Remaining bullish as the cycle goes on

- We stay bullish on risk assets as we believe the medium term outlook for markets has actually improved
- The economic cycle is extending once again, in our view, thanks to a combination of more sustainable growth and benign inflation
- Against this backdrop, the Fed has changed its policy stance and investors expect fewer rate hikes than in the beginning of the year
- Moreover, China has provided a large stimulus package, which has increased our conviction that the Chinese economy will rebound in the months to come

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.

Three months ago, following a brutal period for equities, we **noted** that investors were likely to be rewarded by "being fearful when others are greedy – and greedy when others are fearful". Spectacular returns over the first quarter demonstrated the truth in that old adage.

The question now is: what is left on the table for investors?

Where previously our constructive stance on equities was predominantly tactical, we now believe the medium-term view has actually improved. Two factors are driving a brighter medium-term outlook: the lengthening of the economic cycle and the related scaling down of immediate credit risks.

Frequent readers will know that we in the team believe the economic cycle is an important driver of future expected returns. Equity markets typically anticipate a recession six to nine months ahead.

With the US Federal Reserve (Fed) announcing plans to taper quantitative tightening and anticipating just one further interest rate increase by 2021, we are increasingly of the view that the long economic cycle currently underway is likely to grow longer yet, as Tim argues below. This is bullish, in our view, as it gives space for markets to go back to more mid-cycle dynamics – where investors tend to buy equities on the dip, instead of selling the rallies.

Legal & General INVESTMENT MANAGEMENT

STRUCTURAL HEADWINDS

We wouldn't be true ourselves, however, if we failed to point out the structural headwinds that remain. We have written extensively about our worries over demographics, debt, income inequality and the new political paradigm of populism.

But legendary investor Warren Buffett was spot on when he said: "You only find out who is swimming naked when the tide goes out." We believe the likelihood of these structural headwinds triggering a 2008-style credit crisis is partially dependent on the economic cycle. And a crisis is more likely around a recession than it is mid cycle.

So, we believe credit risks over the coming 12 months are less imminent (famous last words). China remains crucial in this part of the market narrative as well – there are admittedly still severe warning signs over credit creation, which we continue to monitor. Chinese credit risk and China's global economic footprint are clearly big enough to impact our overall macro risk positioning. But we struggle to identify a catalyst for a Chinese credit event, given the country's fiscal space, the decent loan-to-deposit ratios within its banking sector and its limited dependence on foreign investors.

Moreover, we believe the world's second largest economy managed to stabilise its deleveraging process over the past few years, even though we have seen increased credit growth in the first quarter this year – something inconsistent with an imminent crisis – while we expect capital flight to subside or even reverse. Finally, as Magdalena writes below, a rebound in Chinese economic activity is likely, pepping up the outlook for global growth over 2019.

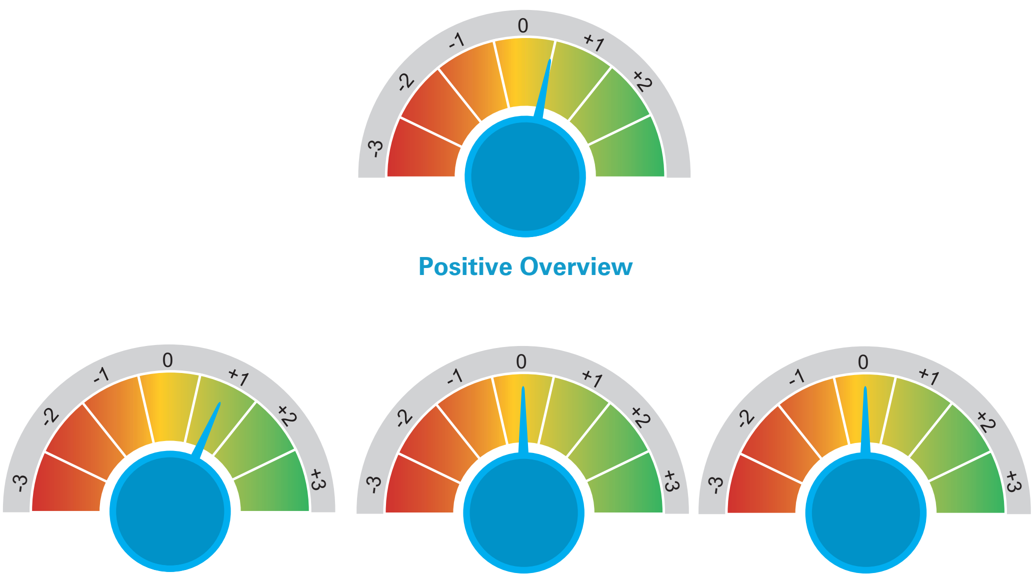
MONITORING POLITICS

Lastly a word on another particular bugbear of ours: political risk. This remains a source of anxiety for us, given rising populism, widening income inequality and the **Thucydides trap** in which the US and China find themselves locked – as well as the ongoing fractures in Europe, as detailed by Hetal later in this outlook.

