Q4 market outlook:

America first... but for how long?

Whether you're looking at equities, bond yields, currencies or economic strength, it's the US that's been leading the charge. Is this likely to continue?

Emiel van den Heiligenberg joined LGIM in August 2013 as Head of Asset Allocation with responsibility for asset allocation, strategy and multi-asset macro research.

As the S&P 500 reached new highs this quarter (notwithstanding the falls in recent weeks) and interest rates are on the rise, we are sticking with our tactical long position in equities. The cycle is still positive for risk asset, in our view, and earnings remain strong. Although the cyclical argument gets more uncomfortable with the progress of time, it helps that our economists have pushed out their estimate of when the next recession will come. However, indicators such as the flattening of the yield curve (admittedly not a perfect timing indicator) make us increasingly cautious.

Meanwhile, we believe that additional Chinese stimulus is on its way. Erik Lueth, our China guru, went on a research trip to the country last week and policymakers were as clear as they could be in his view that more stimulus is coming.

Lastly, we believe that the risks around a trade war have fallen as the negotiations moved from a multi-lateral conflict (US, Mexico, Europe, Canada, China) to a more bilateral one (predominantly between China and the US), at least for now. This seems enough for markets to reduce its focus on trade wars and to price out a worst-case scenario.

In this quarter's outlook, we focus on the key question for investors: should you put American equities first? We consider what the US yield curve is saying and whether emerging markets (EM) – led by China – could be about to stage a comeback

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OUR VIEWS AT A GLANCE

- **Positive on equities in the short term –** we also have moved from underweight to neutral on emerging markets overall, leaning against the current very bearish sentiment given that we expect the Chinese economy to reflate following upcoming stimulus
- **Constructive on emerging market hard and local currency debt –** growth overall is steady despite some idiosyncratic weakness, spreads are attractive on a relative basis and we have been topping up during market dips
- **Broadly negative bias on credit –** we believe credit markets may fall first as we approach the end of the cycle
- **We favour inflation protection, as well as exposure to the US dollar and the Japanese yen as a hedge –** targeting protection against trade wars and rising protectionism (which pose inflationary risks), and also against a selloff in risk assets

Overview			Strategic allocation		
Equities	●	●	●	●	○
Duration	●	●	○	○	○
Credit	●	●	○	○	○
Inflation	●	●	●	●	○
Real estate	●	●	●	○	○

Fixed income			Strategic allocation		
Government bonds	●	●	○	○	○
Investment grade	●	●	○	○	○
High yield	●	●	○	○	○
EM USD debt	●	●	●	●	●
EM local debt	●	●	●	●	○

Equities			Strategic allocation		
US	●	●	○	○	○
UK	●	●	○	○	○
Europe	●	●	●	●	○
Japan	●	●	●	●	○
Emerging markets	●	●	●	○	○

Currencies			Strategic allocation		
US dollar	●	●	●	●	○
Euro	●	●	○	○	○
Pound sterling	●	●	●	●	○
Japanese yen	●	●	●	●	○
EM FX	●	●	●	●	○

This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of Mar 2018
The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point.

Lars Kreckel
Global Equity Strategist

US EQUITIES: WHAT COULD UPSET THE APPLE CART?

Has it been a good year for equities so far? Your answer to that question depends on which index you look at to get your bearings. If you're a US investor you might be pleasantly surprised with the performance of equities overall this year. If you follow any other market, however, you might be disappointed that equities have not recovered, and worrying about negative momentum.

Ex-post rationalisation is easy. US equities have done so much better than other regions because domestic economic growth has surprised to the upside, while growth expectations elsewhere have been revised down. The Institute for Supply Management (ISM) US manufacturing index has risen to 14-year highs, while Purchasing Managers' Index (PMI) readings in the rest of the world have been trending downwards since the start of the year.

In addition, US earnings growth has accelerated to above 20%, while profit growth everywhere else has been at best steady. Rightly or wrongly, the consensus view has become that the US will be a relative winner of trade wars. Technology has again been one of the year's top-performing sectors and it forms a large proportion of the US market. The list could go on.

But this seeming invincibility breeds its own vulnerability. With great outperformance has come increasing investor bullishness: everyone loves US equities. In a recent survey more than 50% of respondents expected the US to continue delivering the best returns, a record high percentage and a sharp reversal from only 15% earlier this year. We believe this makes US equities more vulnerable to something not playing out perfectly.

