MONTHLY HOUSE VIEWS

September 2019

Keeping Balance

Global tensions are heightened as the US announced impending tariffs on all imports from China beginning in September, sparking fears that the slowdown in growth might continue. In turn, business confidence among manufacturers continued to wane. On the other hand, consumer confidence and spending remain supportive – US households have reduced leverage, unemployment is low or falling across the globe and confidence among services businesses has ticked higher recently. We expect the global economy to slow but not to tumble into recession; this equilibrium could last for years. Indeed, a tick back into expansion next year cannot be ruled out. Perhaps most importantly, slowing growth with no recession on the horizon provides a favourable backdrop for risky assets.

Moreover, hopes have risen for near-term policy easing. In the US, the Federal Reserve (Fed) has halted the shrinking of its asset portfolio ahead of schedule and a second rate cut is widely expected this month. The European Central Bank (ECB) is also expected to cut its deposit rate in September, by at least 10 basis points, and other measures designed to support bank lending – longer-term refinancing and "tiering" of deposit rates – are likely to be introduced. The Bank of England may well cut rates too, in November, with growth slowing due to Brexit uncertainty. Globally, monetary policy remains very supportive. Easier monetary policy may soon be supplemented by fiscal easing, in China and perhaps in Germany; and consumers remain well anchored for now, with rising real wages across most major markets.

Bottom line

Expected returns for equities over any reasonable length of time still far outweigh those from government bonds, which are offering historically low, often negative yields. However, equities can be volatile – thus we continue to have significant allocations to government bonds despite record low yields. We also hold a meaningful allocation of gold in most strategies, which is facing a reduced opportunity cost headwind in a low-yield environment.

Brexit remains a wildcard for investors given a wide set of potential outcomes for Sterling. We do not claim to know the eventual outcome, but it is almost certain British currency markets will continue to be highly volatile as the October 31 deadline approaches. We remain comfortable with our mix of Sterling and non-Sterling exposures.

OUR ASSET ALLOCATION

The table below presents the latest conclusions of our KH Investment Committee:

			Summary house views					
			Strong UW	UW	N	OW	Strong OW	Change since last KHIC
EQUITY		GLOBAL EQUITY			■			
		United States			■			
		Eurozone			■			
		United Kingdom				■		
		Japan			■			
		Emerging		■				
FIXED INCOME	SOVEREIGN	GLOBAL RATES		■				
		U.S. Treasuries		■				
		German Bunds		■				
		UK Gilts		■				
		EM Government Bonds ($)				■		
		Duration USD*			■			
		Duration EUR*			■			
		Duration GBP*			■			
	CORPORATE	US Investment Grade		■				
		Eurozone Investment Grade		■				
		UK Investment Grade		■				
		High Yield				■		
FOREX		EURUSD			■			
		USDJPY			■			
		GBPUSD				■		
		EM FX (vs. USD)			■			
ALTERNATIVE		COMMODITIES				■		
		Brent			■			
		Gold					■	+
		ALT. STRATEGIES			■			
		L/S Equity				■		
		Event-Driven				■		
		FI Arbitrage		■				
		Global Macro		■				
		CTAs				■		

	Positioning	*Duration
O/W	Overweight	Long – 7-10 years
N	Neutral	Intermediate – 5-7 years
U/W	Underweight	Short – 3-5 years

EQUITIES	
United States	US equities have continued to outperform year-to-date, even during August after the US announced planned tariffs on all imports from China. However, valuations are rich. We remain Neutral.
Europe	Despite low earnings growth expectations, euro zone equities are supported by high dividend yields. We remain Neutral.
UK	With an uncertain Brexit outcome and weak profit growth, many are overlooking attractive valuations, historically high dividends and a large-cap index largely insulated from domestic geopolitics. We are Overweight.
Japan	Valuations are well below their 10-year median. However, the impending VAT hike and the impact of yen strength on exports suggest caution is warranted.
Emerging (EM)	Emerging market equities have underperformed as slowdown and trade war worries have raged. Moreover, earnings growth has slumped to low single digits. We are still Underweight.

FIXED INCOME	
Sovereigns	While government bonds offer poor value in absolute terms, the normalization of bond yields has ended with most yields collapsing to record 2016 lows again in 2019. They continue to be critical in offsetting risks from equities in multi-asset portfolios.
Duration*	We have a medium duration position across most portfolios.
Investment Grade	Accommodative financial conditions, low inflation and steady growth are supportive, but spreads are tight and absolute yields are low. We prefer yield pick up further down the risk spectrum.
High Yield	It is unlikely that HY spreads will tighten much – however, attractive carry means decent return potential. We remain Strong Overweight.
Emerging debt (in $)	EM credit spreads have risen as global economy has slowed, hitting the highest level since early 2016. However, overall macro imbalances have improved meaning better credit quality.

