Macro Matters.

'Is that an iceberg on the horizon, captain?'

Contribution by Emiel van den Heiligenberg - Head of Asset Allocation

Emiel joined LGIM in August 2013 as Head of Asset Allocation with responsibility for asset allocation, strategy and macro research.

He has wide experience in managing a range of multi-asset strategies, including absolute return, diversified growth funds, LDI and fiduciary, balanced mandates and multi-manager mandates.

Emiel graduated from Tilburg University with a Master's degree in economics and holds a post-graduate qualification from VBA/EFFAS (the European Federation of Financial Analysts Societies).

"On the night of Sunday 14 April 1912, the sea was flat calm, the sky clear and moonless, and the temperature was dropping towards freezing. In such conditions, sea ice is very hard to spot."[1] Despite these hazardous conditions, and despite several warnings of sea ice in the vicinity, the Titanic was travelling at close to its maximum speed at the time of its fatal encounter with a North Atlantic iceberg.

The sinking of the Titanic reminds us of the dangers of being 'imprudently reckless'. Travelling too fast (or, in the world of investments, taking too much risk) through dangerous waters can end in disaster.

However, we also believe it is crucial to avoid being 'recklessly prudent'. The only genuinely 'unsinkable' ship is one that never leaves port; just as the only genuinely riskless portfolio is one that invests entirely in T-bills. Never taking any risk implies never arriving at your intended destination.

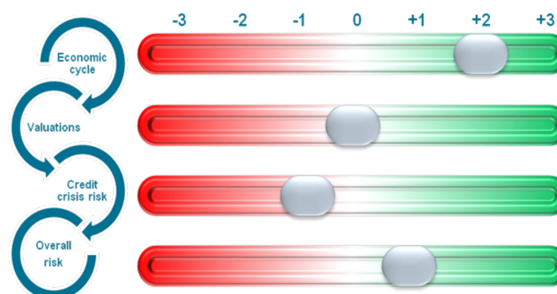
In the Asset Allocation team at LGIM, we believe our primary skill lies in understanding the medium-term market environment. Shorter term corrections are quite difficult to predict as they are driven by intangible elements like sentiment, positioning, and short term, quite random swings in market focus and consensus. Hence we spend the majority of our risk budget on the medium-term view (let's say one to five years) instead of the very tactical views (less than three months).

Some people feel that this medium-term focus means we are not active enough, that we do not swing the portfolio around enough. We disagree! First of all, and in the true spirit of the LGIM culture, we would argue that a low turnover keeps total costs for our clients down which, over time, makes a huge positive difference to our clients' final outcome. Secondly we believe that it is crucial to make good progress when the seas ahead of us are clear, allowing us to slow down when the icebergs start to appear. Mixing nautical and agricultural metaphors, we need to 'make hay while the sun shines'.

The LGIM framework for medium-term risk taking

Figure 1 shows our framework for analysing the macro environment for risk assets. We focus on three factors: the economic cycle, valuations and credit crisis risk. The level of overall risk we take in our dynamic portfolios depends on our assessment of the combination of these factors. There are no fixed weightings of these factors and the final score is mostly a qualitative view of the senior people in the team. It is worth examining each of these in turn to understand both our current stance and potential next moves.

Figure 1. Framework to analyse LGIM's medium-term view on risk assets



Source: LGIM

[1]Taken from a BBC documentary: 'The Rise and Fall of Titanic' http://www.bbc.co.uk/history/titanic.

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The economic cycle

The economic cycle score is based on the outlook of our economists and what we call our 'Macro Mapping'. This proprietary research maps asset class risks and returns in different parts of the economic cycle. For instance, the research shows that equity returns have historically been sensitive to the growth environment, but relatively insensitive to the inflation environment. Economic downturns are typically associated with falling corporate earnings, rising defaults and rising risk premia. All tend to be negative for risk assets such as equities and corporate bonds[2] .

LGIM's 'Macro Mapping' shows that the best environment for equities is that of a mid-cycle economy. Economic growth which is not too hot and not too cold; it's what most investors call a 'Goldilocks scenario'. During mid-cycle, the chances of a recession-induced bear market are generally low. Late-cycle economies are usually characterised by tight capacity, unbalanced economic growth, excessive credit growth, tight monetary policy and worrying inflation pressures. At the moment we have none of these.

