HBZ Investment Quarterly

Higher rates, diverging growth

Q4 2018

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Editorial

Dear Reader,

Nervousness among investors increased noticeably during the summer months and early fall. Now, in the last quarter of the year, there are certainly plenty of reasons to worry, not least signs of greater divergence in the performance of the world's economies, higher USD rates (which continue to exert pressure on many emerging markets in particular), and increased political risk. And yet, despite all of these concerns, much still depends on whether you see the glass as half full or half empty. There is also no shortage of positive developments such as the relative resilience of many EM economies, strong corporate earnings, and the generally higher level of market yields; bond investors are finally beeing offered somewhat better returns again.

As regards our investment strategy, while we have adjusted our risk appetite to account for the greater uncertainty outlined above, we believe it is still too early to run for cover. We recommend positioning portfolios more defensively – and this includes holding a higher-than-usual cash allocation – but at the same time maintaining exposure to various risk factors that will continue to deliver returns via dividends, coupons, premiums and, in some cases, even capital gains.

Given the advanced phase of the global cycle, our 'Special topic' in this edition is devoted to answering a simple but important question that is likely to be preoccupying many of our readers: How will this all end?

For now, we remain constructive – albeit with a healthy dose of realism.

We hope you enjoy reading our commentary and, as always, look forward to your suggestions and feedback.

Yours sincerely,

Dr. David Wartenweiler, CFA
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The macro backdrop: Vulnerabilities building

Overall, global growth has remained robust but it has become less synchronized as higher US rates and oil prices have exposed significant fault lines. With the Fed committed to further policy normalization and Europe yet to confront some of its old demons, times are bound to get tougher again.

US: Who holds the key – President or Fed?

Strong US expansion is set to continue into 2019, although the pace can only moderate following the country's stellar performance in Q2. The Fed meanwhile appears determined to maintain its policy of gradual tightening although the ultimate path of rates will be contingent on macroeconomic performance and inflation, in particular. Forward-looking measures of underlying inflation suggest substantial upward pressure; however, structural changes in the economy could act as major brakes. The unresolved trade dispute with China is an important wild card in this respect that has the potential to morph into a headwind for growth. Should the Republicans lose control of Congress in the upcoming mid-term elections, President Trump may no longer be able to pursue, or at least implement, some of his key policies, such as further tax cuts and deregulation. With the risk of a recession setting in by 2020 (whatever its causes), the incentive for Trump to avoid all-out confrontation with China and seek a compromise could also become more compelling.

Europe at a crossroads again

Recent economic data confirms that activity in the eurozone has started to roll over; the best of the bloc's growth lies behind us. Simultaneously, systemic risks have been building, most visibly in Italy where the new government is throwing the sustainability of the country's already outsized public debt into doubt. Add to this a messy Brexit (best-case scenario) and substantial exposure to emerging markets, and the reigning optimism about Europe could dissipate quickly. And this time it may take more than an open-ended commitment from the ECB to steady the ship.

Vulnerabilities across emerging markets

Higher US rates, higher oil prices, and a worsening international political environment have created big headaches for many EM economies. While China, by far the largest and most important EM country, still exhibits a high degree of stability, its cyclical picture has worsened; this will inevitably impact the larger complex – in particular Emerging Asia. The elevated oil price, a boon for producer nations, will increasingly challenge importing nations and expose those with high external leverage. Painful adjustments – with or without IMF support – will be required in many cases (e.g. Turkey and South Africa).

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

	2018E	2019F	2020F	Short-term trend
United States	2.9	2.5	1.9	↘
Eurozone	2.0	1.8	1.7	→
Germany	1.9	1.8	1.6	→
United Kingdom	1.3	1.5	1.6	→
Japan	1.1	1.1	0.6	↘
China	6.6	6.3	6.1	↘
India	7.5	7.4	7.5	↘
Russia	1.8	1.5	1.7	→
Brazil	1.5	2.4	2.6	↗

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

	2018E	2019F	2020F	Short-term trend
United States	2.5	2.4	2.3	↗
Eurozone	1.7	1.7	1.7	↗
Germany	1.8	1.8	1.8	→
United Kingdom	2.5	2.1	2.0	→
Japan	0.9	1.1	1.5	↗
China	2.1	2.3	2.4	→
India	4.8	4.6	4.8	→
Russia	2.9	4.6	4.0	↗
Brazil	3.7	4.2	4.1	↗

