FFG

FORUM FINANCE GROUP

1994

INVESTMENT PERSPECTIVES 2019
MID-YEAR REVIEW & OUTLOOK

JULY 2019

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EXECUTIVE SUMMARY

In this mid-year publication, we review our January expectations and analyse some current key economic indicators before outlining the asset allocation that we recommend for the second half of the year.

Our equity exposure has been reduced since the beginning of the year

Our assumption that markets were overpricing risks of a recession during the December correction led us to start the year being overweight equities, as we had not cut our equity allocation despite the high level of market stress. This proved to be rewarding as the strong rebound observed in the first four months of 2019 contributed to the strong performance of the portfolios, especially with bond markets also rallying.

We took advantage of the strong rise of equity markets to reduce our equity allocation significantly from overweight to underweight, reflecting our cautious outlook in view of the rising level of uncertainty. Whilst we had not expected government bond yields to climb much, the year-to-date collapse of yields has been a big surprise and a major contributor to the strong returns of fixed-income exposures

U.S. policies are a source of increasing uncertainty for markets

The high level of market stress observed at the end of 2018 was quickly replaced by a four-month period of declining volatility where markets proved to be relatively immune to negative headlines. This changed significantly in May when the optimism over a trade deal between the U.S. and China gave way to concerns over a major breakdown of trade talks following a series of "tweets" by Donald Trump. This was compounded by restrictions placed on business between U.S. companies and the Chinese tech giant Huawei and tariff threats on imports from Mexico. This list of destabilising market factors is far from exhaustive but their common point is that they all originate from the White House which has been flexing its muscles to achieve some of its objectives. With the launch of the U.S. presidential election campaign, this is likely to continue to represent a source of uncertainty and of volatility for the markets.

Markets have been boosted by the end of monetary policy normalisation

The 180-degree turn of the Federal Reserve, in announcing a pause of its cycle of rate hikes and the end of its balance sheet reduction, has been one of the key drivers of the bond and equity markets this year. Under the end-2018 pressure from the markets, the Fed abandoned its pre-set path of one rate hike per quarter and announced that the shrinking of its balance sheet would formally end in September, much earlier than planned. At its June 18-19 meeting, the Fed turned even more dovish and opened the door for a rate cut as early as July. The European Central Bank President Mario Draghi has also been trying to reassure market participants about the bank's ability to act amid growing doubts on the real effect of monetary policy in case of a recession. Another key driver of the markets' rally has been the huge provision of liquidity by the People's Bank of China (PBOC), equivalent to 60% of the creation of credit over a 12-month rolling period.

We have a cautious positioning ahead of the second half

At the onset of the second half we have modest underweight allocations towards debt instruments and equities and an overweight cash position. We feel that markets are on a sugar high as a result of increasingly dovish central banks. They also appear to be consciously ignoring a number of risks including, but not limited to, disappointing corporate outlooks, weaker economic trends, delayed central banks' actions and a deterioration of the relationship between the U.S. and the rest of the world. At the risk of missing some short term upside we prefer to focus on the management of risk, especially when considering the appreciable year-to-date portfolio returns.

In the next section of the document, we will evaluate the macro environment and the prevailing financial conditions by highlighting several key indicators that we observe. Following a brief overview of the first half returns of the different asset classes, we will outline our current market outlook and asset allocation.

