The signals and the noise

Following the recent rally, we have dialled down our tactical equity exposure to neutral from positive, in light of market expectations for central bank action and the still-simmering trade war

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 we look ahead to the next three months, and consider how to invest on behalf of our clients, we are confronted by seemingly conflicting signals from depressed bond yields and exuberant equities.

Many market commentators suggest the two asset classes are telling different stories. But we see them as pricing in the same macroeconomic factors: slightly lower growth, far less inflationary pressure and highly accommodative central banks. This is borne out by the outperformance of defensive stocks versus cyclicals, while 'bond proxies' shine.

With a shift to looser monetary policy in developed markets, real yields have dropped back to the floor. Adjusted for inflation, 10-year yields range from a paltry 0.30% in the US, to a painful -1.3% in Germany, to an eye-wateringly poor -2.4% in the UK.

This environment is encouraging investors to seek out positive real yields wherever they can find them, supporting equities and encouraging flows into local debt markets across the emerging world. But any failure by the US Federal Reserve (Fed) to meet hopes for policy easing – which have helped drive the returns enjoyed by these asset classes – could catch markets off-guard. (For more, see Magda's piece on page 4.)

At the same time, most of the sentiment indicators we monitor, and a clutch of recent surveys, paint a picture of quite cautious equity investors.

How does this mood fit with the S&P 500 index hitting fresh all-time highs? Investors could be feeling more pessimistic than is suggested by their positioning. There are also many relevant counterfactuals we do not know: if there were no trade war between the US and China, would equities be significantly higher? Probably so: price-to-earnings ratios – even for the S&P 500 – remain a good way below 2017 levels.

As we seek to separate the signals from the noise, we recognise that the economic cycle has been extended, as we wrote last quarter.

But we are also concerned that following the recent rally, markets may be pricing in too low a probability of the trade war escalating and too high a probability of significant monetary bounty. The Trump administration is inherently unpredictable, and central bankers have been known to be fickle.

In this context, we have dialled down our tactical equity exposure to neutral from positive, while maintaining our moderately bullish medium-term view on risk assets.

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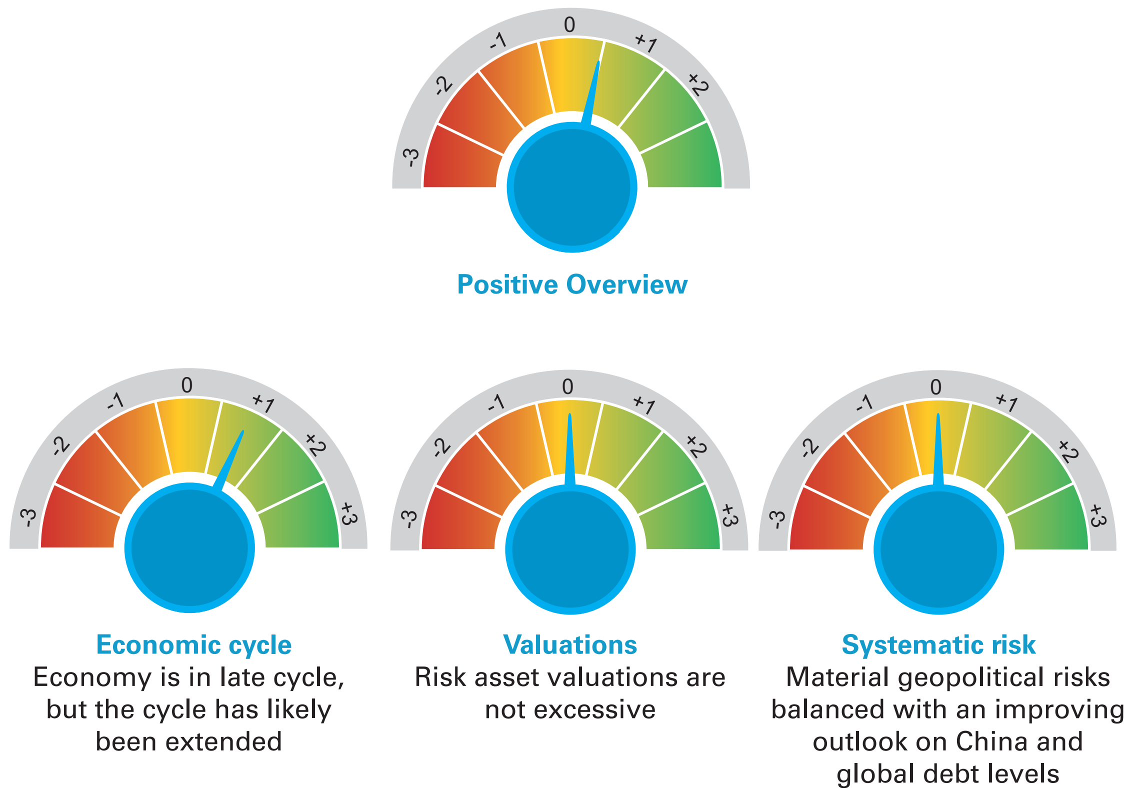
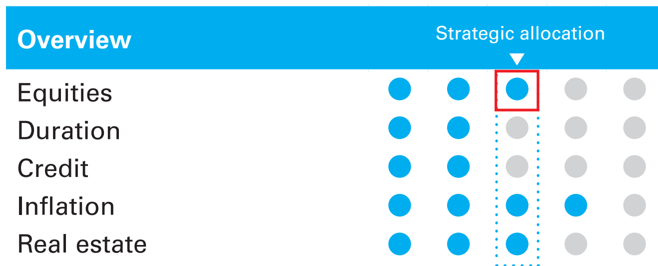
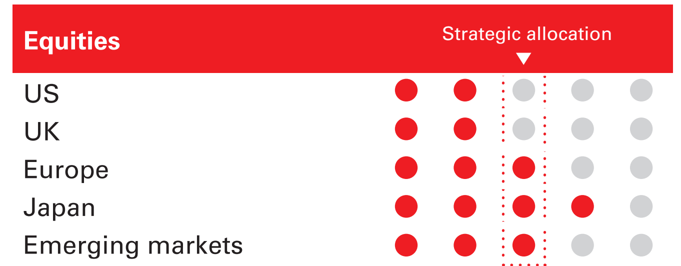
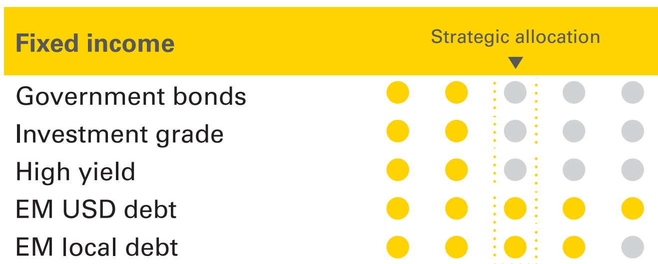
INVESTMENT MANAGEMENT

