NO TIME FOR BRAVE INVESTORS

Uncertain markets call for strategic investing

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KEY POINTS

- After a strong start to 2019 for financial markets, different markets are giving us varying signals about the direction of the global economy.
- Fixed income markets – government bonds specifically – are bearish amid concerns of slower growth, while equity markets continue to inch higher.
- Investors should avoid taking unnecessary risks in the current market and instead take a selective and thoughtful approach to asset allocation.

MARKETS ARE GIVING US MIXED SIGNALS

In the current environment, we believe now is not the time for investors to be brave. The theme for financial markets in the first half of 2019 was of solid forward momentum, with the major asset classes performing strongly. Not only did equity markets rise, but so too did conservative fixed income markets, such as government bonds. Central banks turned dovish, the trade dispute between the US and China seemed to be heading to a potential resolution, and equity valuations were more attractive after the selloff in the last few months of 2018.

Despite this, different markets are giving us varying signals about the health of the economy. Equity markets have largely expressed bullish sentiment this year, with the S&P 500 Index in particular breaking through new all-time highs. However, it's been a different story in government bond markets, where investors have been much more bearish. Yields have come down, with some turning negative or becoming even more negative.

Given these conflicting signals, we don't think now is the time to take any big risks.

So, what seems to be going on?

For much of the past decade, developed equity markets have generated steady positive returns in a goldilocks environment characterised by low interest rates, modest economic growth, and benign inflation. With bond yields sitting at low levels, investors have had little choice but to move further up the risk curve in search of yield. This trend has helped to sustain a prolonged bull market, not only in equity markets, but also in high-yield bond and emerging market debt.

To a certain extent, financial engineering from central banks has been a major factor in keeping the current cycle alive. Low interest rates and large-scale bond-buying programmes from central banks – known as quantitative easing or QE – have been highly supportive of risk assets over the years, helping equity markets to reach new highs.

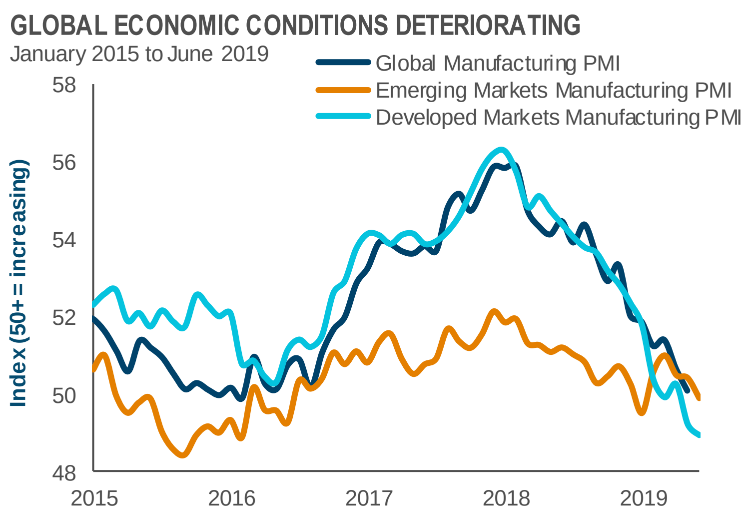
The challenge, however, is that conservative fixed income investors are becoming increasingly concerned that we are now in the later stages of the market and economic cycle, and that global growth is starting to fade. While most economies do not expect a recession in the near term, it is difficult to deny that the risk of a recession is rising.

Earlier this year, many observers began fearing an imminent recession when the US Treasury yield curve became inverted. A yield curve inversion happens when the yields on long-dated government bonds are lower than those on short-dated bonds. Bond yields, which move in the opposite direction of prices, are typically higher on bonds with longer maturity dates to compensate investors, because they are more exposed to interest rate and inflation risks. This is often called the term premium. Historically, the yield curve has tended to invert ahead of recessions, so some fear it's the harbinger of a looming economic contraction.

It is clear fixed income investors are somewhat bearish, but on this occasion, we don't think the yield curve is necessarily warning of an imminent coming recession. Instead, we believe this has been caused by a combination of the US Federal Reserve (Fed) hitting the pause button on interest rate increases, low inflation, modest economic growth, and downward pressure on bond yields after years of QE, rather than by hiking too aggressively.

We also believe it is difficult to predict exactly when a recession might come. While measures of manufacturing activity – known as purchasing managers' indices or PMIs – clearly show a decline at a global level, most economic models still place us midway through the cycle, with a small chance of recession in the next 12 months.

PURCHASING MANAGERS' INDICES 2015-2019 YTD



Sources: Haver Analytics/[JP Morgan/IHS Market, Business Roundtable, Federal Reserve Bank of New York]

OUR POSITIONING

We are in a market environment where global growth is beginning to slow down, central banks in developed markets are beginning to cut interest rates once again, and there is uncertainty about where equity markets will go from here. We are modestly underweight equities following a strong start to the year. There is still room for equities to grow in this market, but we are also aware that valuations are at higher levels and this brings an increased risk to the downside.

In fixed income, government bonds have a low correlation with equity markets and therefore offer a buffer against equity risk, but with bond yields sitting at already low levels, they currently may have limited firepower. Nevertheless, we think, maintaining exposure to conservative assets, such as government bonds, is important to diversify portfolios and balance risks.

Overall, we believe now is the time to make strategic investments. In equities, we see better opportunities in growth compared to value, and we also like emerging markets. In fixed income, we believe there are attractive opportunities in emerging market debt and high yield markets for selective investors who are seeking yield.

We believe active management – both tactically changing the asset allocation and selecting securities within asset classes – is especially important now, because uncertainty brings major risks. This gives good active managers the opportunity for to add value through uncertainty.

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