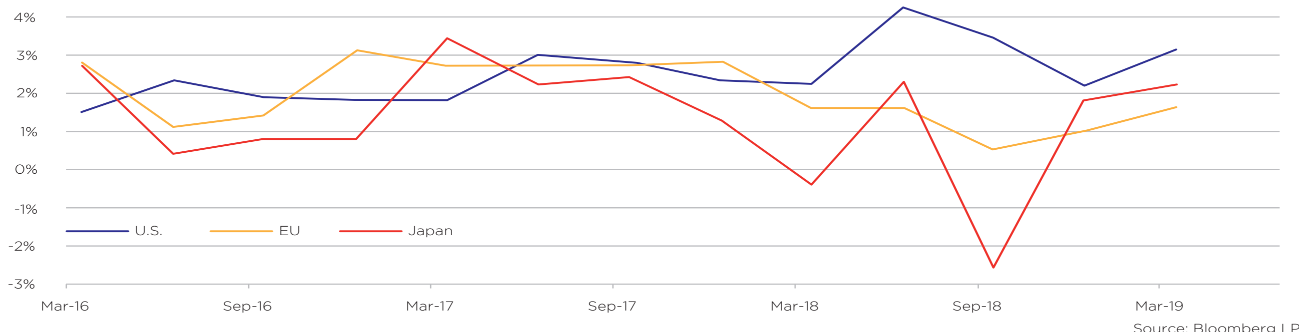
THE MACRO ENVIRONMENT

WORLD ECONOMIC GROWTH

Global economic growth is unlikely to accelerate much from the current level

Global growth peaked towards the end of 2017 and has since continued to weaken, with the exception of the United States, where growth was boosted by the tax reform and strong labour markets. Their contribution is, however, starting to wane and U.S. growth is widely expected to drop from close to 3% last year to below 2.5% in 2019. Similar decelerations are anticipated for other major economies this year, with the World Bank forecasting Euro Area GDP growth to fall from 1.8% in 2018 to 1.2% and China's to decline from 6.6% to 6.2%. The main reasons for these trends are weakness in trade and manufacturing, a slowdown of global investment and heightened policy uncertainty. Amid low global inflation expectations and a deterioration of the growth outlook, the major central banks have already started to react and signalled a willingness to provide renewed support. Their ability to boost economic activity appears very limited, however, and an improvement of the current situation could well depend on a positive resolution to the trade tensions between the United States and China and on an orderly exit of the United Kingdom from the European Union.

GDP GROWTH (% change on previous quarter, annualised)



Source: Bloomberg LP

The chart above shows the contrast between an acceleration of U.S. economic growth in 2018, as a result of the massive fiscal reform and the slowdown observed in the Eurozone. These trends appear to be reversing as economic activity in the Eurozone is modestly rebounding following a close-to-recessionary end of 2018. The U.S. economy advanced an annualized 3.1% in this year's first quarter, but it was driven by two of the more volatile components of GDP, inventories and exports. With a fading impact of the fiscal reform, expectations are pointing towards a slowdown of the U.S. economy in the quarters ahead.

WEAK EXTRA-EUROZONE EXPORTS REMAIN A HEADWIND

Economic conditions in the Eurozone have deteriorated rapidly since the middle of 2018, particularly in the manufacturing sector. This results mainly from a decline in exports, especially to China and the Central Asia region. The ongoing trade tensions between the United States and China has meant that this headwind is becoming more entrenched and the hoped-for improvements in manufacturing and exports are being delayed further. The industrial sector in Germany continues to be a weak spot for the Eurozone economy; it is weighed down by weakness in key export markets and by an ongoing drag from the auto sector and, at this

stage, there are few signs of progress. Domestic demand in the Eurozone has also softened, albeit to a lesser degree, thanks to declining unemployment and real wage growth. On a more positive note, composite PMI data for the Eurozone has shown some improvement, almost exclusively thanks to the services gauge.

THE DESTABILIZING IMPACT OF U.S. POLICIES

In the context of a more fragile global economy, the frictions triggered by the trade and foreign policies of the Trump administration have added to the ongoing headwinds. Global industrial activity and goods trade have lost considerable momentum; goods trade growth and new export orders have fallen back to levels observed at the start of 2016, when concerns about the global economy were elevated. The increasing use of tariff threats and of economic sanctions have deteriorated not only the relationship between the U.S. and the rest of the world, but also the stability of the economic environment. This makes business and investment decisions even more challenging and largely explains the negative trend in global investments.

