QUARTERLY HOUSE VIEWS

Q4 2019: The Power of Balance

Following on from the first two quarters of the year where global equity and bond markets rallied, the third quarter of 2019 saw gains too, although they were modest. While it continues to be an excellent year for investment returns – an equity bull running towards an eleventh year; a bond bull nearing four decades – a sense of alarm is rising for some. This is predicated on an undeniable deceleration in global growth, with fears of a trade war increasingly being manifested in lost output. This is particularly acute for manufacturers, where survey data has shown contraction in industrial production and capital expenditure. It is reasonable to worry whether it could spill over into services.

A number of geopolitical tensions are also flashing ominously. In early September, about half of Saudi Arabia's daily oil output was briefly halted by an attack. This raises the risk of armed conflict in the Middle East, and potentially skyrocketing oil prices. This could lead to the current economic deceleration turning into an outright recession. Closer to home, the "Brexit" conflict rumbles on seemingly without end. Parliament and Downing Street are at loggerheads – the latter suffered quite a bruising rebuke on its prorogation of the former from the Supreme Court – and tensions are rising. Sterling is trading with a volatility typical of emerging market currencies.

The factors above include some of the triggers that may lead the ongoing equity bull run to come to an end. However, there are also mitigating factors. In regard to growth, consumers remain well anchored for now and are providing critical impetus. Confidence and spending are both robust, and wages are well above inflation in most major markets. Moreover, China and the US have struck a more conciliatory note in recent statements, raising hopes of a temporary ceasefire in the trade war. Both have more to gain than lose by striking a deal, which could prove an important fillip to the world economy.

Markets also continue to receive powerful support from central banks. Over the quarter, the European Central Bank announced wide-ranging easing. The US Federal Reserve cut rates again too. The Bank of England may well also join the party, depending on how "Brexit" unfolds. While monetary policy is admittedly suffering from diminishing returns, there is evidence that fiscal policymakers will be increasingly more active.

Bottom line

It is important to remember we are in the 'slowdown' phase of the current business cycle, where global growth is still positive. This tends to be a favourable environment for risk assets, and slowdowns can last for years. In addition, while equity valuations are between fair to expensive, the asset class remains in an uptrend but surrounded by negative sentiment, which we view favourably as a contrarian signal. It is also far more attractive than cash or government bonds.

We also tend to ignore the noise generated from geopolitics. Financial history is replete with evidence of such factors rarely helping determine overall risk allocation. Nonetheless, "Brexit" clearly has implications on sterling, which can seriously impact portfolios referenced in that currency. Instead of guessing unknowable political outcomes, we have chosen to make sure our portfolios can deal with, or indeed benefit from, large swings in sterling. Depending on the portfolio, this can include using hedging selectively or maintaining a higher than usual global exposure.

We remain neutrally positioned. Equities remain our most significant allocation in balanced mandates. However, over the course of this year, we have been steadily bolstering our defences, notably by lengthening the duration of our government bonds and increasing our allocation to gold.

OUR ASSET ALLOCATION

The table below presents the latest conclusions of the KH Investment Committee[1]:

			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+ years
N	Neutral	Intermediate – 5-7 years
U/W	Underweight	Short – up to 5 years

[1] Our generic "Overweight" to UK Equity may not necessarily be reflected in all strategies; for example in UK-biased strategies where there may be tactical reasons to be underweight the strategic benchmark UK Equity allocation.

EQUITIES	
United States	Momentum remains strong, but profit growth should be negligible this year and in mid-single digits next. We are Neutral.
Europe	Valuations are supportive, but earnings growth is likely to be barely positive this year. We are Neutral.
UK[1]	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 below their 10-year median. The impact of a strengthening Yen on exports suggests caution is warranted.
Emerging (EM)	Emerging market equities have underperformed as slowdown and trade war worries have raged. Moreover, earnings growth have been revised down. We are Underweight.

FIXED INCOME	
Sovereigns	While government bonds offer poor value in absolute terms, they continue to be critical in offsetting risks from equities in multi-asset portfolios. Moreover, bond prices are in a strong uptrend, and may even get higher from here.
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 Overweight.
Emerging debt (in $)	Many emerging markets central banks have turned dovish and the 300bp spreads available on hard-currency sovereigns still look attractive. We are Overweight.