CURRENCIES	
EUR/USD	The European Central Bank (ECB) is likely to ease in September. However, there is a limit to what the ECB can do. We see range-bound trading over the next months.
GBP/USD	Sterling is trading at historically low levels and is significantly undervalued versus the US dollar. However, the currency is divorced from fundamentals, and clearly trading on Brexit news flow.
EUR/GBP	Risks on both sides – Brexit uncertainty on one hand and political and weak manufacturing sector on the other – will keep the exchange rate steady.
USD/JPY	The Japanese yen is prized as a safe haven in times of trouble. However, the BOJ is still in active "loosening" mode.
Emerging	The broad emerging currency index has plumbed new depths this summer. All in all, we would not expect a recovery in EM currencies until the global outlook improves.

ALTERNATIVES	
Hedge funds	We prefer low volatility strategies which hold their own in bear markets, such as Merger Arbitrage.
Gold	Strong demand and safe-haven qualities continue to underpin gold prices. We are Overweight.
Oil	Trade war worries have pushed oil prices lower in recent months, but steadier growth ahead should see them stabilise.

Source: Kleinwort Hambros 04/09/2019
*Duration: short = Up to 5 years, medium = 5-7 years, long = 7+ years
HY = High Yield bonds (higher return but greater risks), IG = Investment Grade bonds (higher quality but lower return)

ECONOMIC OUTLOOK

Growth is slowing but policy mix remains supportive

The global economy faces headwinds, but there are robust tailwinds too. While growth is undoubtedly decelerating, this equilibrium could last for years. Indeed, a tick back into expansion next year cannot be ruled out. Most importantly, slowing growth with no recession on the horizon provides a favourable backdrop for risky assets.

Crosscurrents at work

August has seen a sharp revival in trade tensions between China and the United States, with the announcement of further tariffs covering nearly all goods each country imports from one another. By extension, this trade war escalation brings into sharper relief a synchronised global economic slowdown. Germany, an exporting powerhouse, may be close to recession, with business confidence at lows last seen in 2012. In the US, the Markit manufacturing purchasing managers index fell below the critical 50-level, which separates expansion from contraction, for the first time since the financial crisis; new orders and export sales were especially hit. Furthermore, the yield on 10-year US government bonds fell below that of two-year issues – this has often been a prelude to recession, although central bank buying may have caused distortions. The Chinese economy also continues to be in the eye of the storm, with GDP growth this year expected to be the slowest in three decades.

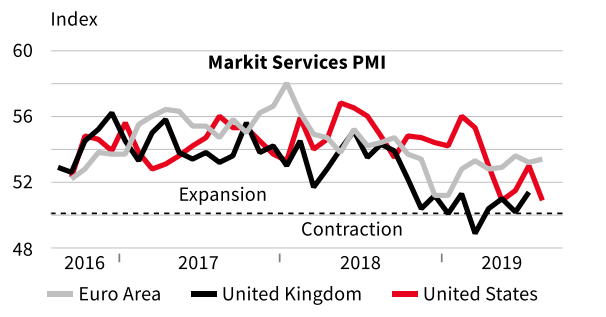
The sun behind the clouds

Nonetheless, there is strong support for the global economy too. First, central banks appear to have renewed pledges to support growth. The Bank of Japan is actively buying bonds and other assets. The European Central Bank is running a negative deposit rate and has signalled it will reverse the seven-month hiatus on its asset purchase program in September. The US Federal Reserve called an end to a string of nine rate increases, cutting its base rate late in July and is likely to do so again. The Bank of England may well cut rates too, in November, with growth slowing due to Brexit uncertainty.

Second, fiscal stimulus is also expected across key global economies. Perennial budget surpluses in Germany and a relatively low debt-to-GDP ratio (~60%) allows for fiscal stimulus, which the chancellor has alluded will come "depending on the situation". The US president has stated he is actively considering payroll tax cuts, which by some estimates could increase disposable incomes by $250 billion. Furthermore, while there is severe political deadlock, one area with bipartisan support is infrastructure spending. China too is likely to ramp up its infrastructure spending, in addition to tax cuts and reduced social security contributions by corporates.

Third, consumer activity – by far the dominant contributor to advanced economies' growth – remains well anchored. Latest figures from the US show annual earnings up by 1.3% after adjusting for inflation. Similar figures for the UK and the Eurozone show growth at 1.8% and 1.1%, respectively. This brightening wage picture coincides with reduced household leverage in the US, leaving plenty of room for further consumption.