Though we have seen some improvement in the noises around a possible trade deal between the US and China, we don't believe any of the fundamentals have improved lately. We believe investors should remain diversified globally to minimise the impact of spikes in geopolitical risks.

So, we remain bullish tactically and now express this stance in our medium-term view as well. Given our more constructive view on the economic cycle, monetary policy and China, we are inclined to buy market dips should they occur. We acknowledge that we will need to remain tactical where we can, as most of the positive equity returns we anticipated for 2019 have already been chalked up in less than a quarter.

Figure 1: Positive medium term overview



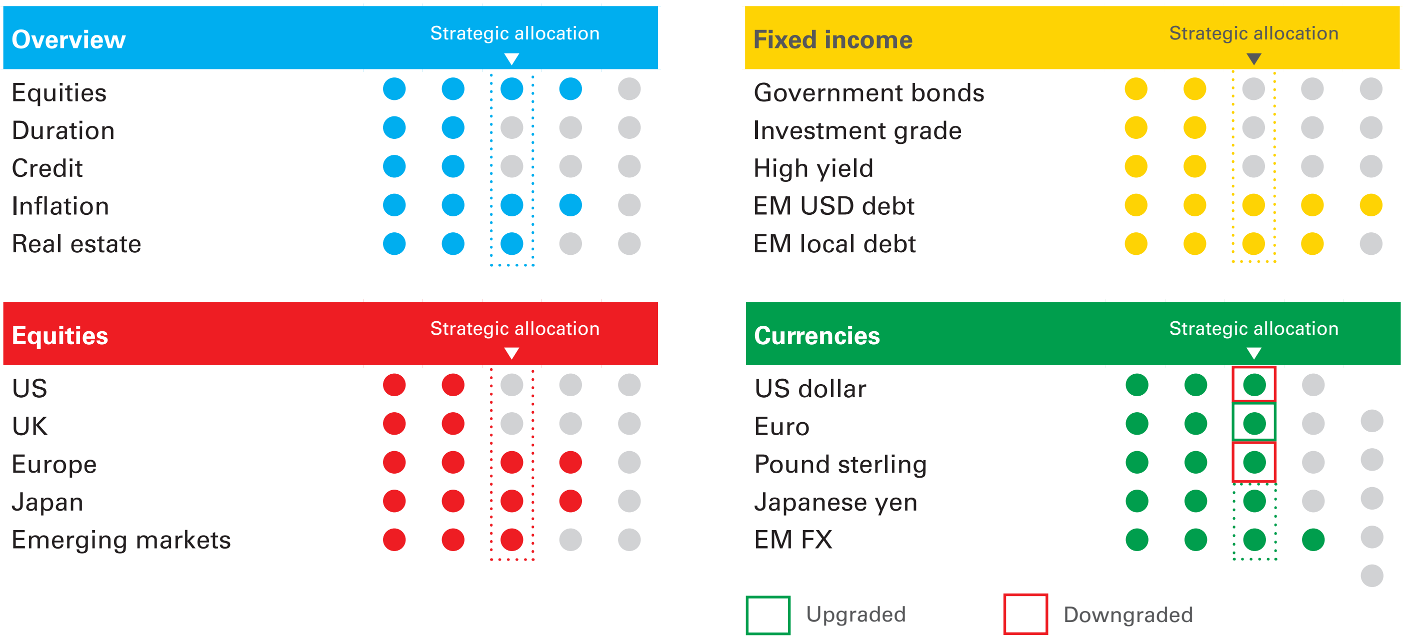
Economic cycle
Economy is in late cycle, but the cycle has likely been extended

Valuations
Risk asset valuations are not excessive

Systematic risk
Material geopolitical risks balanced with an improving outlook on China and global debt levels

Our views at a glance:

- **Positive on equities** – increased our medium-term view to positive. We favour Europe and Japan, which trade at more attractive valuations compared to the US. Neutral overall on broad emerging markets, but tactically positive on China and Mexico
- **Constructive on hard and to a lesser extent on local currency emerging market debt** – spreads are attractive on a relative basis given improved quality and reduced default risk in recent years
- **Cautious on government bonds** – we expect yields to reverse their declines and rise back to what we consider as fair value and levels seen at the beginning of the year
- **Broadly negative bias on credit** – we are still approaching the end of the cycle and valuations have deteriorated this year
- **Less constructive on the US dollar** – downgraded to neutral as we anticipate less risk-reducing impact from the currency, given the US's slowing economic growth and the Fed's dovish shift. After recent sterling strength vs. the euro, we have moved to a neutral view on both currencies



This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of March 2019. 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.

Tim Drayson,
Head of Economics

Magdalena Polan,
Senior Economist

EXTENDING THE US CYCLE

A surprising plunge in bond yields has increased anxiety about the prospects for global growth – even as our concerns about the risk of a US recession, heading into 2020, have somewhat paradoxically ebbed.