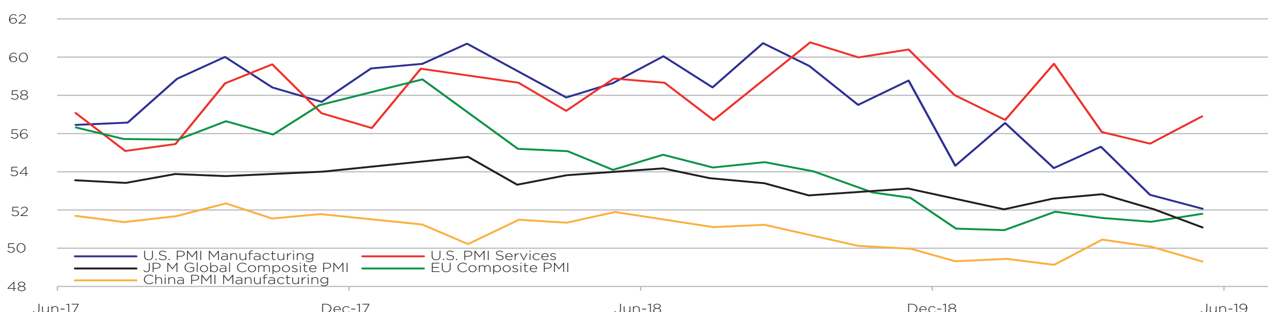
CHINA STIMULUS IS FOCUSED ON DOMESTIC CONSUMPTION

Following several quarters of deceleration, growth appears to be stabilizing in China as economic activity has been supported by monetary and fiscal stimulus. China's central bank has been injecting liquidity and cutting the reserve requirement ratio for banks, while state banks have been called on to lend more money to small and midsized businesses. A series of tax cuts have also been introduced to stimulate domestic consumption and to help the private corporate sector. These measures have been taken to counter the weakness in trade flows and the lower output of manufacturing.

Compared to China's last round of stimulus which lasted from 2015 to 2017, the current policies are less likely to produce similar effects to those observed in the past, especially for the rest of the world. China is somewhat constrained by both GDP and financial stability targets, and due to its economy's reliance on credit to grow, it obviously can't reach both targets simultaneously; to grow GDP by a unit also requires much more credit than in the past. China's shift towards a consumption-driven economy also means that the measures targeting more domestic consumer spending will only have a limited positive impact for the rest of the world, and for the Eurozone in particular.

LEADING INDICATOR

PURCHASING MANAGER INDEXES



Source: Bloomberg LP

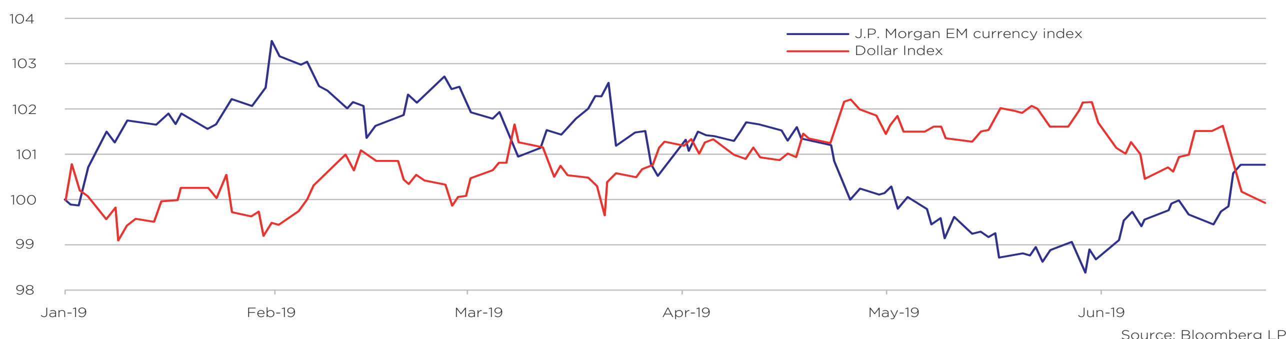
The chart shows that global PMIs peaked in early 2018 and have since consistently trended lower, especially manufacturing ones, to fall into contraction territory across many regions. The combination of rising uncertainty over trade, the slowdown of the U.S. tax tailwind, weaker economic growth and the ongoing Brexit saga are just some of the headwinds that have affected the PMI Indices the most. In Europe, the export-oriented economy of Germany has been hit particularly hard by the weakness in the auto and the overall export sector. On a more positive note, the latest data have been showing a stabilisation in the Eurozone, and even a slight improvement.

FINANCIAL CONDITIONS

BOND MARKETS GO TOTALLY OFF SCRIPT

The most spectacular trend observed so far this year has been the decline of long-term interest rates. The yield on a ten-year Treasury bond 10-year yield traded below 2% in June from an-end 2018 level of 2.68% while ten-year Bund yields have dived back into deep negative territory and reached new all-time lows. These moves were completely unexpected; in January the 10-year Treasury yield forecasts by the Wall Street Journal Survey of Economists showed end of June predictions going from 2.40% and 3.75%, which are in stark contrast to the actual end-June level of 2%. These low bond yields have contributed to the strong performance of other asset classes as the expected returns on these assets, such as the earnings yield on equities or the rental yield on property, should logically stay in line. These extremely low yields also reflect the markets' extensive anticipations of interest rate cuts, by the Federal Reserve in particular, which presents a major challenge for the central bank not to appear being a hostage of market pressures.

