SILEX

CLEAR CUT

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THE GREATEST POLICY PUT IN HISTORY

Welcome to CLEARCUT, a monthly discussion on macro and allocation

HIGHLIGHTS

- The global economy is slowing down but this does not imply a recession is coming just yet
- Central banks and governments across the globe are committed to avoid a growth accident at any cost
- With volatility grinding higher, S P A R K favours a barbell allocation with overweight positions in equities and cash, underweight positions in government debt and neutral positions in credit

M A C R O

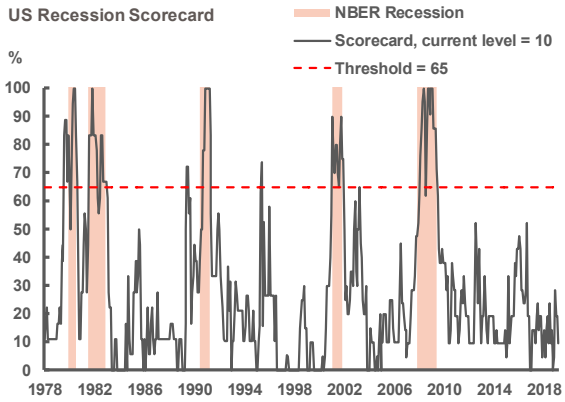
The global economy has been slowing down since the second half of 2018, driven, in part, by the fiscal boost in the US fading away and by a struggling Chinese economy hit by trade disputes and the 2017 policy tightening.

Everyone's wrongly looking for the 'big short'. The "R word" has been hitting our screens every day since the global slow down. The trauma left by the Great Financial Crisis is one reason why investors are obsessively looking for the next recession. However, history does not repeat itself that easily and financial crises are rare occurences. The next recession, whenever it comes, is likely to be a boring, traditional economic downturn, in line with patterns since 1945. What will matter for markets then is how high valuations and leverage are. As of now in most parts of the market, neither of those looks particularly threatening.

The US is alright. On our metrics, the US economy is certainly slowing down but not worryingly so (*Exhibit 1*). The fiscal boost from the Trump administration is fading and collateral damage is being felt from the trade disputes with China.

These should bring the US economy to a soft landing around 2% growth this year, in line with trend growth since the Great Financial Crisis.

Figure 1: The US is some distance away from recession



Note: Composite index of 12 US economic indicators
Source: Department of Commerce, BEA, Fed, S I L E X

Can we trust the yield curve? Additional evidence was brought to the bears this month as the US yield curve inverted for the first time since 2007. Yield curve inversions have correctly predicted about 80% of recessions since the 1950s, with a time lag of 9 to 24 months. Never in history though has market signalling on bond markets been so heavily distorted by QE. Is it disqualifying the yield curve as a useful indicator? Nobody knows although it is possible.

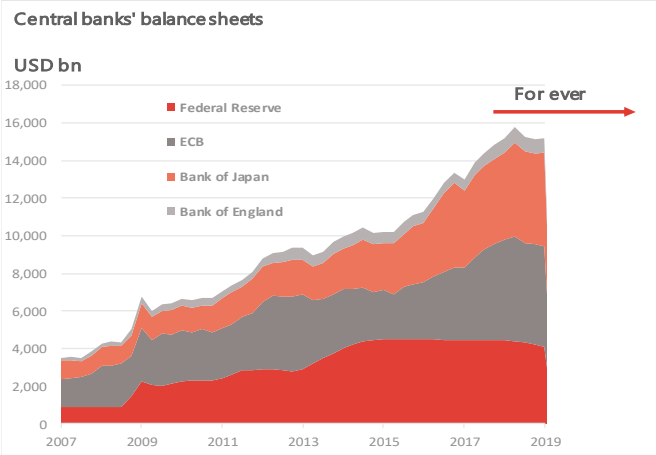
Economic cycles do not die of old age. The fact that we have entered the tenth year of expansion in the US does not tell us anything about the possible end to the current cycle. Cycles only die of shocks that push economies away from their normal path. Fortunately, the Fed knows that. A new paper from the central bank finds that "a state currently in an expansion of duration 42 months has probability of 3.3% of turning to recession. In contrast, an expansion of duration 170 months has transition probability of around 4.5%"[1].