Service sector shows resilience



Source: SGPB, Macrobond, 30/08/2019

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FIXED INCOME

Yield differentials favour high-yield corporate bonds

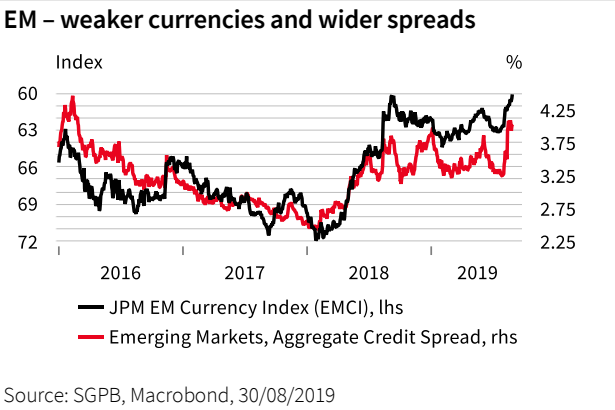
As central banks have brought forward easing plans, investors have rushed to sovereign bonds, pushing yields to historic lows, but they continue to be critical in offsetting risks from equities in multi-asset portfolios. For yield, we prefer riskier borrowers such as Emerging Market (EM) sovereigns and High-Yield (HY) corporates than investment-grade corporates (IG).

Sovereigns

US. The Federal Reserve (Fed) signalled a shift to easier policy in late 2018 and duly followed through in July with the first rate cut in almost 11 years. More are expected and, with heightened trade tensions weighing on business and investor confidence, yields on longer-dated US Treasuries (UST) have lurched towards their 2016 lows. In such phases of buying panic, lower yields still cannot be ruled out. However, with 10-year yields now negative after inflation, UST offer little long-term value.

Eurozone. The rush to buy long-dated bonds has pushed 10-year bund yields well below the ECB's negative deposit rate – indeed, all German government bonds now trade with negative yields-to-maturity (YTM). In addition, spreads between euro zone periphery bonds and bunds have widened modestly as investors have balked at chasing Spanish and Portuguese yields into negative territory. As with UST, there are few pockets of value in euro zone government bonds although the impending dovish shift from the ECB should keep a cap on yields.

UK. As the UK government moves to suspend parliament in order to complete Brexit by the October 31 deadline, uncertainty has skyrocketed and investors have begun to factor in rate cuts from November this year. 10-year UK Gilt yields have followed US and European yields ever lower and now offer less than 50bps YTM. However, Brexit-induced sterling weakness should put upward pressure on inflation, a long-term negative for such low-yielding bonds. In the near term however, buying pressure is strong, keeping yields low.



Source: SGPB, Macrobond, 30/08/2019

Credit

US. Growth and trade war concerns pushed corporate bond (credit) spreads wider in early August but they have recovered somewhat since. Higher-quality investment grade (IG) and lower-quality high yield (HY) spreads are now close to the average over the past 12 months. As indicated in previous comments, the current context makes it difficult for spreads to tighten much but the carry remains appealing, especially on HY issues, which offer a reasonable real return – about 200 basis points above inflation – a novelty in fixed income markets.

Eurozone. With the ECB expected to resume asset purchases, IG credit spreads should remain at tight levels. Negative government bond yields and shrinking bund issuance mean that more room may be made for corporate securities purchases. With Germany close to recession and hard Brexit risks rising, it is unlikely that HY spreads will tighten much – however, attractive carry means decent return potential.

UK. Government yields continue to plummet as the uncertainty around Brexit grows. Credit spreads have risen well above those in the euro zone, and indeed the US, but weaker domestic activity and falling business confidence have conspired to weaken appetite for sterling credit.

Emerging debt

With global trade slowing and heightened trade war concerns, emerging market (EM) currencies have plumbed new depths. EM credit spreads have risen in sympathy, hitting the highest level since early 2016. While there are idiosyncratic problems in Argentina or Turkey, overall macro imbalances have improved, meaning better credit quality. However, unlocking this value may take time and EM currencies will remain a critical factor to return.

EQUITIES

Slowing earnings but supportive policy mix

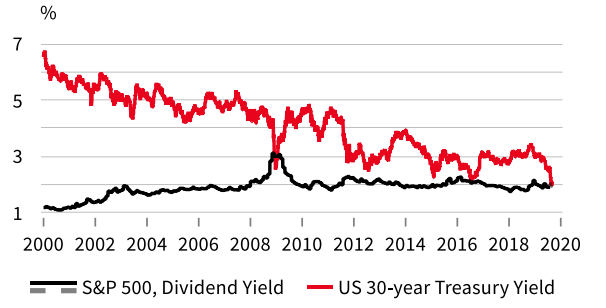
With global earnings growth in low single digits, equity performance has been driven by rising valuations so far this year, in marked contrast to 2018. In geographic terms, we prefer the UK over other developed markets and still suggest underweighting emerging markets (EM).