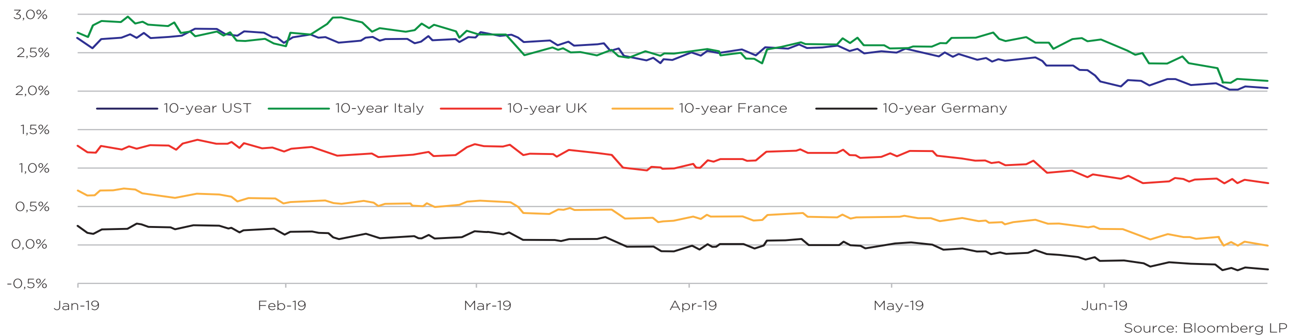
U.S. DOLLAR PRESSURES ARE ABATING



Source: Bloomberg LP

The chart above shows that both the J.P. Morgan EM Currency Index and the Dollar Index have evolved within relatively tight ranges so far this year. Since the end of May, the increasingly dovish communication of the Federal Reserve has triggered dollar weakness to bring it back to early-year levels.

A WIDESPREAD COLLAPSE OF GOVERNMENT BOND YIELDS



Source: Bloomberg LP

Since the beginning of the year, the yields of G-7 sovereign debt have moved in sync and consistently trended lower. Concerns over weaker economic growth, declining inflation expectations, a massive injection of liquidity by the PBOC and expectations of looser monetary policies have been the key drivers of the bond market rally; ongoing political issues have been another reason for the strong year-to-date performance of these defensive assets. European peripheral debt has also performed extremely well, reflected by 10-year Greek yields plunging from 4.35% to 2.43% and Portuguese ones falling from 1.71% to 0.47%; 10-year Italian yields have also declined, but to a much lesser extent, from 2.74% to 2.10%.

INTEREST RATES AND INFLATION

INTEREST RATES

The ECB is running out of ammunition

Mario Draghi, the President of the European Central Bank (ECB), has recently been talking up the possibility of further stimulus in view of the bank's gloomy economic outlook and low inflation expectations for the Eurozone. Draghi is only four months away from the end of his mandate, but he remains the main driver of the central bank's policies and wants to make sure that they will be extended under his successor. He is also trying to convince sceptical markets of his message; the euro has been appreciating while the rally of Eurozone bond yields is more down to the Federal Reserve's dovish stance and to geopolitical concerns. Unlike the Fed, the ECB has been unable to cut back its support for the economy, in the shape of negative interest rates and an extensive bond purchase program, and appears to have only limited tools left to counter economic weakness. It is difficult to imagine much lower interest rates and the scope for buying more government bonds is quite constrained. This explains why Draghi is also attempting to urge European governments to prepare for more fiscal stimulus, in the absence of a rebound of the Eurozone economy.