Source: Bloomberg, IMF, HBZ

Key points

- Fed to continue raising rates, irrespective of global context
- Italy is latest threat to eurozone cohesion
- Vulnerabilities exposed in many EM economies, but China set to hold up

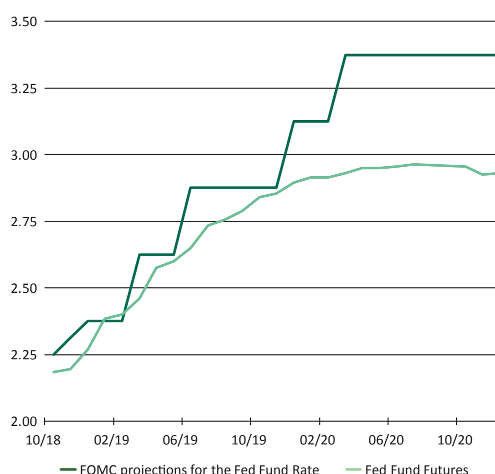
Investment strategy: Macro vs. micro

Financial markets had a difficult summer quarter, and the outlook for Q4 is not altogether rosy either. The calendar is dominated by a number of crucial events and deadlines which will require investors to stay nimble. The bottom line? Review your risk appetite and keep your powder dry!

The price of money

As interest rates are the single most important driver of asset prices, it's little wonder that their steady rise in the US could have serious consequences. Investors finally woke up to the threat of a more hawkish Fed following the September FOMC meeting; this fact, combined with a set of very strong US macro data, caused the surge in bond yields in early October. Higher yields imply higher discount rates and equity markets will thus have to rely yet more heavily on strong earnings to maintain their current valuations. For the last two quarters of the year we will probably continue to enjoy solid earnings growth, at least in the US, but 2019 could be more challenging and any major disappointment would spell trouble. EM equities are already in bear market territory and, despite more favorable valuations, they are unlikely to rebound meaningfully any time soon. We are therefore sticking with US stocks, for which we recommend reducing the cyclical tilt. Higher yields are of course a threat to bond markets, too, but they also create more attractive entry levels. Investment-grade corporates and EM bonds have already shed some of their valuation fat. Corporate high-yield bonds look increasingly vulnerable, however; we exited this sector some time ago and do not intend to change our approach in the foreseeable future. We currently see more return potential in a number of hedge-fund strategies (e.g. equity and credit market neutral).

Chart 1: The market does not believe the Fed (in %)



Source: Bloomberg, HBZ

Current positioning

We have gradually reduced our risk exposure and built up our cash position but we still have substantial skin in the game, mainly in the form of (US) equities, investment-grade credit, and EM sovereign bonds. We have considered extending our duration and going back into US Treasuries but the macro context currently remains unfavorable for such a shift.

What to watch

The looming US mid-term elections and the ongoing Q3 US earnings season are currently at the front of our minds. While we are constructive on corporate results, we are ambivalent with the respect to the US mid-terms and fear no outcome will be positive for markets. Elsewhere, we are continuing to monitor the Brexit drama, Italy's debt management and, of course, events in China. Unexpected weakness here would certainly send a chill through markets.

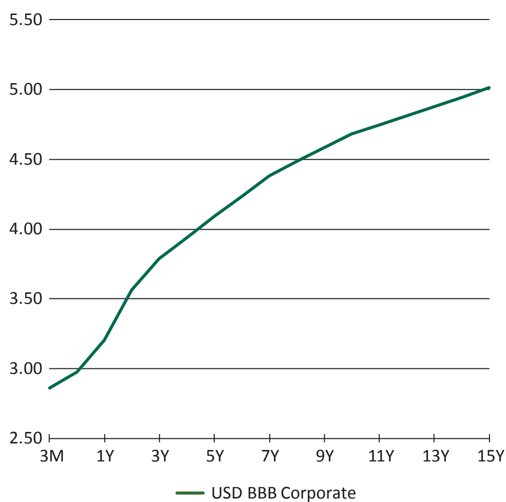
Key points

- Higher rates will become a challenge for asset returns
- Market-neutral strategies offer an interesting risk/return profile in current markets
- US mid-terms and events in China could be game changers

Fixed income: Dealing with higher rates

Some thought it might never happen, but finally US long-term rates have moved decisively higher. Fundamentals suggest they should move higher still, generating more tension in rates and on credit markets. One way of dealing with this new environment is to focus on shorter duration and superior quality.