China stimulating at any cost. There is now little doubt that the Chinese economy has been hurt by a combination of two factors. Firstly, a trade and manufacturing recession in the second half of 2018 has hurt exporters. It appears to be driven by trade disputes with the US and a downturn in the electronic cycle. Secondly, the policy tightening of 2017 has reduced credit expansion on which China relies heavily. With a delicate political situation at home, incentives for the government to reach its short-term growth target are high, even at the expense of building more imbalances further down the line.

Europe is doing less well. The region where data has disappointed most is Europe. Clearly exposure to the global manufacturing cycle has been a major driver, as evident from the heavier toll on Germany and industrial sectors compared to domestically-oriented services. And the endless Brexit saga is not helping. While the case for a significant fiscal package in Germany is building, policy room is very thin in most other countries. Once again, the burden rests on the ECB's shoulders.

QEternity. Central banks and governments across the globe are doing anything they can to avoid a growth accident. Not only have they proved incredibly cautious in normalising policy, they have also tended to overreact to any threat of an external shock. It is now clear that balance sheets will be part of the standard toolkit of central banks, implying that financial repression is investors' new normal (*Exhibit 2*).

Figure 2: QEternity



Source: National sources, S I L E X

[1] Berge, Travis J., and Damjan Pfajfar (2019). "Duration dependence, monetary policy asymmetries, and the business cycle," Finance and Economics Discussion Series 2019-020. Washington: Board of Governors of the Federal Reserve System.

The paradox of low ammunition. Many had thought that central banks would rush to normalise policy as soon as they could in order to rebuild ammunition for the next downturn. What has happened is the exact opposite. Because central banks have low ammunition, they have turned more activist to use it and prevent bad scenarios at all cost. This is what the ECB and the Fed have done this month by reacting strongly to a moderately poor dataflow and giving up optionality by tying their hands virtually until year end.

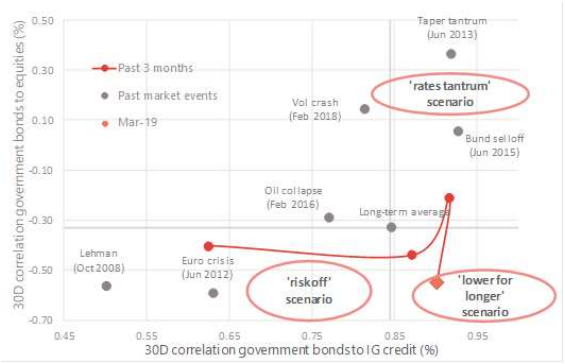
The greatest policy put in history. The result of all this is the strongest coalition we have ever seen committed to manage the downside. The Fed, the ECB, the Trump administration and the Chinese government have all lined up to make sure nothing too serious happens to markets or the economy. As a result, at least in the short term, it would really take extreme events or extremely bad luck for this fine team to fail delivering on its objective of keeping us all safe.

ALLOCATION

Why do markets go down? As discussed above, investors exhibit what sociologists call 'recency bias': a tendency to expect recent patterns to repeat. However, evidence suggests that market declines have more to do with valuations and leverage. High valuations provide room for asset prices to go back closer to fundamentals while leverage provides the technical conditions for investors to be forced to sell at the worst time. Based on these two yardsticks, current market conditions appear reasonable. Not great, but reasonable.

Shifting correlations. Correlations can tell a lot about market environments. In March, our mapping of the two key cross-asset correlations (government bonds to equities and government bonds to credit) was pointing to a shift away from a 'risk-off' environment where risky assets suffer while safe-havens gain. Rather, the coordinated move by central banks has led markets back to a 'lower for longer' environment, where the entire fixed income complex performs while equities struggle with growth concerns (*Exhibit 3*).

Figure 3: Shifting correlations



Source: ICE-BofA, MSCI, S I L E X

Return-free risk. 'Lower for longer' also means that expected returns for government bonds are very low. The US term premium, a key metric measuring the excess return required by investors to hold long-term securities over rolling short-term bills, currently trades at about -70bps. In other words, investors are paying a fee to have the privilege to lend to governments. As a result, the only reason to hold any government debt at the moment is negative correlation to risky assets.

Market capped. Equity markets have had a strong run year-to-date despite earnings expectations having come down. In our view, expected returns looking forward are moderate but worth the risk. Equities are the best way to get exposure to growth and in a world of growth scarcity, equities have no reason to be significantly undervalued, especially in a QEternity setup. The US market appears the most richly valued though, and we favour non-US markets, notably Europe and Emerging Europe.