The Fed increasingly under pressure to cut interest rates

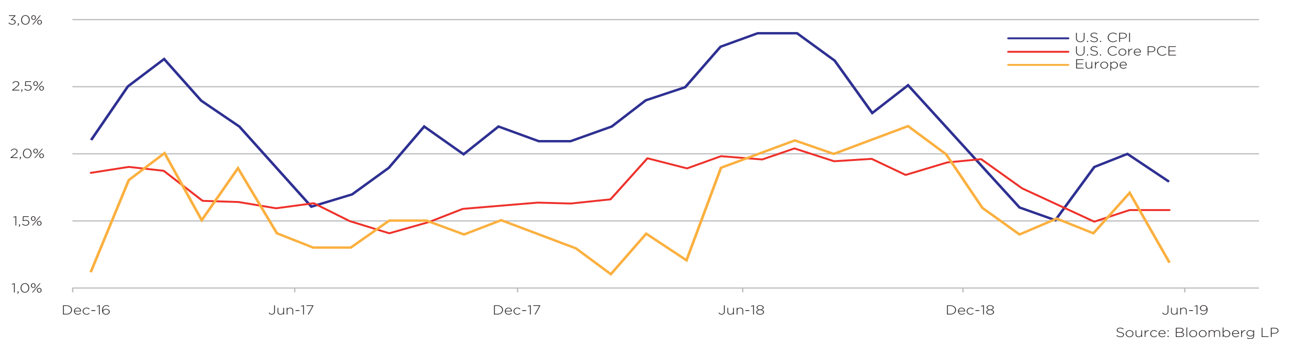
Until the last quarter of 2018, the Federal Reserve had appeared to be in control of the cycle of its rate hikes, as the expectations of the markets had been well aligned. Then onwards, the divergence between market expectations and the Fed's outlook consistently widened, despite the central bank's early-January shift towards more flexibility after it had announced a pause of its hikes. This failed to assuage the markets which, in June, were pricing in a 75% probability of three rate cuts by the end of the year. At its June 18-19 meeting, the Fed partially gave in to the markets' pressure by opening the door to a rate cut without, however, formally committing to act. The failure to cut rates at the next FOMC meeting would likely result in a violent reaction of the markets.

INFLATION

Inflation sliding away from central banks' targets

The absence of a pick-up in inflation and of inflation expectations continues to puzzle the main central banks which have had a tendency to consider this trend as transitory. In the Eurozone, this has proved to be wrong and inflation expectations have had to be consistently downgraded, amid a slowdown in the cost of energy and services. With global growth remaining moderate, Eurozone inflation is likely to continue to deteriorate. In the U.S., periods of rising inflation have been short-lived and both inflation and market-implied inflation expectations have declined, despite the strength of the labour markets. This lack of inflation pressures explains in part why markets believe that the Fed has sufficient room to cut interest rates several times.

INFLATION IN THE U.S. AND EUROPE

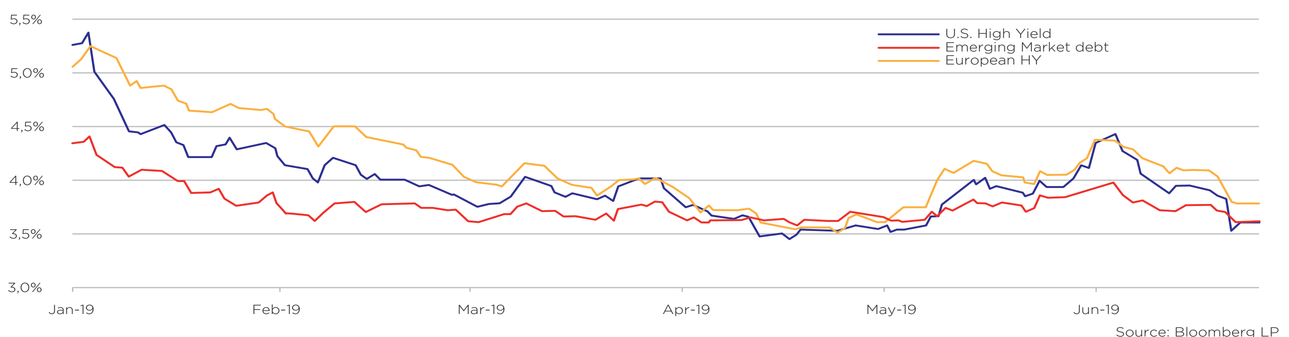


Source: Bloomberg LP

Inflation levels have been declining once again and been moving away from the central banks' targets. In the United States, the latest reading of headline CPI was of 1.8%, while the Federal Reserve's preferred measure, the core PCE (Personal Consumption Expenditures) index picked up slightly in April to reach 1.6%. In Europe, inflation as measured by the Harmonised Index of Consumer Prices continues to undershoot the ECB's 2% target and dropped to 1.2% in May; the central bank has also recently lowered its inflation forecasts for 2020 to 1.4%.