US. Despite demanding valuations and a sharp slowdown in earnings growth, US equities have continued to outperform global peers year-to-date, even during August after the US announced planned tariffs on all imports from China. According to consensus estimates, earnings growth is set to slump to 2% this year from 24% last year, meaning that rising equity prices are almost entirely due to higher valuations.

However, US equities continue to be attractive compared with other asset classes – the S&P500 yield is now higher than that on 30-year UST for the first time since early 2009. Moreover, the US market is in a strong uptrend. Overall, we remain neutral.

Eurozone. Export-sensitive euro zone economies such as Germany continue to see weakness in manufacturing confidence surveys and, although consumer spending and services are brighter, earnings growth expectations for this year have slumped to barely 1%. However, euro zone equities are supported by a 3.7% dividend yield, a welcome source of income with so many government bonds offering negative yields. Nonetheless, euro zone equities will struggle to outperform the US as long as Brexit and the trade war remain key concerns for investors.

S&P 500 Dividends yield more than 30-year Treasuries



Source: SGPB, Macrobond, 30/08/2019

UK. Despite the boost to competition brought by the fall in Sterling, UK equities continue to struggle against European peers. The fog surrounding the government's Brexit plans has caused many international investors to shy away. Unsurprisingly, earnings growth is barely positive. However, valuations are below their 10-year median and a 5.1% dividend yield looks compelling against the 0.4% available on 10-year gilts. Moreover, the market remains in an uptrend, and surrounded by negative sentiment: all factors that support our Overweight position.

Japan. Japanese equities are not without their attractions. Corporate governance is improving, domestic growth is still positive, valuations are well below their 10-year median and the market yield is well above the US (2.7% versus 1.9%). However, the impending VAT hike and the impact of yen strength on exports suggest caution is warranted.

Emerging Markets. After keeping pace with most developed markets apart from the US, emerging market equities have underperformed as slowdown and trade war worries have raged. In addition, high-profile problems in Argentina and Turkey – although idiosyncratic in many ways – have dampened investor enthusiasm. Moreover, earnings growth has slumped to low single digits while the price-to-earnings ratio remains some 12% above its 10-year median. All in all, an Underweight stance remains warranted.

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CURRENCIES

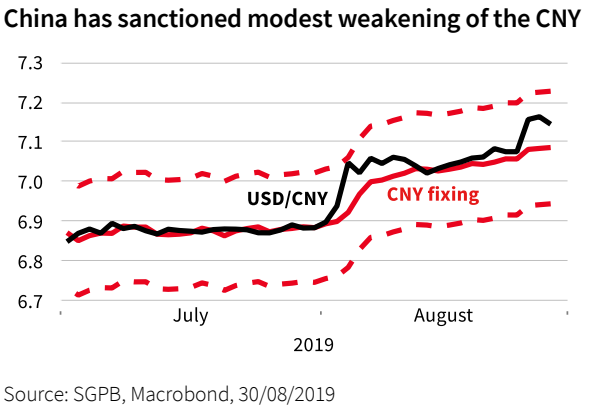
Range-bound trading for the dollar

The US dollar has risen over the course of the year, but inflation and growth expectations have fallen recently. Europe appears beset by anaemic growth and low inflation, with ECB likely to cut its base rate by at least 10 basis points in September. Sterling is significantly undervalued, but clearly not trading on fundamentals.

Dollar Index. The US dollar has risen this year versus its main trading partners. Initially USD strength was due its better inflation and growth profile coupled with higher rates. However, over the Summer as trade tensions spiked, it was safe-haven buying which bolstered the dollar. Yet inflation and growth expectations have fallen in the US too, and the Fed cut rates in July following a long string of hikes. Further cuts are expected and US 10-year government bond yields have fallen precipitously from above 2% a month ago to under 1.5% now. All in all, the picture remains mixed, and we expect choppy range-bound trading.

EURUSD. Europe appears beset by anaemic growth – especially in manufacturing – and low inflation. The European Central Bank (ECB) is likely to cut its base rate by at least 10 basis points in September and has signalled it will reverse its seven-month hiatus on its quantitative easing program. However, there is a limit to what the ECB can do – rates are already negative (-0.40%) and it is already the owner of nearly a third of all government debt. We see range-bound trading for now.