CURRENCIES	
EUR/USD	We expect no major move in EURUSD in coming months but some modest strength on a 12-month view.
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 weak manufacturing sector on the other – will keep the exchange rate range-bound.
USD/JPY	The global industrial slowdown is bad news for many Japanese exporters. However, the JPY is viewed as a safe haven and tends to rally in times of volatility.
Emerging	Despite increasingly attractive valuations, a meaningful rally is unlikely until global growth picks up.

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	The vulnerabilities of Saudi Arabia's oil infrastructure may add some risk premium to oil prices. However, demand is clearly lower given a widespread slowdown in growth. We expect oil prices will trade only modestly higher over the next 12 months.

Source: Kleinwort Hambros 04-October-2019

[1] Our generic "Overweight" to UK Equity may not necessarily be reflected in all strategies; for example in UK-biased strategies where there may be tactical reasons to be underweight the strategic benchmark UK Equity allocation.

*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

Short-term clouds but limited recession risk

Macro risks proliferate and global manufacturing has experienced a sharp slowdown in output, order books and capital expenditure plans. However, consumer spending on goods and services remains resilient and the mix of monetary and fiscal policies has turned more supportive.

The economists at the Organisation for Economic Cooperation and Development (OECD) recently updated their assessment of the global economic outlook. They highlight the trade war and Brexit as key risks, to which we should add the heightened tensions in the Persian Gulf after the recent attacks on Saudi Arabia's oil facilities. Their forecast for global GDP growth for 2019 was cut to 2.9%, the lowest level in a decade.

Trade war tensions ratcheted higher this summer with President Trump's unexpected announcement of punishing tariffs on all imports from China. Talks were halted and are only just about to resume. However, as concerns about the impact of the tariffs on both growth and inflation have proliferated, so have signs of a more conciliatory approach. This suggests that neither party feels it can afford the recessionary impact of a long-running trade war: the social contract between the government and the Chinese people hinges on economic prosperity and the US president has an election to fight in just over a year.

For China, the trade-war effect was noticeable in August's industrial production data – at +4.4% year-on-year, output growth was at its lowest level since February 2002. And in the US, the Institute of Supply Management's survey of manufacturing confidence dipped into contraction territory for the first time since the late-2015 slowdown, a cause of much market angst. Ironically, such data points appear to have concentrated policymakers on agreement.

In the UK, tensions have also run high in recent weeks – the October 31 Brexit deadline looms. The OECD (Organisation for Economic Co-operation and Development) has warned that "no-deal" Brexit would hit exports hard and push the economy into recession. However, before suspension, Parliament did pass a law designed to prevent this and requiring Prime Minister Johnson to seek another delay if withdrawal is not approved by mid-October. Sterling surged on the news.

While the situation remains extremely fluid, Mr Johnson has been forced to abandon much of his hardline negotiating stance and appears to be seeking solutions which might solve the thorny issue of Ireland's border with Northern Ireland, enabling him to deliver Brexit as promised. In addition, his Brexit Secretary has suggested that the standstill period before separation might be extended by two years to 2022, a welcome breathing space which would help smooth transition.

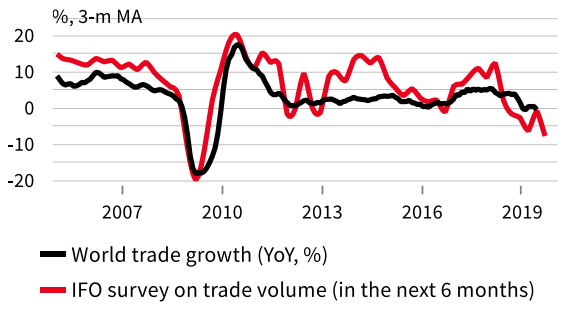
Insufficient time has elapsed since the September 14 attacks on Saudi Arabia to have a clear idea of their long-term implications. For now, indications are that one-half of lost Saudi output has already been restored and that end-August levels could be achieved by early October.

Over the past few months, the global oil market has been in oversupply with US output continuing to reach new all-time highs. This has kept prices low and helped rebuild plentiful commercial stocks.

Oil prices have thus retreated from the immediate post-attack spike and remain well below year-ago levels. Nonetheless, these attacks are likely to add an additional risk premium to oil prices for the long term.

Bottom line. We expect these risks to continue to slow economic growth in coming months. However, strong job markets, wage growth and consumer confidence should combine to mitigate recession risks for next year.