BOND SPREADS

EMERGING MARKET DEBT AND HIGH YIELD SPREADS



Source: Bloomberg LP

In a similar fashion to equities, high yield and emerging market bonds rebounded strongly during the first four months as they benefited both from lower risk-free yields and from a significant tightening of spreads. The primary market also gradually reopened following a period when it had been totally closed to lowly-rated issuers. During the risk-off month of May, spreads widened, in the high yield segments in particular, with the steep drop of oil prices contributing to a larger negative impact on U.S. high yield bonds.

THE MACRO ENVIRONMENT/FINANCIAL CONDITIONS: CONCLUSIONS

The outlook for the global economy remains fragile amid trade tensions, a deceleration of global economic growth and unresolved geopolitical issues, even if the risks of a global recession still appear to be contained. The extended period of uncertainty over trade is being reflected by weaker trade flows, a contraction of manufacturing output and lower investment trends. The much-awaited G20 summit in Osaka on June 28-29 is not expected to deliver a meaningful solution to the ongoing trade concerns.

Financial conditions have become more supportive for financial markets. The widespread shift of central banks towards more accommodation has translated into a pronounced decline of bond yields whereas credit and emerging spreads have tightened; the early-year headwind represented by a stronger U.S. dollar is also dissipating, mainly as a result of an increasingly dovish Federal Reserve.

The normalization period for the Federal Reserve has come to a premature end and markets are fully expecting several rate cuts this year; this could result in disappointment if the Fed failed to deliver. On its side, the ECB has not been able to build more reserves to act against any serious economic slowdown and markets are failing to respond to the bank's premise that additional measures would still be effective.

FINANCIAL MARKETS

	End 2018	May 2019	June 2019	MTD	2019
EQUITIES					
S&P 500	2506.9	2752.1	2941.8	+ 6.9%	+ 17.3%
Euro Stoxx 50	3001.4	3280.4	3473.7	+ 5.9%	+ 15.7%
MSCI EM	965.8	998.0	1054.9	+ 5.7%	+ 9.2%
YIELDS					
UST 10-year	2.68%	2.12%	2.01%	- 11bps	- 67bps
Bund 10-year	0.24%	- 0.20%	- 0.33%	- 13bps	- 57bps
BBB EU	1.89%	1.17%	0.87%	- 30bps	- 102bps
CURRENCIES					
EUR/USD	1.147	1.117	1.137	+ 1.8%	- 0.9%
USD/CHF	0.982	1.001	0.976	- 2.5%	- 0.6%
EUR/CHF	1.126	1.118	1.110	- 0.7%	- 1.4%
USD/JPY	109.7	108.3	107.9	- 0.4%	- 1.6%
GBP/USD	1.275	1.263	1.270	+ 0.5%	- 0.4%
COMMODITIES					
CRB Index	169.8	175.4	181.0	+ 3.2%	+ 6.6%
Oil, WTI	$ 45.4	$ 53.5	$ 58.5	+ 9.3%	+ 28.9%
Gold	$ 1'282	$ 1'306	$ 1'410	+ 8.0%	+ 10.0%

A spectacular rebound for equity markets has been dampened by rising uncertainty

The first four months of 2019 saw global equity markets recover all of their losses recorded during the last quarter of 2018. This rally was essentially driven by the 180-degree shift of the Federal Reserve, the unwinding of excessive recession fears and optimism over a U.S.-China trade agreement. This enabled the MSCI World Index to hit its previous peak level of September 2018 while some key U.S. indices reached new all-time highs. The month of May proved to be much less friendly, with losses of around 6.5% for the main indices, in large part due to a breakdown of the negotiations between the United States and China, as well as to an increasingly aggressive posturing of Donald Trump towards some of his country's trading partners. In particular, a ban on the Chinese tech giant Huawei, limiting its ability to trade with U.S. companies, badly hurt the whole technology sector. June has seen markets regain some composure, essentially in anticipation of help from the Federal Reserve in the shape of several interest rate cuts.

