MULTI ASSET PERSPECTIVES

Caution prevails

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In contrast to the year's earlier volatility, markets are currently range-bound and lack conviction. Against this backdrop, the Asset Allocation Committee met last week to discuss investment strategy. A brief summary follows.

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Markets puzzle amid steady growth

A general sense of caution and a corresponding lack of investor conviction continue to hamper market performance.

Markets have struggled this year against a myriad of challenges. In early February, US-led 'wage rage'—fears that accelerating US wages might trigger higher inflation and a more forceful response from the Federal Reserve (Fed)—caused bonds and stocks to slump. March then brought 'trade rage', namely concerns that US tariffs might spark a global trade war. More recently, weaker-than-expected growth in Europe and emerging markets has further dampened sentiment, offsetting a stellar Q1 earnings season. The US dollar's latest rebound has also taken a toll on local currency emerging fixed income performance.

Still, the markets' soggy performance remains puzzling. After all, most of the fears cited have yet to manifest into much more than, well, fear. Inflation is not accelerating rapidly anywhere. President Trump's tariffs have not sparked counter-measures so far, in part because these protectionist measures have been watered down. The markets' subdued reaction to the Trump administration's decision to pull out of the Iran nuclear deal also appears to reflect a sense that policy rhetoric will be worse than policy outcomes.

There is also little reason to be pessimistic about global growth. Even though growth surprise indices have disappointed this year, it is difficult to see how the global expansion is fundamentally at risk. Financial conditions and policy settings remain supportive. Few economies show signs of imbalances, overheating or other stresses. Growth in major advanced and emerging economies remains underpinned by jobs formation in the household sector and profits growth in the corporate sector. Income, not debt, remains the key driver of a stable and resilient global expansion.

Fresh market risks

But sentiment has clearly changed. Why?

One reason is politics. In 2017, equity market performance was underpinned by anticipation of accelerating and synchronous global growth, bolstered by business-friendly tax cuts and de-regulation in Washington. But the start of 2018 has seen a reversion in US politics to what worked in 2016—populism. In an election year, protectionism, anti-immigration and 'tech-bashing' have pushed business-friendly policies to the margins of US politics.

A second factor is the recovery of the US dollar. A weak dollar in 2017 was a boon for emerging markets and commodity producers. Corresponding euro and yen strength, which last year dampened inflation in Europe and Japan, allayed concerns that their central banks would soon follow the Fed towards policy normalisation. The dollar's abrupt recovery in recent weeks has led to a sharp reversal in emerging local currency debt markets. And if dollar strength persists, accompanied by higher oil prices courtesy of Iran sanction fears, inflation might yet arise as a concern for the European Central Bank or the Bank of Japan, putting further upward pressure on global bond yields.

To wit, the inability of bond markets to rally this year on negative growth surprises suggests that debt issuance is beginning to weigh on fixed income markets. And with good reason—US government debt issuance is expected to grow rapidly in the coming years, accompanied by rising corporate indebtedness.

In summary, last year markets were buoyed by supportive growth and policy developments. This year growth has peaked, policy has become less business friendly and the combination of dollar strength and rising bond yields poses fresh market risks.

Asset allocation implications

From the beginning of this year we have cautioned that a repeat of last year's high return and low volatility environment was not likely in 2018. By late January, we had adopted a more cautious approach across our various strategies. We see little reason to change that view.

In brief, our asset allocation approach is as follows:

Equities. In global equity markets, we have trimmed market directional exposure, cut allocations to Europe and shifted to quality as a style. We remain committed primarily to those equity markets where earnings are likely to surprise to the upside, such as emerging markets and Japan. Apart from select parts of the information technology sector, we expect significantly less contribution from rising equity multiples.

Fixed Income. We maintain our long-standing aversion to long duration fixed income, whether in government or corporate bonds. We have also lowered allocations to select areas of subordinated debt. Following recent weakness, we see opportunity in emerging debt markets, but funded via commodity currencies rather than the US dollar. We continue to prefer non-traditional areas of credit fixed income, including short duration, non-agency mortgaged-backed securities and insurance bonds.

Alternatives. We continue to explore potential in alternative strategies that provide uncorrelated returns to stocks and bonds. Long/short equity and multi-asset target return approaches remain our preferred alternative investment vehicles.

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