USDJPY. The Japanese yen is prized as a safe haven in times of trouble, which explains its strong outperformance versus the USD in August (~2%). However, the BOJ is still in active "loosening" mode. We expect the currency to remain range-bound for now, though it could strengthen should there be a big negative shock in markets (e.g. worsening trade scenario).



GBPUSD. Sterling is trading at historically low levels (£1 = ca. $1.21) and is significantly undervalued versus the US dollar on most valuation measures. However, the currency is clearly not trading on fundamentals – rather, it is all about "Brexit". In the short-run, there are three broad possibilities: A) Hard Brexit (i.e. no deal); B) Soft Brexit (i.e. a deal); or C) some other outcome (e.g. a general election or a delay). It is impossible to know which outcome is more likely at this stage, and volatile trading is likely to continue.

Our primary goal is not to guess the direction of the currency based on unknowable geopolitical factors, but rather to ensure we are comfortable with risks to globally oriented, multi-asset, Sterling-referenced portfolios. Should further Sterling weakness occur, our portfolios currently stand to benefit. Should Sterling strengthen, globally oriented strategies should face a currency drag; thus we "hedged" part of the non-Sterling exposure earlier in the year and may do so again should Sterling fall further.

EM currencies. The broad emerging currency index has plumbed new depths this summer. On one hand, trade war escalation has pressured currencies such as the Chinese yuan. On the other, broad dollar strength has proved painful for indebted economies such as Argentina. All in all, we would not expect a recovery in EM currencies until the global outlook improves.

USDCNY. A slowing domestic economy and trade war headwinds have led the renminbi to weaken beyond the psychologically important CNY 7 versus the US dollar. However, the authorities will be keen to stem capital outflow risks, especially as foreign currency reserves remain static at about $3 trillion, well below the $4 trillion record reached a few years ago.

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ALTERNATIVES

Gold is the preferred safe haven

Trade war worries have pushed oil prices lower in recent months, but steadier growth ahead should see them stabilise. Strong demand and safe-haven qualities continue to underpin gold prices. In hedge funds, we continue to highlight more defensive strategies such as Merger Arbitrage.

Commodities

Oil

Brent prices have continued to slide after reaching a 2019 high at almost $75 per barrel (b). This comes despite OPEC production cuts, tightening US sanctions on Iran, the collapse of output in Venezuela and disruptions in North Africa, which have all contributed to reduce oil supply to the global market.

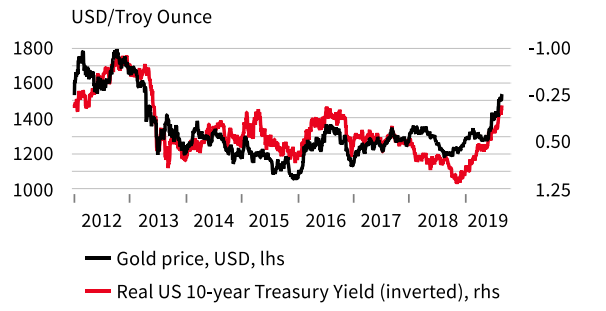
However, these factors have been overwhelmed by the continued rise in US output. The Energy Information Administration expects the US to reach 12.3 million barrels of oil per day (mb/d) this year (up from 8.8mb/d in 2016) and 13.3mb/d next year. Moreover, recession worries sparked by the revival in trade war tensions have pushed Brent some 7% lower so far this month.

While global growth is slowing, there are supportive factors and no recession in sight. With Saudi Arabia considering further output cuts, we expect Brent Prices to return to $65/b over time.

Gold

According to the World Gold Council, gold demand rose 8% YoY in Q2, reaching a three-year high. The main contributors were central banks, India and ETFs – gold reserves were boosted by 374 tonnes (t), the largest H1 purchases by central banks in 19 years; strong demand in India's jewellery market pushed demand up to 169t; while 67t of purchases by ETFs took their aggregate holdings to a six-year high at 2'548t.

Negative real rates burnish gold



Source: SGPB, Macrobond, 30/08/2019

Investing in gold is often decried because it is an asset which offers no yield. However, the total stock of negative-yielding bonds has reached $17bn, twice the end-December level, making gold look more attractive in comparison. Moreover, gold provides a very useful source of diversification in portfolios in times of stress, as shown in August.

Hedge funds

Event Driven

Managers specialising in Special Situations tend to build up exposure to markets trends, making such strategies vulnerable when markets correct sharply like in early August. We continue to prefer Merger Arbitrage – deal volumes are picking up (cf. the mooted remerger of Altria and Philip Morris), and spreads in price between predator and prey still look attractive.

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Channel Islands

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