



Rational exuberance?

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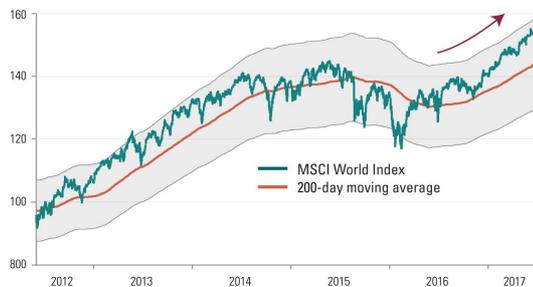
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Investors have remained optimistic, both because they believe the global economy is still growing at a decent clip (though things look a bit shakier of late in the United States) and because they have lost none of their faith in the wisdom of central banks. For the past eighteen months, this gilded balance between tepid growth and soft monetary policy (see our June Note, [“What Else?”](#)) has not only enabled investors to take political and other uncertainties in their stride; it has also kept them from fretting over equity and bond valuations. And while they may wonder at times how much longer such a good thing can last, they are all the more determined to take full advantage of its closing phase. The broadly upbeat mood reflected in today’s historically low market volatility suggests that investors feel perfectly comfortable with the tightrope act under way. What makes that mood rational is that immediate political risk has receded in the US and Europe, the world economy is still powering ahead and the leading central banks have pledged to proceed cautiously. But even so, more attention should be paid to the sources of fragility currently building up in the environment.

The Fed’s impeccable track record

Since the Federal Reserve gave advance warning in 2013 of its intention to taper its asset purchases, which triggered significant market stress with Treasury yields nearly doubling between May and September, from 1.6% to 3%), the US central bank has gone about tightening its monetary policy with sufficient caution to allow markets to painlessly price in the shift taking place. The result has been that, after a few fits and starts, US Treasury yields have settled in roughly halfway between those two recent extremes. Meanwhile, the S&P 500 has continued to climb – to the point that it now stands 30% higher than where it was in early 2014.



Source: Bloomberg, 30/06/2017



But is this equilibrium stable?

After raising the federal funds rate 25 basis points as expected, Janet Yellen provided greater detail in June on her plan to start unwinding the Fed's balance sheet before the year is out. That shrinkage is likely to happen slowly, but with the general direction now spelled out, the central bank has less leeway. (And sure enough, in its recent statement, the Fed downplayed how data-dependant the pace of policy normalisation will be.) Moreover, this will be an experience as unprecedented as the launch of the Fed's asset purchases in March 2009 – and it will unfold just as the US business cycle approaches an inflection point.

Financial markets will therefore have to try to anticipate the impact of this unparalleled change on all asset classes. If the US economy were still picking up speed or if President Trump could be relied on to implement his fiscal stimulus plan, the Fed's move to dry up liquidity could result in much higher long-term yields and a stronger dollar. But that was then: now Trump's reforms have come to a standstill and the business cycle is peaking. We therefore infer that monetary policy will be tightened only very gradually. The risk of a surge in long-term yields seems limited and growth stocks could soon start outperforming once again.

It is worth noting that, in this scenario, emerging economies should also continue to do fairly well. They are supported by sound fundamentals and no longer face the threat of a sharp appreciation in the US dollar.



Source: www.wealthmanagement.com

Why Europe is different

If yields on risk-free bonds rise sharply and the euro appreciates too swiftly, any rally in European equities may have a hard time gaining traction.

So far Mario Draghi has bravely withstood pressure from Germany and some of the European Central Bank's governors to tighten policy. The argument is that the currency bloc's debt ratio, particularly in countries like Italy, makes it necessary to keep nominal interest rates low. However, the central bank's asset-buying programme will inevitably wind down in the coming months (for starters, because the stock of financial assets eligible for ECB purchase will be depleted). Such a shift is justified by the Eurozone's economic recovery, even if inflation doesn't get off the ground just yet. That means that the European Central Bank is also heading towards less accommodative policies, and for good reason.