Government bond yields have collapsed, with those of Bunds reaching record lows

Government bond markets have rallied since the beginning of 2019, as central banks turned increasingly accommodative, once again, and on concerns over slower economic growth. 10-year Treasury and Bund yields have plunged respectfully from 2.68% and 0.24% to 2.01% and - 0.33%, an all-time low for the benchmark Bund yield. The absence of inflationary pressures has been another contributing factor for this rally and the markets are currently pricing in close to three interest rate cuts by the Federal Reserve by the end of 2019. Credit and emerging markets have also performed well, especially in the early part of the year, as spreads have tightened significantly and risk-free yields collapsed.

The major FX crosses have evolved within tight ranges

Within the currency markets, the main trends have been the early-year contained strength of the U.S. dollar and a certain stability of the major foreign-exchange (FX) parities. The currencies of oil-producing countries have performed well, in the wake of rising oil prices, whereas trade-dependent economies, such as South Korea, have seen their currencies lose value. The major FX crosses have evolved within relatively tight ranges and have ended June with price changes which are generally less than 2%. As an example, the EUR/USD parity has fluctuated within a 1.11-1.155 range to end the semester at 1.137; conflicting forces have been neutralizing each other and this appears likely to continue in the short to medium term.

A four-month rally of oil prices halted by demand concerns

In a similar trend to equities, oil prices rebounded significantly during the first four months of 2019 before dropping steeply in May. Oil-producing countries maintained their discipline in regards to production cuts, but concerns over the trade dispute between the U.S. and China and a lower global oil demand forecast by the International Energy Agency (IEA) triggered a reversal of the early-year rally. Oil prices have been climbing again in June as a result of rising tensions between Iran and the United States.

MARKETS' OUTLOOK

Rising uncertainty is a major concern for financial markets

Following the stressful last quarter of 2018, the rebound of equity markets this year has been most welcome. The macro environment remains fragile, however, with the Eurozone and China struggling to regain momentum and the United States showing some signs of weakness as the impact of the fiscal reform starts to fade. Early-year optimism over successful trade negotiations between the U.S. and China has soured and Donald Trump has extended the use of tariff threats as a weapon to extract concessions from trading partners. This issue, on top of the application or threat of sanctions, have added to the concerns over a slowing global economy and raised the level of uncertainty faced by investors. Despite the setback of equity markets in May, they have regained a firmer footing in June, which contrasts with the bearishness on the economic outlook expressed by the bond markets since the beginning of the year.

Many reasons to be more cautious

The extreme divergence between the expectations of the markets and the outlook of the Federal Reserve is of concern as the risk of markets being disappointed is high. We do expect the U.S. central bank to continue to respond to these expectations by tweaking its communication but we are not convinced they will deliver what the markets are anticipating. The probability of a quick resolution of the trade deadlock between the U.S. and China appears quite low at this stage and this could dent the markets' confidence in a deal agreement. In Europe, the mess that is Brexit is still far from being resolved and the likely nomination of Boris Johnson as the next British Prime Minister will not be welcomed by the European Union; the risk of a no-deal exit is still very present and definitely not discounted by the markets. These are just some of the reasons which makes us more cautious at the onset of the second half of 2019.

DEBT INSTRUMENTS

G-7 sovereign debt yields are unlikely to rebound much

Our main scenario is for G-7 sovereign debt yields to remain relatively capped from the current levels, in view of the dovish key central banks, and despite valuations which are very unattractive. The end of the normalization of the Federal Reserve's policy, in terms of higher interest rates and balance sheet reduction, has already been announced, while the European Central Bank is unable to shift away from its very accommodative monetary policy. This should continue to provide support for investment-grade credit and emerging market bonds as long as the Fed leaves open the possibility of cutting its benchmark interest rates. The trend of high-yield bonds should continue to be closely correlated to equity markets as their spreads are being more driven by market sentiment than by fundamentals

EQUITIES

Equities could face resistance in the near term

Our outlook for equity markets is cautious at this stage and our allocation is slightly underweight. Following the early-year rally, equities are now facing more headwinds and could struggle to breach recent highs. For this reason, we are positioned more defensively than in January and our above-average allocation to cash provides us with "dry powder" to take advantage of potential market corrections.