Tariffs weigh on world trade



Source: SGPB, Macrobond, 20/09/2019

FIXED INCOME

Attractive carry from high-yield corporate and EM bonds

Within fixed income markets, sovereign bonds offer little value, with some exceptions such as emerging markets (EM). Corporate credit continues to offer more potential, especially in risk-adjusted terms. Our preference goes to high-yielding bonds, thanks to the attractive carry available.

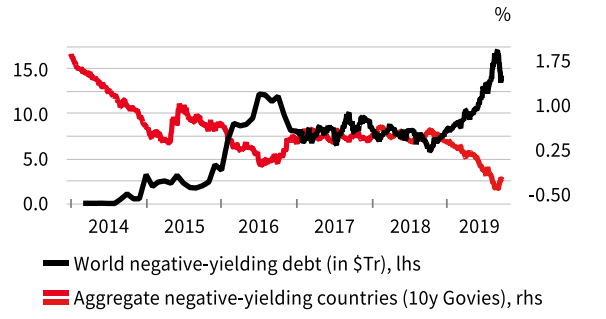
Sovereigns

UK. With global central banks embarked on a concerted round of easing – and Brexit uncertainty set to remain high – the Bank of England is unlikely to tighten any time soon, despite inflationary pressures. Still, gilt yields remain sharply negative after inflation and offer negligible long-term value. Moreover, the new cabinet's spending plans are likely to increase government borrowing, meaning more gilt issuance. However, once again, political risk appears to have the effect of bringing gilt yields lower, as does volatility in equity markets; this is precisely why we continue to hold them.

US. The Fed implemented its second rate cut of this cycle in September and investors expect more to follow over coming quarters, given the macro and geopolitical headwinds. Moreover, recent money-market tensions suggest the Fed may resume asset purchases in coming months. Nonetheless, we continue to judge that fears of recession are overblown, leaving longer-dated US Treasuries (UST) at the potential risk of a sell-off. In balanced mandates, we continue to hold them primarily to diversify against equity risk. Moreover, the yields in the bond market has continued to humble many with its ability to test new lows.

Eurozone. The ECB delivered a raft of easing measures in September in the face of decelerating industrial output, most worryingly in Germany which faces recession risk. While further easing is still possible, the ECB preferred to call on governments to play their part via fiscal policy – and there are signs that the subject is no longer taboo in capitals like The Hague and Berlin. Core government bonds offer sharply negative nominal yields and remain unattractive.

Negative yields drive investors toward riskier credit



Source: SGPB, Macrobond, 20/09/2019

Credit

UK. The UK economy has slowed more than its neighbours and Brexit uncertainty has led investors to shy away from UK credit, keeping spreads well above those in euros or dollars. This is only likely to change once more clarity has emerged about the UK's future trade status with the European Union, which is unlikely in coming months. Until then, we suggest a cautious stance, particularly on Investment grade (IG) issues.

US. IG corporate credit spreads have tightened a bit further since late August as UST yields have risen. High Yield (HY) bonds look more attractive today – spreads are at fair value but the current yield pick-up ("carry") should translate into stronger returns going forward, especially as attack-induced upward pressure on oil prices should help the energy sector, a sizeable HY issuer.

Eurozone. IG spreads have tightened significantly in anticipation of ECB buying and no longer offer much value as credit quality in less robust issuers looks stretched. Moreover, much of the segment trades with a negative yield today. As a result, HY bonds continue to hold our preference – they continue to attract yield-hungry investors and still offer an attractive source of carry.

Emerging debt

Emerging economies have improved economic governance – via central bank independence, free-floating currencies and reduced current account deficits in many cases – and inflation levels are under control. Macro news-flow remains worrying, especially as regards the US-China trade war, but with global investors hungry for yield and many EM central banks following the Fed's lead on policy-easing, the 300bp spreads available on hard-currency sovereigns still look attractive.

EQUITIES

Moving more defensive

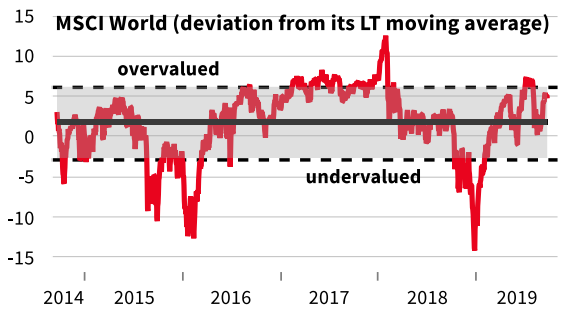
While equity valuations are between fair to expensive, the asset class remains in an uptrend but surrounded by negative sentiment, which we view favourably as a contrarian signal. It is important to remember we are in the 'slowdown' phase of the current business cycle, where global growth is still positive.