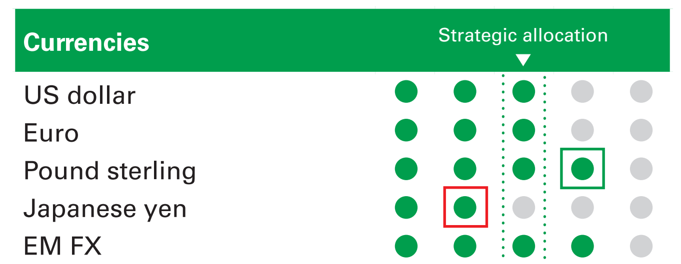
Figure 1: Summary of LGIM asset allocation core view











Upgraded   Downgraded

This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of June 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. The tactical score for equities has been reduced to neutral but the medium-term remains positive. From medium-term perspective, risk will be added cautiously on equity market weakness.

OUR VIEWS AT A GLANCE:

Tactically neutral on equities –

While our medium-term view remains positive, due to the belief the economic cycle has been extended by recent developments, we reduced our tactical view to neutral given equity market gains year-to-date. We still favour Japan relative to the US and UK, owing to more attractive valuations.

Remain positive on emerging market debt –

Spreads remain relatively attractive and default risks still appear low.

More negative on developed market government bonds –

We feel the recent fall in yields has taken them below fair value.

Remain negative on credit –

The asset class tends to underperform at this part of the cycle and valuations remain unattractive.

GBP from neutral to slightly positive –

We feel the market is pricing too big a risk of a hard Brexit.

Christopher Jeffery
Strategist

DISSECTING THE CENTRAL BANK U-TURN

During the second quarter, we saw an about-face from major central banks. In some countries, there were rate cuts when hikes had previously been promised (Australia). In others, plans to tighten policy were abandoned and an easing bias adopted (the Eurozone, the United States and Japan). This pivot can be best understood as the response to two risks to the global economy: one acute, one chronic.

The acute risk is the escalating trade tension between the US and just about everyone else – Mexico, China, India, Japan and the European Union have all been threatened with tariffs. That threat poses a profound risk to stretched global supply chains, with a paralysing effect on investment intentions for firms operating across borders. The manufacturing sector – often the bellwether of the global economic cycle – has lurched lower from an already weak starting point.

The chronic risk, meanwhile, is the perpetual downside surprises in inflation. Realised inflation has repeatedly undershot expectations over the past five years. The collapse in expected inflation (on both market- and survey-based measures) in recent months has been the straw that broke the camel's back.