Chart 2: Yields for BBB US corporate bonds (in %)



Source: ICE Index, Bloomberg

Everything hinges on Treasuries

The US Treasury yield curve is the anchor for USD rates globally and, as such, it also impacts the curves in other currencies. So when US rates move the way they have done this year, the effect is felt everywhere. And more could well be in store. So far, the rise in US yields has principally affected emerging markets, several of which have been forced to go cap in hand to the IMF. As long as growth remains solid, corporates should be able to deal with higher rates; but once the tide goes out, some are sure to be left stranded.

Quality vs. yield

Investment is all about risk and return – which in fixed income translates to yield vs. quality. At this stage of the cycle we think it is time to pay more attention to quality. After the sell-off in investment-grade bonds earlier in the year, quality has actually become attractive again, even in terms of yield. However, investors who wish to benefit from the higher yields of issuers rated BBB and above should also think about managing their duration risk. We continue to believe that private investors are best off occupying the three to five-year portion of the maturity spectrum where the payoff between interest rate risk (duration) and yield is the most balanced. We continue to think investors are no longer adequately compensated for the risks they incur in the high-yield space. Our preference remains with EM sovereigns with short to medium duration and fundamentals which can withstand higher rates and lower growth. We are more cautious on the high-yielding, single B issuers; only investors with the appropriate risk profile and sufficient funds to build a truly diversified portfolio should venture into this segment.

Even the 'front end' is paying again

It has been a while since investors were able to place their US dollars short term and earn a return that even vaguely protected their cash against inflation. Now, even two to three-month LIBOR deposits come close to delivering this. Thus, as long as the rate outlook remains uncertain, parking cash has once again become a viable solution. Investing in floating-rate notes or senior loans (in the latter case as part of a collective investment) will further lift yields but will also entail (at times substantially) higher credit risk exposure.

Key points

- Still some upside potential for USD rates
- Preference for quality over yield
- LIBOR deposits and floating-rate notes – options for parking money in uncertain times

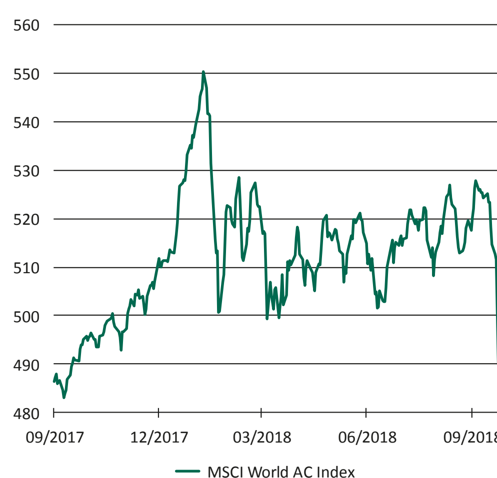
Equities: Facing ill winds

Trends in global equities have become highly dispersed in 2018, as the US has outperformed Europe and emerging markets by a wide margin. Growth concerns, fears surrounding the US-China trade dispute, and home-made problems are all conspiring to further cloud the outlook for equity markets.

US as earnings stronghold

The muted stock performance of 2018 has surprised many investors who were spoiled by last year's exceptional equity returns. Headwinds for stocks have unquestionably been building this year as supportive factors waned (less central bank liquidity) and challenges proliferated (political risks, demanding valuations for US stocks in particular and trade tensions). For now, earnings remain strong in the US and other regions, to be sure – analysts expect them to continue driving equity market performance in the quarters ahead and targets have climbed steadily over the summer months. The current US earnings season seems to be confirming this trend: annual earnings growth once again stands at over 20%, with cyclical sectors (energy, financials, and materials) expected to rise the most. Most prominently, energy stocks are benefiting from the surge in crude prices on the back of global production cuts. This pace is expected to moderate next year, when slower growth and a higher USD will dampen earnings. Technology stocks may then well lag other sectors due to annual comparisons that have become hard to surpass, stubbornly high valuations and excessive optimism.