UK[1]. The market continues to underperform its peers, despite the boost to competitiveness from sterling weakness, which translates into higher foreign earnings for the globally oriented large caps. 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.

US. GDP tracking estimates suggest Q3 growth will be close to 2%, bolstered by services and consumer spending. Wage growth above inflation is positive for household incomes but negative for corporate margins where we expect a modest contraction. Sales growth has slowed for US companies to low single digits as manufacturing confidence has tumbled. As a result, profit growth should be negligible this year and in mid-single digits next. We are Neutral.

Japan. Tokyo is generally viewed as a cyclical, export-sensitive market, making outperformance difficult to achieve in times of industrial slowdown and trade wars. Moreover, the yen trades on safe-haven flows from global investors, a negative for exporters. Moreover, the impact of October's VAT hike may well subdue consumption more than expected. Nonetheless, valuations are attractive for Japanese equities – the dividend yield is above 2%, well above the long-term average of 1.7% – and the safe-haven yen allows some diversification benefits for international investors in either pure equities or a multi-asset portfolios. On balance, we are Neutral.

Valuations are not as attractive anymore



Source: SGPB, Macrobond, 20/09/2019

Eurozone. The euro zone is particularly sensitive to the trade war and weakness in manufacturing output given its sizeable industrial base and high dependency on exports (which represent 47% of German GDP for example). For now, risks such as "no-deal" Brexit or an EU-Italy budget dispute appear to have faded, but they will remain in the background. Earnings growth is likely to be barely positive this year, although valuations are supportive. We are Neutral.

Emerging Markets. Emerging market equities have underperformed year-to-date. As the trade war bites, analysts have revised earnings growth expectations lower to low single digits. China has continued to ease policy but the impact is not yet visible in data, especially in manufacturing. Moreover, valuations still look demanding – the price-to-earnings ratio is almost 20% over its 10-year median. All of this argues for maintaining an Underweight stance.

[1] Our generic "Overweight" to UK Equity may not necessarily be reflected in all strategies; for example, in UK-biased strategies where there may be tactical reasons to be underweight the strategic benchmark UK Equity allocation.

CURRENCIES

Trading ranges

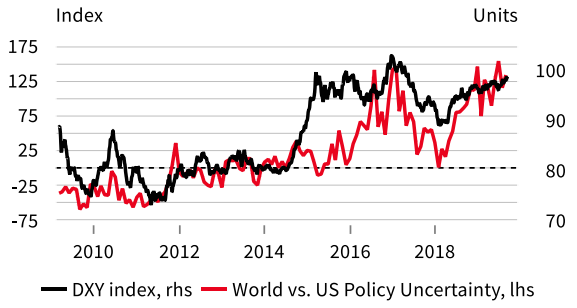
With GDP growth rates converging lower and key interest rates coming down across the globe, we expect sideways trading in foreign exchange markets. Valuation extremes - GBP cheapness, for example - are only likely to unwind in the longer term.

Dollar Index. Macro fundamentals have favoured the US dollar so far this year. GDP growth has been stronger than elsewhere while key rates and bond yields are much higher. However, the dollar index has only inched higher, +2.2% year-to-date. Part of the explanation lies in the tightening of differentials, as the Fed has embarked on a new easing round and growth has slowed. And part lies in relative valuations – the dollar is overvalued against peers, notably EUR and GBP. Looking ahead, the negatives should be offset by solid fundamentals, suggesting sideways trading.

GBPUSD. The parliamentary vote to block "no-deal" Brexit sparked a modest rally in sterling, but it was quickly reversed. Nonetheless, since the stinging rebuke of Prime Minister Johnson's prorogation of Parliament by the Supreme Court, has since concentrated on finding common ground on the contentious Irish border question. However, uncertainty remains high – Brexit day could be delayed again, an early election is likely and the country remains divided between restive Remain and Leave supporters. While sterling is undervalued, Brexit news will dominate volatile trading around current levels for now.