Carry on. We like to hold a large part of our pro-risk exposures through carry instruments. In a 'lower for longer' environment, it is important to have time on our side. This is reflected by overweight positions in European financial debt and Emerging Market local currency debt. These asset classes offer value in absolute and relative terms as well as attractive yield compared to traditional fixed income.

And the machine takes over. At S I L E X, we believe any intuition from man has to go through the rigour of the machine. And all output from the machine must be validated by

man. Our macro expectations for asset class returns are put to the test of S P A R K to take into account risk constraints, historical correlations and deliver optimal, bias-free portfolios.

Volatility getting more volatile. A key insight from S P A R K is that volatility should be front and centre in allocation decisions right now. Equity volatility is rising, as well as volatility of volatility. This confirms the intuition that central banks have increasing trouble to contain market movements.

Barbell. With that in mind, S P A R K delivers a barbell strategy reflecting both opportunities and risk. For moderate risk appetite portfolios, we take overweight positions in equities and cash, underweight positions in government debt and a neutral stance in credit. We are confident that this allocation will help us navigate the ups and downs of markets in coming months.

APPENDIX

S P A R K Cross Asset Allocation

Market	Rationale	Allocation				
		Strong under-weight	Under weight	Neutral	Over-weight	Strong Over-weight
Fixed Income	With core rates at ultra-low levels, we remain underweight in government debt but neutral in credit		●			
Equities	Excessively pessimistic sentiment may lead to some moderate upside in equities through the remainder of the year				●	
Commodities	We expect oil to perform well as supply is constrained and demand steady			●		
Alternatives	Hedge funds are struggling in a world of sustained political risk and low volatility		●			
Cash	Cash is helpful to dampen overall portfolio risk and as an option to add exposures opportunistically				●	

S I L E X Fixed Income Allocation

Sector	Details	Rationale	Allocation	Strong under-weight	Under weight	Neutral	Over-weight	Strong Over-weight
Euro Government Bonds	• Underweight duration • Overweight short dated BTPS	• Bund curve tight and flat: "return-less" risk			●			
US Government Bonds	• Prefer risk-reward in front end of curve • Neutral on long end of curve	• Expect slower Fed rates increases • Risk/reward profile of long end of curve more symmetric	• Short end • Long end			●		
			• Long end		●			
Euro IG	• Overweight extend on credit curve • Underweight cyclical risk	• Euro credit spreads back at Q1 '13/16 levels ECB put not far off • Political risk to deflate vs. increasing cyclical risk					●	
USD IG	• Neutral • Overweight front end • Underweight cyclical risk	• Credit and rates curve very flat, very attractive risk/ reward profile at the front end • Neutral on long end of curve/ underweight cyclicals	• Short end			●		
			• Long end			●		
Euro HY	• Overweight secured, BB, non-cyclical, local risk • Underweight B-CCC & cyclicals	• Rising cyclical and idiosyncratic risk • Fund flow led selloff creates attractive opportunities at higher quality end of universe				●		
USD HY	• Underweight	• Expensive to euro credit and USD IG • Lower quality universe (rating/ sector distribution) refi risk increasing with late cycle dynamics			●			
Euro Financial Sub-ordinated	• Overweight	• To benefit from deflating political risk premium • Continued improvement in credit metrics • Improving technical picture for T1s						●
EM debt	• Neutral	• Benefits of likely weaker USD offset by some specific country risks				●		

S I L E X Equity Allocation

Market	Rationale	Allocation				
		Strong under-weight	Under weight	Neutral	Over-weight	Strong Over-weight
United States	Among the most expensive markets. Crowded trade on the Tech sector		●			
Eurozone	The single most unloved market with a lot of the bad news already in the price				●	
Switzerland	Strong performer year-to-date, fairly attractive relative valuation			●		
UK	Cheap market but high uncertainty related to Brexit and the currency outlook			●		
Japan	Persistent underperformance despite optically cheap valuation		●			
Emerging Asia	The rebound in China is driving the region. Macro and trade data will need to follow			●		
Emerging Europe	Extreme cheapness and low beta make the region attractive				●	
Latin America	The most expensive segment of the EM universe. Some political risk in Brazil		●			

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