We were worried that the infusion of fiscal stimulus would lead to higher US inflation, forcing the Fed to continue tightening policy. But three key aspects have changed.

First, weakening global growth and China's slowdown have reduced imported price pressures. While we are confident that Chinese stimulus will help to stabilise growth, we are not expecting a significant boost to commodity prices.

Second, US growth has slowed. Not disastrously, but enough to reduce the risk of the economy overheating. It appears that uncertainty around the trade war with China, the government shutdown and general dysfunction in Washington have undermined business investment.

Finally, inflation expectations have unexpectedly declined. This is crucial, as it will likely put downward pressure on price- and wage-setting behaviour. The Fed now appears willing to keep interest rates lower for longer, in order to generate a modest inflation 'overshoot' eventually to help drag inflation expectations higher. Indeed, the potential move to average inflation targeting represents a change in the central bank's reaction function.

In terms of the US recession indicators we track, the lower path for inflation and interest rates means many of the variables linked to debt servicing are likely to deteriorate less rapidly than we had previously expected.

And despite the tight labour market suggesting the US is late cycle, there is little evidence of excesses in the private sector or signs of **asset prices bubbles which could burst**. Some slowdown into 2020 still seems likely as the fiscal stimulus fades, but providing a major disruptive shock can be avoided, it seems likely the cycle will go on.

CHINA'S RECOVERY: A NEW SCRIPT

We have seen this before – or have we? After a marked slide in economic activity, the Chinese leadership embarks on a sizeable stimulus, ultimately leading to a rebound in economic activity and provide the global economy with a badly needed boost. But any recovery in Chinese growth, and its impact on the rest of the world, is not going to follow the same old script to the letter. Let's see how the situation has developed since our **last update on China**.

First, the growth impulse is coming from other channels than leverage alone. While the authorities have indeed re-opened the money taps, with credit growth on the up again, there is more to this stimulus than another infrastructure and investment push.

This time, the government is also cutting taxes – especially on consumption. As a result, the shift from investment- to consumption-driven growth is accelerating, while Chinese imports shift away from commodities and towards consumer goods. More money in Chinese consumers' pockets also means more spending on services, which are generally less tradable. Second, the patterns of global trade are changing, with more integration within regions but less involvement of far-flung suppliers in global production chains. Overall, this means not only that this stimulus will have a smaller impact on global commodity prices and commodity-exporting emerging markets, but also that it should prompt a relative shift of Chinese demand towards regional- or Chinese-owned producers.

That said, **China's share of the global economy is still increasing**. So while 6% growth is certainly lower than the heydays of 10% expansions, the absolute size of the demand impulse coming from China is still large, and still positive for the global economy.

The numbers paint a good picture: just one extra percent of growth in Chinese GDP these days means more than USD130bn added to the global GDP (roughly the size of Ukraine or Hungary's economy), versus about 50bn a decade ago. This still implies a large boost, and better outlook for global growth in 2019.

Hetal Mehta,
Senior European Economist

EUROPE: POLITICAL RISKS STILL ABOUND

As a theme, if we have learnt anything from the last few years, it is that European political risk is one that has definitely got legs – as well as arms, hands and feet.

There has been a constant stream of events for investors to fret about, from the rise of Syriza in Greece in 2012; to German, French and Dutch elections in 2017; to the formation of Italy's Lega-Five Star coalition last year.

This year will be no different, with Finnish, Spanish, Greek, Polish and EU Parliament elections all still to come.

It is also possible that Italy holds early elections so that the Lega can capitalise on outstripping its coalition partner Five Star in the opinion polls.

The overriding concern is that populism will continue to grow, leading to questions as to the impact of politicians' promises on growth and public finances. And for the EU elections, scheduled for late May, the key issue is whether increased representation in the Parliament will influence the appetite for further economic and political integration.

EU elections will see populist parties such as the AfD (Germany); National Front and Yellow Vests (France); Five Star and Lega (Italy); Podemos and Vox (Spain); among others represented in the EU Parliament.

While the share of seats these parties will win is still likely to be relatively small, they will probably influence the larger, mainstream parties. Some of the influence they already exert can be detected in the euro area's fiscal stance, which in 2019 is set to be its loosest since 2010 and – somewhat surprisingly – broad-based.

Italy's government is loosening policy in an attempt to boost growth, while France's Emmanuel Macron had to cave in to the *Gilet Jaunes* protests by suspending fuel tax hikes and pledging to use government money to raise the minimum wage. Even typically prudent Germany will lower personal taxes and raise spending.

With these EU elections also comes the musical chairs of the top EU jobs and then **the race to succeed Mario Draghi** at the European Central Bank.

Still, volatility provides opportunities for investors. European politics certainly has scope to give us more volatility in the coming months – and we haven't even mentioned Brexit yet.

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