Emerging markets and Japanese equities have lagged since the beginning of the year, but we have maintained our exposures to these regions due to attractive valuations, expectations of further China stimulus and catch-up potential were progress to be made on the trade front.

FX

We do not foresee major FX moves

The U.S. dollar has failed to build on its early-year gains and appears to be losing momentum as markets increasingly price in U.S. rate cuts. Stronger U.S. economic growth has been countered by tighter interest rate differentials between Treasuries and Bunds and the half-year changes in the values of the major FX crosses have been very limited; we fail to find many reasons for a radical change of the current trends. Despite the challenges faced by the Eurozone, a lot of investor pessimism is already priced in the euro and the EUR/USD parity remains range bound; at this stage, we do not intend to change our underweight dollar exposure for EUR-denominated portfolios. For the Swiss franc, we do not expect it to appreciate against the euro from the current level of around 1.11 francs per euro.

ASSET ALLOCATION 2ND HALF 2019

CASH (12%)

Overweight

The allocation to cash is well above our long-term average and results from the reduction of the equity exposure. In the current environment we have decided to err on the side of caution and are prepared to remain patient before adding risk to the portfolios.

DEBT INSTRUMENTS (34%)

Underweight

With an aggregate allocation of 34% into debt instruments, slightly below the neutral level of 35%, the underweight has continued to be progressively reduced. Our main investment-grade positions, into sovereign and quasi-sovereign bonds issued by the most creditworthy nations as well as Euro-denominated corporate credit, have benefited from the significant drop of government bond yields and from tighter credit spreads. In the current context, we feel comfortable with our investment-grade positioning, despite valuations that we consider unattractive.

Our allocation to high-yield bonds is overweight and mainly implemented through investments into senior secured loans, high yield bonds and a maturity-dated high-yield fund. We increased the exposure to the high-yield market segment by investing into a strategy with a flexible approach, allowing the manager to position his portfolio much more defensively when market conditions deteriorate.

The «specialist bonds» allocation has remained overweight and is close to the maximum of its range. Flexible and non-benchmarked funds have been a source of stability during the challenging market conditions observed in 2018 and are at the core of the fixed-income allocation. The exposure towards convertible bonds is unchanged and this asset class remains an important component of the portfolios.

EQUITIES (41%)

Underweight

The exposure to equities is lower than at the beginning of the year as we took advantage of the strong equity rebound to lock in some profits and also to reduce portfolio risk. From an initial overweight, the equity allocation is now underweight, reflecting our concerns over the rising level of uncertainty and over a more fragile global economy. Our regional exposure is well diversified across the different economic areas. We essentially took profits on equities of developed markets, on the back of their strong performance and significant alpha relative to their benchmarks.

In relative terms, equities still offer the better value but we feel that they could be overpricing global growth prospects, especially if trade tensions and weaker economic data were to persist. The markets' current anticipation of several interest rate cuts by the Federal Reserve mean that they are at risk of being disappointed by the central bank's effective decisions.

COMMODITIES (0%)

Underweight

We do not have any direct investments into the commodity space. We continue to monitor the evolution of the price of gold closely as it did not reach our target entry price during this year's first half; it is currently drifting even further away due to declining real yields and a weaker U.S. dollar, as well as rising geopolitical risks.

HEDGE FUNDS (13%)

Overweight

The allocation to alternative strategies is overweight, but less so than at the beginning of the year, following our decision to redeem our Long/Short credit fund. Hedge funds have offered diversification, admittedly, but they continue to struggle to produce significant contributions for the portfolios, which is of concern.

ASSET ALLOCATION GRID 2ND HALF 2019

For our balanced accounts, we apply the following grid:

	ALLOCATION	JULY 2019
SHORT-TERM DEPOSITS	0 – 20%	12%
DEBT INSTRUMENTS	15 – 55%	34%
Investment grade bonds	5 – 45%	10%
EM & high-yield bonds	0 – 20%	12%
Specialist bonds	0 – 15%	12%
EQUITIES	20 – 60%	41%
Developed markets	15 – 50%	34%
Emerging markets	0 – 30%	7%
COMMODITIES	0 – 15%	0%
Physical gold	0 – 5%	0%
Other commodities	0 – 10%	0%
HEDGE FUNDS	0 – 25%	13%
		100%

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