LGIM's Head of Economics, Tim Drayson, published our 2015 outlook in the December Fundamentals 'Divergence'. Tim and team have a high conviction view for decent global growth and very low headline inflation in 2015, which will keep monetary policy looser for longer. It is basically a similar outlook to 2014, albeit with slightly better global growth momentum and some Federal Reserve (Fed) action over the summer. Tim stated: "The global economy has some engines of growth, but many countries continue to struggle. As this pattern persists in 2015, monetary policy is likely to diverge further." Arguably this is largely the consensus view. What is probably less of a broadly held view is that Tim and team see upside risks to our economic scenario. For instance, lower oil prices and increasing wages could trigger a US consumer boom, generating higher GDP growth relative to our base case.

The regional growth divergence, the weakness in US wages and the disinflationary pressures in various economies can be thought of as a blessing in disguise for investors. It makes a prolonged mid-cycle more likely, with it taking longer for the economy to reach full capacity.

Should our economists' alternative scenario materialise – a higher than expected economic growth, thanks to a US consumption boom – the point of full capacity could be reached faster than expected which would, all else being equal, imply a gradual reduction to our medium-term exposure to risk assets, possibly as soon as mid-2015.

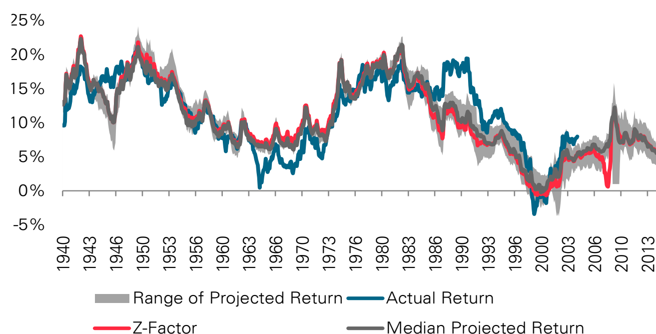
Valuations

The second factor we need to consider is valuations. There is a lot of debate amongst academics, investors and pundits around valuations. I have to admit that some of the macro investors I greatly admire – both within LGIM as well as outside our company – are convinced that equities are grossly overvalued[3].

We in the Asset Allocation team at LGIM disagree, particularly with the belief that equity valuations are already exceptionally rich, based on research by both Lars Kreckel, Equity Strategist, and Martin Dietz, Portfolio Manager. First of all, valuations only matter in the long run and or when they are at extreme levels. In addition, one needs to be aware that using a single valuation indicator is taking a shortcut that makes many implicit assumptions, whatever indicator you use. For instance the long-term valuation indicators often used by the valuation bears might be too conservative, as required risk premia have come down over the last 70 years thanks to better corporate governance, better banking and market regulation and improved transparency.

LGIM's proprietary Z-factor indicator combines a range of equity valuation measures which we find intellectually robust, which have strong track records of predicting equity returns and that represent a broad range of different types of multiples (Shiller PE, Bianco PE, trailing PE, price-to-book ratio, Ev/Sales, Q-ratio) to provide a consistent valuation multiple going back 75 years. Based on this composite indicator, we expect single digit annual equity returns over a 10-year horizon. This may sound below par by historic standards, but remains significantly more than one can expect from most alternatives in the fixed income space or compared to a risk free rate[4].

Figure 2. LGIM Z-factor equity valuation indicator



Source: LGIM

The Risk of a Credit Crisis

Finally, the last and probably most complex factor we need to consider is the risk of a credit crisis developing in a systemically important part of the world. Sudden swings in credit availability can be induced by a rapid market reassessment of debt sustainability. History teaches us that major credit disruptions can significantly disrupt both economies and markets. In our view, the sell-offs of 1987, 2000 and 2008 were bear markets induced by credit events.

We need to keep a focus on debt dynamics to stay ahead of the game. In this light, it is great that the Asset Allocation team at LGIM has close links with our Active Fixed Income team. We share research and many investment meetings. Jointly debating and analysing credit-related issues provides both teams with an essential edge. The global debt overhang is something that has been a huge worry in recent years.

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[2]See Chris Jeffery, Diversified Thinking, June 2014: 'The importance of macroeconomic regimes for multi-asset investing'.

[3]See www.hussmanfunds.com for extensive and excellent research on equity valuations. John P. Hussman PhD argues in his latest Market Comment: 'The line between Rational Speculation and Market Collapse' that 'current equity valuations provide no margin of safety for long-term investors. One might as well be investing on a dare.'

[4]See Lars Kreckel, Fundamentals of July 2014: 'Re-thinking equity values'

In a way, we have been sailing on an ocean with a few potentially lethal icebergs on the horizon. With the passage of time, the density of those obstacles is slowly but steadily increasing. Moreover, just like with an iceberg, we need to be humble about our abilities to assess the extent and nature of nascent credit problems.