Chart 3: The breaking of a trend



Source: Bloomberg, HBZ

Defensive again

Obviously, given these headwinds, investors would be well advised to temper their return expectations and opt for an increasingly defensive tilt. Since the global economy is still in expansion mode, we think it is too early to expect a sharp, recession-induced equity market drop, but investors should nonetheless focus their attention on companies with safer business models and stable earnings, as well as reasonably priced low-volatility stocks of companies with wide fundamental 'moats'. It is also possible that we will experience very mixed sector performance over the coming months, where some cyclical sectors advance together with defensive ones. In addition to diversification, downsizing individual holdings will also lower risk and improve portfolio volatility substantially. Ultimately, in the course of next year, investors should revisit their equity allocations since stocks are almost certain to suffer a setback if volatility spikes. In the end, though, there may be no place to hide – that is to say, stocks may simply not generate positive returns. The global growth trajectory is not yet signaling the need to rush into full-blown defensive mode, however.

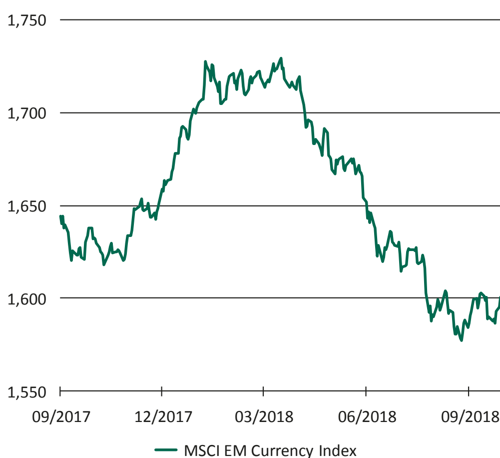
Key points

- Earnings growth in the US still very strong
- Anticipate sector rotation
- Stay diversified and add defensive stocks

Commodities and FX: Another quarter in the roller coaster

Commodities and currencies have had a roller-coaster ride this year. While commodity performance has been driven largely by energy, EM currencies suffered in line with many other risk assets as the USD rallied across the board. Expect more of the same.

Chart 4: EM currencies' ongoing slide



Source: Bloomberg, HBZ

Commodities: Will the advance of oil continue?

Energy prices have risen in double digits this year and have rallied further recently in response to flaring geopolitical risks. Further supply disruptions (e.g. the unprecedented production declines in Venezuela and renewed US sanctions on Iran) combined with tightening global spare capacity could drive oil prices even higher. The short-cycle nature of US shale oil has incentivized operators to accelerate activity, driving global production above pre-OPEC deal levels. The outlook for commodities in general is yet more uncertain as global demand could fall on geopolitical risks, especially any further ratcheting-up of trade tensions. The trade-weighted USD is the most significant negative variable for commodities. Given the recent strength of the greenback, based on economic growth as well as widening interest rate differentials, we expect some downside risks to persist. Gold has halted its earlier slide as volatility kicked in in October. Despite the fact that some inflationary pressures are rising in a US economy at full employment, we do not foresee a pronounced rise of the gold price. This might change next year as the headwinds of rising US bond yields and the strong USD could start to abate.

FX: Emerging markets out of favor

In recent months investors saw the currencies of many EM countries hammered as they, along with many other risk assets, suffered a meltdown. Argentina, India South Africa, and Turkey stand out in particular. It is mainly country-specific factors that are weighing on these economies as they desperately attempt to re-establish a solid growth path. The Brazilian real was a positive exception to the rule – it appreciated strongly in the run-up to the presidential elections. Looked at over a longer time horizon, however, even after their sharp fall, the valuations of many EM currencies remain close to their multi-year highs. Should global demand decelerate materially, EM as well as carry currencies could cause more pain for investors. Another major source of worry is the (still unresolved) issue of Brexit. Shaky investor sentiment is putting stocks and the currency at risk as the decline of the GBP has already lifted inflation and placed a strain on real household incomes. Investors are therefore encouraged to weigh up the currency risks in their portfolios. We advise giving greater weight to the respective home currency.

