House View

Keep calm and seek carry

Our investment framework constantly looks at cyclical economic and corporate drivers, but the growing importance of political uncertainty is a demonstration of some deep-seated structural issues facing societies and markets.

Andrew Milligan
Head of Global Strategy

Craig Hoyda
Multi-Asset Investing
Quantitative Analyst

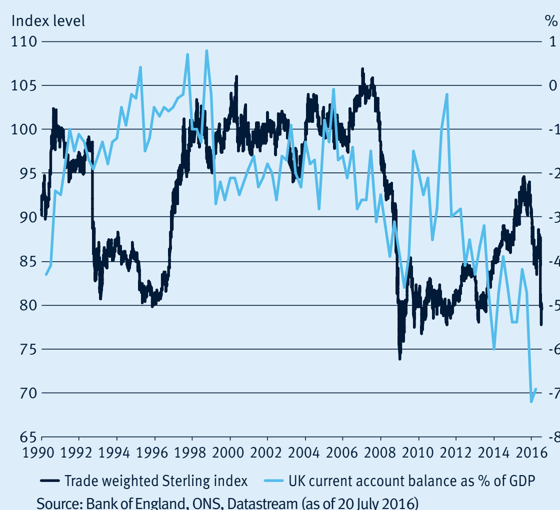
Winds of change

The Global Investment Group (GIG) held its quarterly meeting in early July, an apt time to assess the future direction of the global economy given the vote in the UK to leave the EU. The GIG was reassured that the stability of the global financial system was not in jeopardy, thanks to a variety of measures put into place by regulators in recent years, although it noted that the vote was a further headwind to globalisation. For much of the time after the 2008-09 recession, investors have found it best when making investment decisions to focus on cyclical drivers in general, and central bank policy decisions in particular. In the past 18 months or so, the importance of structural drivers has increasingly been recognised; the House View has emphasised that investors are operating in a world of low numbers, which strengthens the case for sustainable yield as an investment approach. More recently, testing the sustainability of that yield is important in an environment where corporate earnings have come under pressure. Politics are beginning to affect financial markets even more, and that was the case even before the EU referendum. We are now in an environment of radical uncertainty, so there are multiple potential outcomes to political discussions and treaty negotiations. All this means fiscal policy and structural reforms are becoming more important to determine whether countries can escape the low inflation world.

Politics in the driving seat

Recently, the EU referendum has been at the epicentre of many investors' attention. The market reaction is best exemplified by the initial plunge in the sterling exchange rate, showing the largest daily fall (around 8%) since the collapse of the Bretton Woods International Monetary System in 1971. It is important to remember, though, that the vote was not the only event of political importance this year: Spain is still negotiating to form a new government, while the result of the Australian election gives the government less room for manoeuvre. Over the coming year, a major risk is more political uncertainty: Italy is holding a referendum on constitutional reform that could potentially see the government fall; the US chooses between two candidates with very different aims and objectives for president; while the Dutch, French and German

Chart 1
Crunching the current account



Source: Bank of England, ONS, Datastream (as of 20 July 2016)

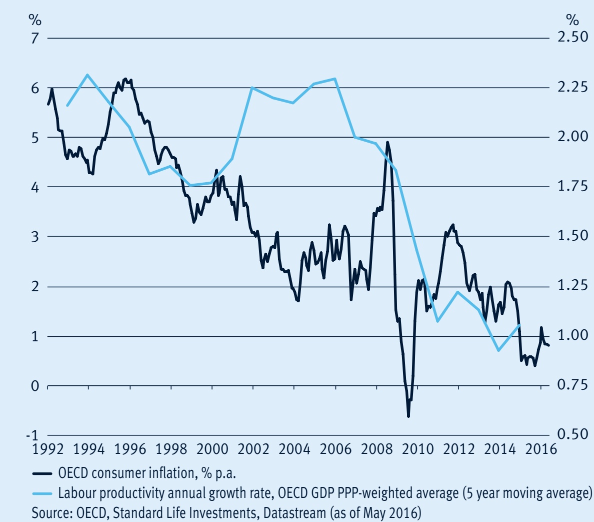
elections in 2017 will be extremely important in determining the future direction for the EU project. We see the result of the EU referendum as tying in with a trend in many countries towards euro scepticism, anti-establishment pushback and anti-globalisation, which collectively could potentially lead to significant changes in government policy.

Politics can affect markets in many ways. For example, we see sterling as the asset most exposed to the UK's exit, as its direction of travel will be highly sensitive to UK/EU negotiations. At the very least, sterling is an important adjustment mechanism, or shock absorber, as the UK economy begins to alter to the new reality. There is a low, but non-trivial, risk of a sterling crisis at some point should overseas investors cease to provide the necessary capital to meet the UK's sizeable current account deficit (see Chart 1). To accommodate this view on a medium-term time horizon, the GIG has taken a Light position in sterling versus the US dollar. Meanwhile, the dollar is preferable to the yen due to Bank of Japan policy moves to weaken the currency, and to the euro due to fears over Italian banks or other political obstacles affecting the single currency.