What could upset the apple cart? We expect the US fiscal stimulus to fade next year, potentially reversing some of the tailwind that the US has enjoyed relative to other regions. The earnings picture looks very similar. The extraordinary earnings boost from tax cuts will fall out of the comparisons next year and a tightening labour market with rising wages could put greater pressure on labour costs than in other regions.

For us, the above makes for a poor risk/reward ratio, and we have increasingly shifted towards other regions in developed markets to express our positive stance on equities as an asset class. Eurozone equities are the mirror image of the US in terms of sentiment and we continue to see the region as a potential outperformer within developed markets.

James Carrick
Global Economist

THE YIELD CURVE BALL – HOW WORRIED SHOULD WE BE?

The yield curve (defined as the difference between 2-year and 10-year US Treasury yields) has flattened from 250 basis points in 2014 to just 25bps, as at the time of writing. With the US Federal Reserve (Fed) expected to keep hiking short-term rates, the curve could soon invert. This worries some investors and Fed members as an inverted yield curve traditionally foreshadows a recession.

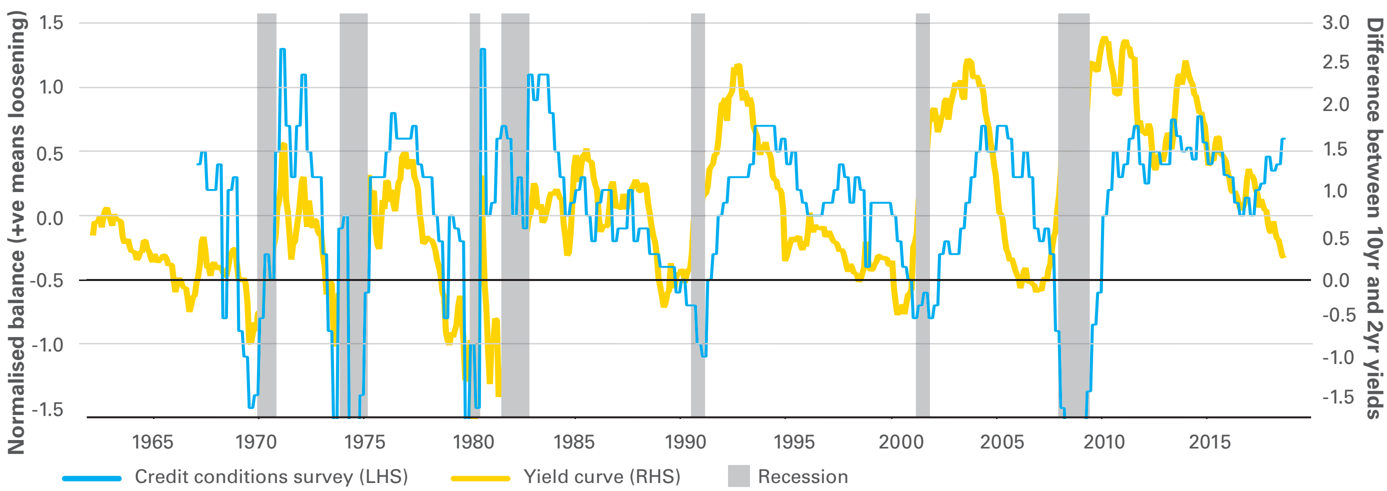
The yield curve has, however, become a less-timely recession predictor in recent cycles. This could reflect structurally lower long-term rates, as well as deregulation of the banking sector, which has reduced the link between short-term interest rates and credit conditions.

Having been scarred by soaring inflation in the 1970s, bond investors subsequently demanded a large premium when lending money to the government for the long term. This premium has fallen in recent decades as deflation rather than inflation has become a bigger concern. With the structural difference between long and short-term yields now lower, it takes less of a rise in the Fed Funds rate to close the gap between them.

Since former President Ronald Reagan's deregulation in the 1980s, which allowed banks to set interest rates according to 'market conditions', there has been a looser relationship between interest rates (and therefore the yield curve) and credit availability.

Rather than the yield curve, my favourite recession indicator of all time remains credit conditions, these continue to loosen rapidly. This is similar to what we saw in the mid-1990s and 2000s, suggesting that the economic expansion could have further to run.

Figure 1: The US yield curve is flattening… how worried should we be?



Source: Macrobond, Federal Reserve, LGIM estimates

Erik Lueth
Global Emerging Market Economist

THE CHINESE DRAGON IS STIRRING: EXPECT STIMULUS

Two findings from our recent China trip stand out. First, the economy is much weaker than macro indicators suggest. Second, the authorities plan a significant stimulus to revive activity.