These challenges mean we need to be vigilant and continue to focus on what could potentially derail our mid-cycle thesis. We see three main problem areas: the euro zone, China and the end of quantitative easing (QE).

Euro zone risk

We are convinced the euro zone still has significant unresolved debt issues which will re-enter the market's focus in the event of a cyclical downturn or a rise in interest rates. The atomised structure of sovereign debt, rather than the size of the debt, is Europe's Achilles heel. That structure implies that it is necessary to think carefully about debt dynamics at the national level.

Our European economist, Hetal Mehta, has done extensive work on debt sustainability across the continent. The situation is on a knife-edge. Under plausible assumptions, debt ratios are set to decline gradually over time. However, the situation remains very vulnerable to an external shock, an unexpected recession or a protracted period of growth disappointment. In particular, it will not take much to focus the market's mind on debt sustainability issues in Italy and France.

China risk

China has been another focal point of concerns about excessive credit creation. A gradual migration towards a lower and more balanced growth, economic liberalisation and slower credit growth is very difficult to achieve. It will, almost inevitably, imply repeated setbacks and unintended consequences.

Brian Coulton, our emerging market economist, is relatively relaxed about the immediate credit risks in China. The slowdown in the housing market and lower growth targets form the backdrop, but policymakers are deploying tools (mainly monetary policy loosening and targeted bailouts) to cushion the adjustment. Debt levels in China are high, but much of the debt is held by state-owned companies or with local governments who still face a low interest servicing burden. Nearly the entire debt stock is held domestically, giving the sovereign the capacity and incentive to manage an orderly slowdown in borrowing in these areas. China's high savings rate and strong external finances leave it much less exposed to a 'sudden stop' in foreign capital flows than other emerging markets.

The end of QE

Lastly we need to spend time on the side-effects of QE and the world's addiction to easy money. Via the so-called 'portfolio balance' channel, global QE has pushed private sector investors into assets with greater credit and/or duration risk in a search for yield. Pushing down yields, and pumping up prices, has been an explicit policy goal.

However, there is a great deal of uncertainty about how that monetary experiment will end. The early adopters of QE (the Federal Reserve and Bank of England) have now finished buying assets, but central bankers do not know whether it is the total stock of assets or the flow that matters for monetary conditions and financial assets.

Most likely, but not exclusively, the sensitivity towards an end to QE lies in emerging markets. The combination of weak commodity prices and a strong dollar has left commodity exporters vulnerable. However, global risk assets have also shown some vulnerabilities. Equities have shown weakness during the end of QE1 and QE2, as well as arguably in October this year with the end of the Fed's gradual tapering process. In this light, the gradual widening of credit spreads in the second half 2014 is a quite worrying development, as it reminds us of 1999 and 2007, and is something we will monitor very closely in the New Year.

Positioning in 2015

We believe that none of the fundamental conditions to end the bull market are firmly in place. Our mid-cycle economic outlook is positive for risk assets, especially equities. Valuations are rich but not excessive. Credit risks are rising but not prohibitive. There is a risk attached to becoming too defensive in a bull market ('reckless prudence'), so we have followed our high conviction cyclical call and remain fairly long risk.

However, that may well change over the course of 2015. Decent economic momentum can dampen credit risks in the short term, but there are plenty of icebergs to worry about in the year ahead. Elevated political risks in Europe may expose the fault lines in the sovereign debt market; the Chinese slowdown could cause distress among excessively leveraged private sector borrowers; and weak commodity prices, a stronger dollar and higher interest rates linked to the end of QE in the US are a dangerous combination. However, at the risk of sounding a bit like the captain of the Titanic on Sunday evening 14 April 1912; we believe that visibility on the risks is fairly clear.

As I have mentioned many times before, multi-asset portfolio management is a balancing act between seeking opportunities and mitigating risks. Good investors do not prepare their portfolios for the most likely outcome, but try to balance the portfolio for a range of different outcomes. Therefore, despite our relatively upbeat outlook, we are eager to hold a reasonable amount of downside protection in the portfolio by a combination of put spreads, targeted hedges and equity collars.

All in all, I believe 2015 will be another fascinating year for investors. It will remain essential to monitor market drivers like macroeconomics, valuations and credit dynamics. I believe LGIM's asset allocation team is in a great position to be at the cutting edge of these market developments thanks to a robust framework, our extensive resources on macro research, and our close cooperation with our colleagues from Active Fixed Income.

Finally, I would like to wish you and you loved ones all the best for 2015!

Yours,

Emiel

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