Our primary goal remains not to guess the direction of the currency based on unknowable geopolitical factors, but rather to ensure we are comfortable with risks to multi-asset, Sterling-referenced portfolios. In globally oriented strategies, Sterling weakness will lead to positive performance, all else equal. Conversely, should Sterling strengthen, a currency drag will occur; thus we "hedged" part of the non-Sterling exposure earlier in the year and may do so again should Sterling fall further.

Global uncertainty has pushed the US dollar higher



Source: SGPB, Macrobond, 20/09/2019

EURUSD. In surpassing market expectations, the ECB's September raft of easing measures put some short-lived downward pressure on EURUSD. Moreover, Germany looks close to a second consecutive quarter of declining GDP, the textbook definition of a recession. However, fears of "no-deal" Brexit have eased for now and Italy's new government looks more market-friendly, helping revive risk appetite, as has talk of fiscal easing. We expect no major move in EURUSD in coming months but some modest strength on a 12-month view.

USDJPY. The previous two VAT hikes in Japan have triggered recession and a third looms in October. Moreover, global industrial slowdown is bad news for many Japanese exporters. However, the JPY is viewed as a safe haven and tends to rally in times of trouble. We expect that these opposing forces will cancel out, leaving USDJPY close to current levels).

EM currencies. The broad emerging currency index has recovered modestly from early September's dip, but remains down 2.3% year-to-date. The global trade slowdown and dollar strength have kept EM currencies at multi-decade lows, and weak links – such as Argentina and Turkey – have seen sharp devaluations. Despite increasingly attractive valuations, a meaningful rally is unlikely until global growth picks up.

USDCNY. As Beijing and Washington have made conciliatory gestures on trade in recent weeks, the Chinese authorities have let CNY strengthen modestly. However, the daily fixing rate for USDCNY remains well above the psychologically important CNY 7 to 1 USD level and it seems clear that China would not hesitate to allow further weakness if trade talks fail again. In the near term, we expect no big move in either direction.

ALTERNATIVES

Gold for diversification

The vulnerabilities of Saudi Arabia's oil infrastructure may add some risk premium to oil prices. Gold demand remains strong suggesting further upside potential. No changes to our preferences concerning hedge funds.

Commodities

Oil

The oil market was thrown into turmoil on September 14 when Saudi Arabia's largest oil facility was attacked, removing some 6% of global oil supply. After an initial 20% surge, Brent prices settled down as it became apparent that the outage would not last too long. However, the attacks will serve as a wake-up call regarding the vulnerability of key parts of global energy supply, meaning that prices are likely to reflect a higher geopolitical risk premium going forward.

This being said, strong US output gains continue to dominate OPEC and Russian production cuts, keeping the world market in modest oversupply. Moreover, the slowdown in global manufacturing and GDP growth suggest more sluggish demand gains ahead.

All in all, we expect oil prices to trade only modestly higher over the next 12 months.

Gold

Gold demand continues strong. According to the World Gold Council, ETF demand has risen by 292 tonnes (t) year-to-date, taking ETF gold holdings to 2'791t, just 2% below their 2012 all-time highs. In addition, central banks – particularly in the emerging world – continue to add bullion to their reserves : in H1, their 374t purchases were the largest in almost 20 years.

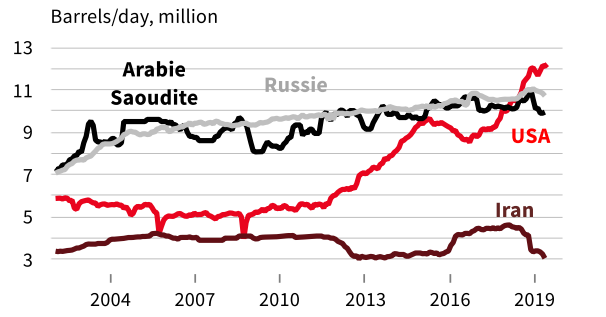
Assets, like gold, which offer no dividend or coupon tend to be shunned when interest rates and bond yields are high. When both are negative, as is so often the case today, the opportunity cost of holding gold dwindles, making it look more attractive in comparison. Add to the mix gold's portfolio construction properties – it tends to perform well in times of market stress – and it becomes apparent why it remains one of our preferred diversification instruments.

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.

US production offset OPEC+ production cuts



Source: SGPB, Macrobond, 20/09/2019

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