History is being made

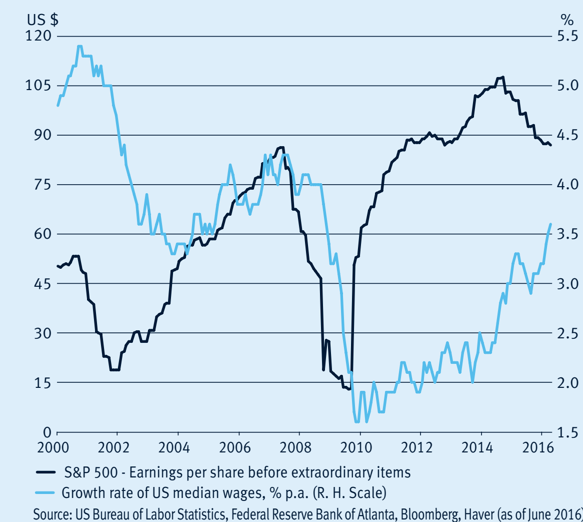
One of the most significant trends during 2016 has been the plunge in government bond yields. A variety of drivers explain this phenomenon: economic, demographic, regulatory and positioning. A series of structural factors have lowered innovation and productivity growth in many countries (see Chart 2), exemplified by the US Federal Reserve sharply lowering its estimate for trend rates of growth. Recent safe-haven flows due to worries about European politics have amplified an existing environment of historically weak economic growth and inflation for the global economy. In addition, even policymakers are asking more questions about the efficacy of monetary policy. The laws of unintended consequences are being seen, such as the adverse impact on markets of Japan's decision to adopt negative interest rates. In particular, as QE programmes drive more government bonds into negative territory (currently around one third of all sovereign debt globally), buying

Chart 2
World of lower numbers



Source: OECD, Standard Life Investments, Datastream (as of May 2016)

Chart 3
Pulling back profitability



Source: US Bureau of Labor Statistics, Federal Reserve Bank of Atlanta, Bloomberg, Haver (as of June 2016)

pressures will grow on the remainder of the bond market with positive yields. Analysis of the global savings/investment imbalance is helpful in this respect. In effect, the demand/supply curve for fixed income markets is shifting rapidly, as a variety of investors reach for long duration assets.

We are confident that both monetary and fiscal policy will ease globally, ensuring bond yields will be lower for longer. Any hopes of the Federal Reserve hiking rates this year have been firmly moderated; the market-implied odds of a 25 basis point rise by the end of 2016 are evens at best. As Europe slows, the European Central Bank is likely to increase the size and scope of its asset purchase programme or abolish some of the limitations of its current approach as it runs out of eligible bonds to purchase. The Bank of England has eased policy to offset the uncertainty shock facing the UK economy, cutting the base rate and restarting its QE programme. An important trigger is whether and how monetary and fiscal policies are co-ordinated. This will depend on the expansionary nature of the decisions taken at November's Autumn Statement or mini-budget. The Bank of Japan looks again to be at the forefront of unorthodox policy moves. This raise questions: will its QQE policy support the large fiscal boost planned in the next supplementary budget? Will we even see some form of helicopter money, despite the legal obstacles?

We emphasise that while it is clear that central banks have done, and will do, their bit to support credit conditions, their firepower increasingly needs to be supported by fiscal policy and structural reforms in order to prevent their domestic economies from suffering undue shocks. Examples of structural reforms would include changes to education, skills, tax and labour market policy. Already the UK looks to be relaxing its budget deficit targets, while the European Commission is permitting several Eurozone members to ease their austerity agendas. In many countries, especially the US and UK, the demand for more spending on infrastructure projects is growing apace. While the carrot for policymakers is improved levels of economic output, the stick is the increased levels of support for populist parties. In all cases, the GIG emphasises that co-ordination would be helpful; if there is a lack of co-ordinated solutions, whether at the level of the G7, the Eurozone or the UK economy, then the final outcome will be suboptimal.

The House View

Sustainable yield remains a key investment theme, although the sustainability of that yield is becoming more significant. The House View continues to expect the hunt for yield by investors to drive asset class returns and, as a result, cash remains Very Light in the portfolios. As markets face a variety of political hurdles in coming months – notably the long, drawn-out process of UK/EU negotiations, requiring continued easy policy from central banks – it would seem inadvisable to be Light duration assets. Select government bond markets do offer return potential – we see safety in the UK gilt market and value in emerging market sovereign bonds.

Corporate profits continue to come under pressure (see Chart 3), as shown by the current S&P 500 Index earnings season, while the ability of companies to issue debt in order to fund share buybacks is lessening. We continue to position further up the capital structure by holding a large position in investment grade credit, and smaller positions in high yield debt as well as emerging market bonds. The yields on such asset classes remain relatively attractive, while these positions to an extent shield the portfolio from earnings or political volatility. We remain more concerned about the impact a continued slowdown in China will have on some markets; hence we are positioned Light in Developed Asia, mainly Australia and Hong Kong.

