outlook will, however, contain the expansion and consequently any upside for the Emirates' stock markets.

UK: Hard Brexit after all?

Three years have passed since the referendum, and Brexit has still not been accomplished. Unable to push her deal through parliament, Prime Minister May finally conceded defeat and stepped down in early June. However, the Brexit deadline remains 31 October and it will be up to her successor — in all probability the mercurial Boris Johnson — to complete the process. Johnson has committed himself to leaving the EU 'come what may', thereby creating renewed uncertainty and considerable further downside risk for the GBP in the event of a hard Brexit. Effectively, the Bank of England has been condemned to watching the drama unfold from the sidelines.

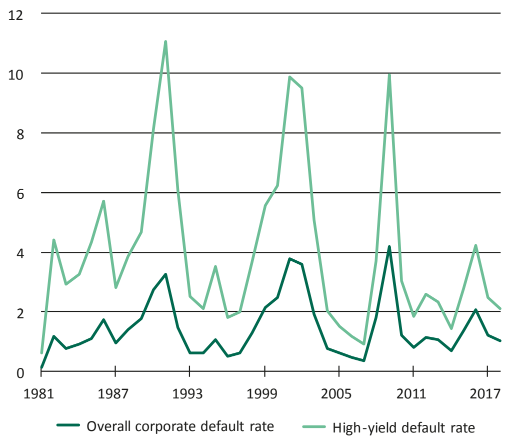
Key points

- IMF deal will help stabilize Pakistan's economy
- Cyclical outlook improving for UAE
- Hard Brexit remains material risk

Special topic: The risks involved in chasing yields

Global monetary policy is once again poised to exert downward pressure on yields. Investors looking for a specific level of return may be tempted to move further down the rating scale in response. We think this is a risky strategy at this stage in the cycle.

Chart 6: Defaults come in waves — don't get caught out!



Source: S&P Global, HBZ

Key points

- Default rates high for low-quality corporate issuers
- Slowing global growth could soon expose weakest credits
- Active management increases chance of avoiding defaults

Issuers do default

The key risk for any buy-and-hold bond investor is not getting paid back in full at maturity; this is typically what happens in the event of a default. While defaults are rare, they do happen — and the lower the issuer's credit rating, the more frequently they occur. Thus, when investors run after lower-rated issues in search of yield, they inevitably increase their exposure to default risk. If, in addition, they buy longer-dated bonds from such issuers as the shorter end of the yield curve does not offer them their desired rate of return, their default risk exposure will increase yet further. Why should this be? We know from historical data that default risk increases over time, as weak credits tend to remain weak and time exposes them to increasing fundamental risks (business model, refinancing, etc.). According to data from rating agency S&P Global, for the period from 1981 to 2018 a full 62% of issuers rated single B at origination had defaulted after five years. For BBB issuers, the default rate was only approximately 4% .

Mind the cycle

Just like financial markets, defaults follow a cyclical pattern. If the economy is doing well, default rates tend to decline; if growth slows or contracts, the number of defaults increases — sometimes dramatically. We believe the global economy is likely to slow in the foreseeable future and that, even without a recession, more issuers could face serious debt servicing and refinancing problems. While low interest rates may limit stress in the immediate term, increased leverage across the non-financial corporate sector has created a risk that will certainly be tested during the next downturn.

The case for active management

If buy-and-hold exposes investors to increased default risk, an active approach is the best alternative, as it is rare for companies to default overnight. There are usually plenty of early warning signs that something may be amiss with a credit — notably profit warnings, impaired assets or a rise in the cost of insuring against default (credit default swaps). These 'red flags' will signal to an investor when it is time to part with a specific bond although loss aversion can stand in the way of timely action. This is why collective investment vehicles are the most sensible solution for investors who are unable or unwilling to forgo the returns offered at the lower end of the rating spectrum.

Market data summary

As of 1 July 2019

Equity indices	Last	-3M %	YTD %	-3Y %
MSCI World USD	6'331.1	2.8	17.0	39.0
S&P 500	2'972.4	3.7	18.6	41.3
EuroStoxx 50	3'506.1	3.6	16.8	21.6
FTSE 100	7'508.7	2.6	11.6	14.2
SMI	9'992.0	4.8	18.5	23.6
Nikkei	21'730.0	1.0	8.6	38.6
MSCI EM USD	492.6	-0.5	10.6	34.7
Sensex 30	39'686.5	2.1	10.0	46.2
KSE 100	33'996.3	-11.4	-8.3	-10.0
Hang Seng	28'542.6	-3.4	10.4	37.3
Russia RTS	1'406.1	15.8	31.6	50.7
Brazil Bovespa	102'036.5	6.2	16.1	95.3

Bond indices	Last	-3M %	YTD %	-3Y %
Citi US gov	1'563.74	3.4	5.1	4.0
CIti US Corp	2'337.26	4.8	9.6	11.6
CIti US HY	1'068.42	2.2	9.9	23.3
Citi Euro gov	246.07	3.5	5.7	4.3
CIti Euro Corp	248.43	2.3	5.3	6.5
CIti EM Sov	881.88	4.5	11.0	15.2
DB EM Local USD	170.41	3.6	8.2	10.7

Currencies vs USD	Last	-3M %	YTD %	-3Y %
DXY	96.13	-0.7	0.4	0.9
EUR	1.14	1.1	-1.0	1.8
CHF	0.98	1.5	-0.1	-1.1
GBP	1.27	-3.6	-0.8	-4.7
JPY	107.85	2.9	1.2	-5.4
AUD	0.70	-1.8	-0.9	-6.9
CAD	1.31	1.6	3.9	-1.5
ZAR	14.09	1.0	2.3	3.6
INR	69.03	0.3	1.2	-2.4
PKR	159.52	-13.3	-13.9	-35.5
Gold oz	1'409.60	7.9	8.5	4.1

Interest rates	3M interbank %	10YR government %
USD	2.32	2.01
EUR	-0.35	-0.35
GBP	0.77	0.80
CHF	-0.73	-0.54
JPY	-0.07	-0.15
AUD	2.96	1.36
CAD	1.17	1.47
ZAR	7.03	8.85

For your notes

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