Few people watch GDP to gauge China's economic cycle. Most follow a set of high-frequency indicators that are lumped together in growth trackers. These trackers suggest that Chinese activity is holding up well despite a drawn-out deleveraging campaign.

However, the mood on the ground flies in the face of this narrative as we discovered during our recent trip to China. Almost everybody knows somebody in the family who closed their business for lack of funding.

We have therefore constructed a growth tracker that relies solely on external data, including exports to China, Chinese tourist arrivals, the PMIs of trading partners, metal prices and commodity currencies. This growth tracker shows a rapid slowdown in 2018.

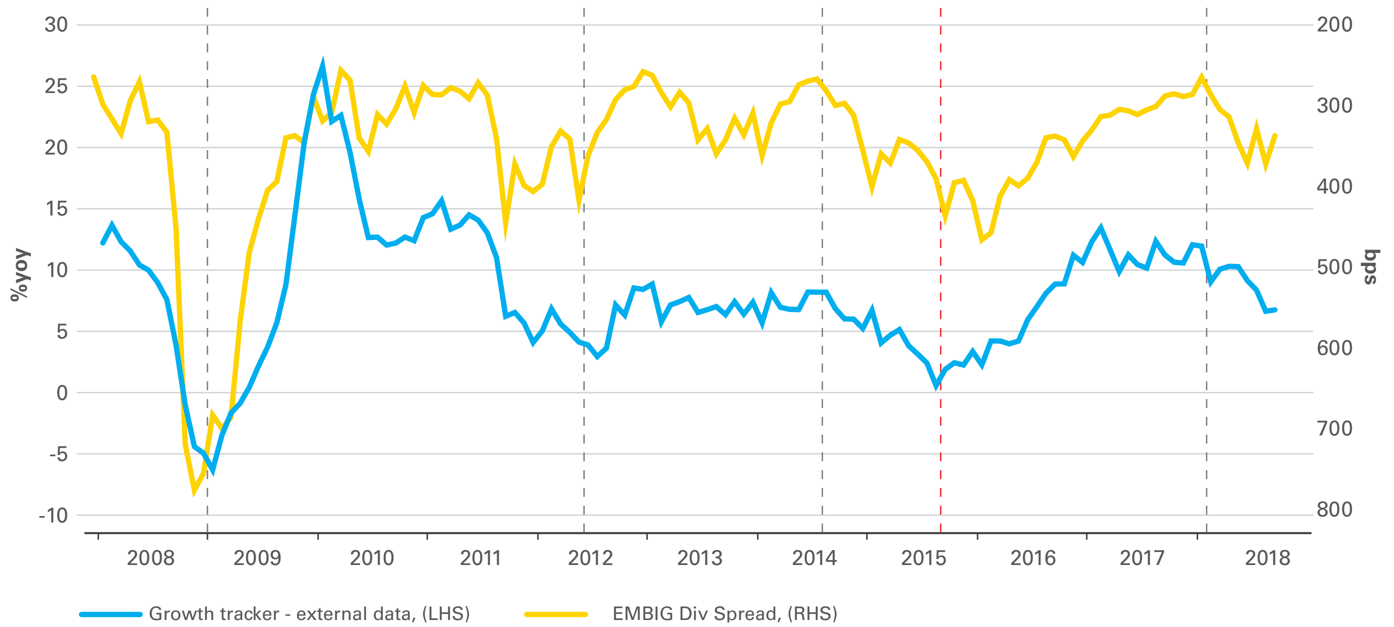
This is aligned with what we heard from Chinese government officials. They acknowledged that it had been a mistake to couple the deleveraging drive with tight fiscal policies and promised stepped-up stimulus. The latter was to come in the form of infrastructure investment with local government and state-owned enterprises as key conduits.

The approach of this stimulus is becoming apparent in the data. The issuance of local government bonds has picked up markedly after a tepid start to 2018 and credit growth looks to have bottomed in July after more than two years of contraction.

What are the time lags involved? It takes 2-3 months for any stimulus to feed through to the economy (This implies a rebound in activity by October or November. With the exception of the 2015 rebound, markets tend to react immediately to changes in growth momentum (Figure 2).

We believe that Chinese stimulus directed at infrastructure investment could benefit commodities, commodity currencies and emerging markets more broadly. This should be the case even if the trade conflict dents exports and leaves headline growth broadly unchanged. We have adjusted our portfolios in Asset Allocation accordingly. This includes moving from underweight to neutral in EM equities.

Figure 2: China- market prices generally react quickly to economic activity



Source: Bloomberg, LGIM

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