Key points

- Oil prices dominate commodity returns
- Commodity complex needs weaker USD to see a price recovery
- EM currencies not out of the woods yet

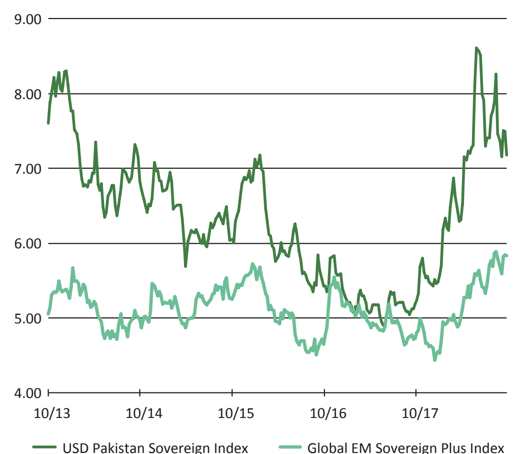
Key markets: Tough realities, hard choices

Having skirted hard choices in the last few years, Pakistan has yet again had to go to the IMF for assistance; the UK is about to enter one of its most challenging periods in recent memory; and the UAE is going to have to think hard about cutting its dependency on bricks and mortar.

Pakistan: Now for the hard part

In a historic election in July 2018, the two main parties, which have dominated Pakistan's politics in recent years, were defeated at the polls. Although the PTI party fell short of an absolute majority, it won sufficient seats to form and lead a coalition government. Taking power with a pledge to change the way Pakistan is run, reality quickly caught up with the new leadership. The parlous state of the country's external accounts required immediate attention. After vain attempts to source funding elsewhere, the IMF was once again approached for a borrowing facility (the country's thirteenth such program). In return, tough conditions will have to be swallowed, including a further devaluation of the currency. Faced with inflationary pressures, the State Bank has already raised rates by 275 bps since the beginning of the year and additional monetary as well as fiscal tightening is likely. The local stock market, already under pressure for some time, faces prolonged uncertainty as the economic outlook has darkened. USD-denominated foreign bonds have turned out to be the better investment given that a restructuring of Pakistan's foreign debt is now only a remote risk. This trend is set to continue for the time being.

Chart 5: Pakistan's USD bonds — higher risk, higher return (yield to maturity in %)



Source: ICE Index, HBZ

UAE: Weighed down by concrete

The outsized dependence on their real estate markets remains the Emirates' chief weakness. As a result, growth in the country has been sluggish for several years now and, with no reversal in price trends expected, this trajectory will not change in the short term. The performance of local stock markets meanwhile diverged, with Abu Dhabi beating Dubai by a mile. Despite the strong showing of the former, the general situation in the region will represent a challenge to both.

UK: Brexit to the wire

So far, Prime Minister May's efforts to secure a Brexit deal have been singularly hapless. EU leaders have dismissed her various attempts at squaring the proverbial circle as have opponents within her own party. With time running out, a 'corner solution' – either no Brexit or a hard Brexit – has become the more probable outcome. That said, the EU is known for conjuring up last-minute 'fudges' so an orderly process is still possible. Surprisingly, the UK economy has fared comparatively well and the GBP remains the main asset through which investors are positioning themselves for an uncertain future.

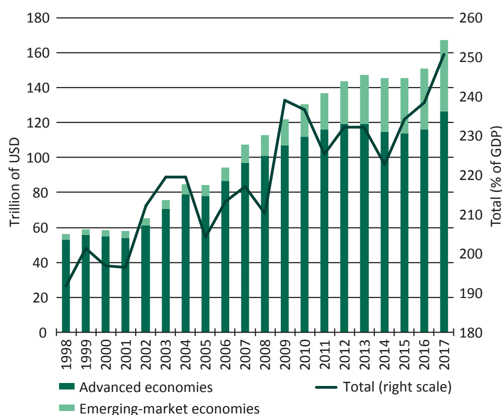
Key points

- High level of uncertainty in Pakistan favors its USD-denominated debt
- UAE at the mercy of its outsized real estate sector
- As goes Brexit, so goes the GBP

Special topic: What will cause the next downturn?

It is hard to predict when the next major economic downturn will occur, but when it does, it will most probably have been precipitated by a combination of several shocks and factors (e.g. US policy tightening and increased global debt levels) rather than by a single, large bubble bursting.