That outlook should help correct the inordinately low interest rates on German government bonds and perhaps give the euro greater potential for appreciation. In addition, the more credible cooperation taking shape between France and Germany could well enhance the geopolitical standing of Europe's common currency at a time when the strengths traditionally sustaining the US dollar appear to be fading. Against that background, cyclical stocks in Europe, most notably bank stocks, should outperform further. That said, it is still worth bearing in mind that if yields on risk-free bonds rise sharply and the euro appreciates too swiftly, any rally in European equities may have a hard time gaining traction.

The existence of a genuine cyclical upswing – the first one of this magnitude since 2010 – makes market risk more sensitive to changes in monetary policy.

Market sensitivity

Helpful central bank intervention since the inception of the financial crisis did more than just drive financial assets, particularly bonds, way up. It also drastically curtailed market volatility. So there is no point in seeking to find some monetary policy "mistake" – it can safely be assumed that financial markets are naturally sensitive to even gradual and cautious moves to phase out monetary policy support.

The existence of a genuine cyclical upswing – the first one of this magnitude since 2010 – is what currently makes market risk more sensitive to changes in monetary policy. In a slowing economy, any tightening of financing conditions will necessarily accentuate the slowdown, whereas in an expanding economy, monetary policy tightening could push up both bond yields and the value of the currency. The golden scenario – a continuing equity market rally – is heading down a narrow path and will be possible only if the Federal Reserve and the ECB very skilfully negotiate the transition.

The uncertainty in financial markets created in 2016 by political risk in the developed world has subsided. Today, we can perhaps even imagine that the US Congress might at long last pleasantly surprise us by passing a couple of laws on deregulation and tax cuts between now and the end of the year. Unfortunately, populism has scored two political victories whose economic impact is yet to come. The UK economy, for one, will be hit by dwindling investment under the shadow of Brexit. Meanwhile, the Trump administration will be at pains to prove it means business by slapping protectionist measures on its trading partners (for example on imported steel). This makes it necessary for Europe, China and Japan to come forward and work adroitly to turn the situation to their advantage. The European construction process in particular might just get newfound economic and political wind in its sails. Careful geographic and sectoral allocation to leverage the most promising investment opportunities will therefore remain a crucial component of any successful asset management strategy. At the same time, such a strategy will require keeping a close watch on how geopolitical issues are affecting financial markets and how central banks are steering their monetary policy normalisation process.

Source: Bloomberg, 30/06/2017

Investment strategy

Equities

Stock market volatility rebounded at the end of the month, and our balanced portfolio construction proved crucial to cushioning the shock. In June, upward pressure on bond yields was what weighed most heavily on equity markets, above all in Europe. Interest rate-sensitive sectors like telecoms, utilities, technology and retail in fact accounted for many of the worst-performing stocks.

In contrast, banking names in the United States, Europe and Japan booked hefty gains during the month. Our overweight position in bank stocks, most notably European and Japanese, partially offset the broader equity market correction. At the same time, our strategy of diversifying our tech holdings beyond US mega-caps paid off, thanks to solid performance by the likes of Samsung Electronics.

Fixed income

All it took was a first hint by the ECB of an upcoming, gradual exit from quantitative easing to send shock waves across fixed income markets in late June. European bond yields, particularly German ones, bore the brunt of the ensuing upward pressure, but due to our strategy of shorting German government bonds, we came out ahead. We also initiated a strategy in June to buy volatility on the long end of the yield curve, which allowed us to benefit from the ongoing rise in yields.

Lastly, the winding-up in June of Spain's Banco Popular and of two Venice-area banks highlighted the need for a selective approach to private placement bonds as an asset class. It also indicated that we were right to focus on private placements by such national banking champions as Santander and Intesa Sanpaolo (which got a bargain on the assets of the failing banks they took over).

Currencies

The euro appreciated further against the dollar, making this a four-month winning streak. A more serene political climate, a livelier economy, the return of foreign investors and the expectation that the European Central Bank will be phasing out its unconventional monetary policy all worked to the advantage of the single currency. As a result, our forex strategy was once again a major contributor to the performance of our global funds. The US dollar's ongoing slide is creating a more supportive environment for emerging-market assets and for oil.

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