Commercial real estate continues to offer an attractive yield over other asset classes, more so outside the UK, if the illiquidity premium can be tolerated. European property should outperform other markets as the Eurozone economy is earlier in the business cycle, while the US market will benefit from cheaper funding costs as the Federal Reserve delays hiking rates. This exemplifies the GIG's view that investors should look on a global basis, and not focus on an individual market.

House View

The following asset allocation is based upon a global investor with access to all the major asset classes.

	August 2016 House View	
Risk	The Global Investment Group retains a cautious medium-term outlook, as a variety of political and economic drivers point to higher levels of financial market volatility. While there are particular areas of value, investors should be highly selective in asset allocation decisions.	NEUTRAL
Government Bonds		
US Treasuries	While the upward trend in wages and tighter labour markets give the Federal Reserve the rationale to raise interest rates gradually, market stress and safe haven flows support Treasuries.	NEUTRAL
European Bonds	Bonds are supported by an environment of low inflation, modest economic growth, further QE and negative official rates. Political pressures could periodically affect peripheral bond markets requiring a quick ECB response.	NEUTRAL
UK Gilts	The Bank of England delivered significant easing measures, and more may be required in coming months, as political uncertainty related to the EU referendum outcome will cause investment and thus the economy to slow.	HEAVY
Japanese Bonds	The Bank of Japan's sizeable bond-buying programme and negative interest rates have driven valuations into very expensive territory, as the authorities continue to try to reflate the economy.	NEUTRAL
Global Inflation-Linked Debt	While inflationary conditions are globally subdued, markets may react to a rise in headline inflation as the impact of previous commodity price weakness becomes less marked over time.	NEUTRAL
Global Emerging Market Debt	We prefer dollar denominated to local currency debt, both on valuation grounds and on expected dollar depreciation. On a selective basis, higher yields are attractive in an environment of easier monetary policy.	HEAVY
Corporate Bonds		
Investment Grade	Our preference is to be higher up the corporate capital structure. Widening US credit spreads create an attractive opportunity over low-yielding Treasuries; ECB bond-buying programmes support euro debt.	HEAVY
High Yield Debt	Recent sell-offs have improved valuations modestly, but overcrowding remains a risk in the US market when monetary policy is tightened. We prefer European debt, which remains supported by yield-seeking investors.	NEUTRAL
Equities		
US Equities	Weaker revenues in key sectors such as energy pose a concern, so earnings management is key. Dividends and share buybacks are still supportive, while valuations have become more attractive.	NEUTRAL
European Equities	Corporate earnings in many European countries will be adversely affected by the uncertainty shock resulting from the UK's referendum, while concerns about banking systems in several countries require careful attention.	NEUTRAL
Japanese Equities	The market has priced in good news in relation to forthcoming decisions on monetary and fiscal policy with the election out of the way. Yen moves are still a primary driver.	NEUTRAL
UK Equities	The economy was slowing already before the result of the EU referendum created additional business uncertainty. Movements in sterling will determine the relative attractiveness of domestically or overseas-exposed companies.	NEUTRAL
Developed Asian Equities	Trade flows are increasingly a headwind, with a strong Australian dollar affecting its terms of trade. China's economic slowdown, especially in private investment, is harming commodity producers and also regional trade.	LIGHT
Emerging Market Equities	There are pockets of deterioration within emerging markets with the commodity price slump badly affecting Brazil, political uncertainty in Eastern Europe, and large behavioural shifts affecting the Chinese market.	NEUTRAL
Real Estate		
UK	The referendum fallout continues to affect liquidity and cause capital depreciation. Income remains attractive versus other asset classes although risks are elevated should conditions turn recessionary or political uncertainty persists.	LIGHT
Europe	Core markets continue to offer attractive relative value in light of the low interest rate environment supported by quantitative easing, while recovery plays are showing consistent capital value growth.	HEAVY
North America	Canadian property faces headwinds from an interest-rate sensitive consumer and significant office construction. The US should benefit from continued economic growth but pricing is quite aggressive.	NEUTRAL
Asia Pacific	An attractive yield margin remains, but markets are divergent. Returns are driven by rental and capital value growth in Japan and Australia, but weakening elsewhere. Emerging Asia markets are risky.	NEUTRAL
Other Assets		
Foreign Exchange	The US dollar continues to benefit from safe haven status in times of uncertainty; European and Japanese central banks aim to keep their currencies weak. The EU referendum result is negative for sterling.	HEAVY $, NEUTRAL €, ¥, LIGHT £
Global Commodities	Different drivers, such as US dollar appreciation, Chinese demand, Middle East tensions and climatic conditions, influence the outlook for different commodities.	NEUTRAL
Cash		
	US rate rises will be postponed until 2017 at the earliest. Easier policy is expected in Europe and Japan.	LIGHT