Chart 6: Balance sheet vulnerabilities — Total non-financial sector debt



Source: IMF, HBZ

Tighter US monetary policy

The Fed currently has five more interest rate hikes penciled in up to the end of 2020. As the effects of this year's tax cuts fade, and with another round of cuts unlikely if the Democrats win a majority in the House or Senate, US growth will inevitably slow in 2019. Rising rates and an appreciating dollar have already been particularly troubling for emerging markets, as they have large amounts of USD-denominated debt outstanding that they may struggle to pay. Lower US growth will only add to the woes of the global economy.

Vulnerable corporate sector

After the 2008 financial crisis, central banks implemented monetary policies that encouraged borrowing to support the recovery. As a result, total non-financial-sector debt has expanded at a much faster rate than the economy. This increased debt burden has rendered the non-financial sector particularly vulnerable to large shifts in interest rates. In the US, the prevalence of 'covenant-lite' debt is one potential issue. Emboldened to leverage their balance sheets by strong investor demand, speculative-grade firms now make up a considerable share of debt issuers. This high-yield corporate debt enjoys weaker protections, so in the event of an economic slowdown, default rates in this sector would be higher and losses larger. Since banks are generally in a better position today than they were in 2008, at least systemically important financial institutions are less likely to get into difficulties than they were in the past.

Key points

- Growth slowdown in US and China as material risks
- Corporate leverage exposed to higher rates
- Italy's debt overhang is a threat to the eurozone

Rising global debt levels

In China, credit has been powering growth, but many believe total corporate-sector debt in the country has now become unsustainable. For the time being, China has the means to avoid a hard landing, with its strong current account position and the ability to ramp up spending. In the unlikely event that such a hard landing did occur, however, the impact would be felt around the world and it might well lead to a global recession. Italy, the third largest eurozone economy, is another weak spot. With its excessive sovereign debt and a large number of problem loans on its banks' balance sheets, the country has the potential to cause much greater damage than Greece ever did. Investors are rightly worried by the confrontational stance the populist government is taking with the EU on budgetary matters.

Market data summary

As of 22 October 2018

Equity indices	Last	-3M %	YTD %	-3Y %
MSCI World USD	5'906.2	-3.2	-0.4	29.4
S&P 500	2'777.6	-0.9	3.9	35.3
EuroStoxx 50	3'204.2	-7.4	-8.6	-4.4
FTSE 100	7'086.3	-7.7	-7.8	11.1
SMI	8'873.2	-1.3	-5.4	1.0
Nikkei	22'614.8	-0.4	-0.7	22.7
MSCI EM USD	446.5	-8.7	-14.4	21.3
Sensex 30	34'134.4	-6.5	0.2	25.1
KSE 100	38'345.4	-7.0	-5.3	13.0
Hang Seng	26'153.2	-7.3	-12.6	14.5
Russia RTS	1'125.9	1.0	-2.5	30.8
Brazil Bovespa	85'496.3	8.8	11.9	79.0

Bond indices	Last	-3M %	YTD %	-3Y %
Citi US gov	1'441.87	-1.1	-2.2	-0.1
CIti US Corp	2'110.34	-0.8	-3.4	7.3
CIti US HY	1'010.35	0.8	1.7	21.8
Citi Euro gov	228.21	-1.7	-1.2	1.6
CIti Euro Corp	236.97	-0.2	-0.4	6.1
CIti EM Sov	786.03	-1.5	-5.1	12.1
DB EM Local USD	156.32	-0.9	-6.3	8.3

Currencies vs USD	Last	-3M %	YTD %	-3Y %
DXY	95.71	1.6	4.2	-0.4
EUR	1.15	-1.9	-4.4	3.0
CHF	1.00	-0.4	-2.2	-2.6
GBP	1.31	-1.1	-4.1	-15.7
JPY	112.55	-1.2	-0.1	7.0
AUD	0.71	-3.9	-9.1	-1.7
CAD	1.31	0.4	-4.1	-0.1
ZAR	14.41	-5.3	-13.3	-6.0
INR	73.33	-6.4	-13.2	N.A.
PKR	132.53	-2.6	-16.6	-21.3
Gold oz	1'227.40	-0.7	-6.5	4.6

Interest rates	3M interbank %	10Y government %
USD	2.48	3.18
EUR	-0.32	0.44
GBP	0.80	1.52
CHF	-0.75	0.03
JPY	-0.09	0.15
AUD	2.96	2.70
CAD	1.17	2.48
ZAR	7.03	8.72

For your notes

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