After downplaying and excusing the undershoot in inflation for years, the doyens of price stability have decided that they can no longer tolerate missing their targets.

The concern is that weak inflation today will morph into deflation tomorrow, in the event of another downturn. Central banks are therefore trying to pre-empt that downturn by providing stimulus.

This chronic threat is, perversely, a boon for risky assets: the prospects of excessively tight monetary and fiscal policy choking off the economic expansion have diminished with the recent pivot. Six months ago, the inverted yield curve and rising real yields were signs of excessive monetary restraint; today, such concerns have disappeared.

Of course, the current economic expansion will not last for ever, but it now seems vanishingly unlikely that central banks will be the cause of its untimely demise.

Magdalena Polan
Senior Economist

EMERGING MARKETS: MIXED FORECAST FOR SUMMER

Looking at market expectations for easing in the US and the euro area, you would imagine the skies are sunny for emerging market (EM) assets.

Indeed, some assets have performed well since early December 2018, when the Fed abandoned its hiking bias. Bonds have rallied, especially in countries with good fundamentals – low inflation, stable public finances and balanced current accounts.

But the debt of less crisis-proof economies has also enjoyed solid gains and higher investor demand; even 'frontier' or first-time issuers enjoyed low yields, as foreign investors were willing to take on more EM duration risk.

Emerging equity markets also did well, despite a temporary flare-up in the trade war in early May. EM currencies, however, have so far failed to strengthen much.

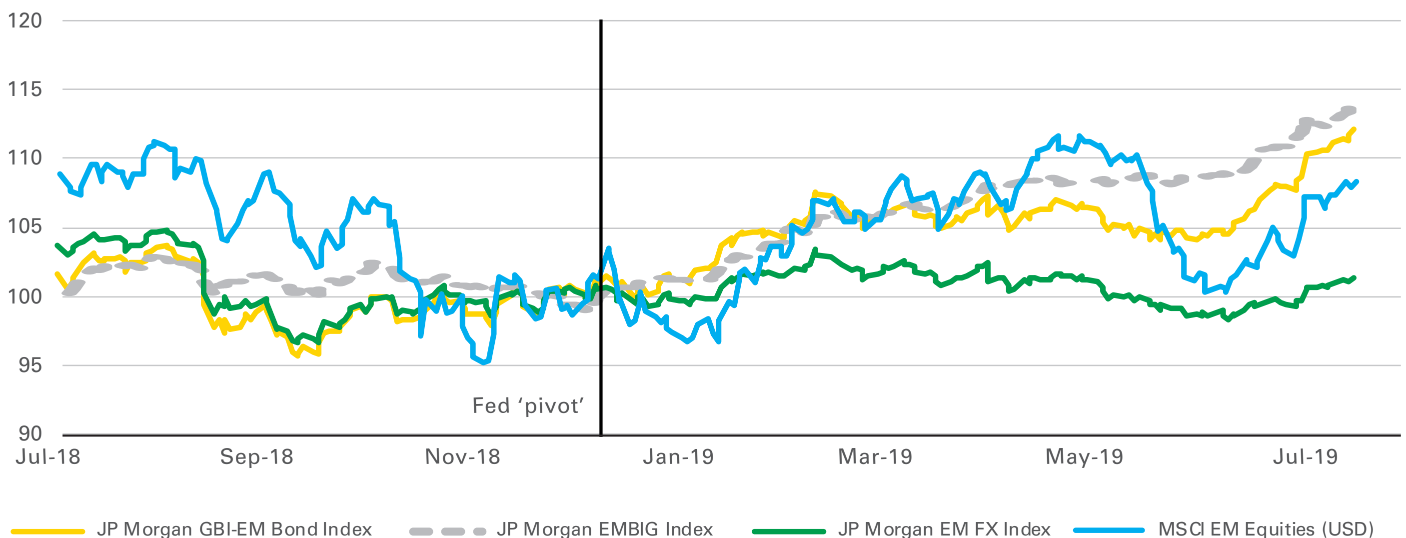
There are clouds on the horizon, too: EM investors cannot expect smooth sailing through the third quarter. The weakening outlook for global economic expansion is limiting the potential for EM assets to rally further, in part due to China's economic stimulus translating into a smaller-than-expected pickup in Chinese growth.

Also weighing on the outlook, though, is the lasting impact of the trade war on sentiment and, in turn, investments, trade volumes and trade routes. Even if China and the US were to reach a lasting truce soon, the deeper issues behind the conflict will remain, as will the damage to expectations for a multilateral, rules-based order governing global trade.

In addition, there is also the risk that market expectations of Fed cuts have gone too far. With the US economy doing well so far, the Fed may surprise markets negatively, leading to higher US rates, and re-pricing of EM debt, just as growth concerns lead EM central banks to consider rate cuts.

This backdrop is likely to keep a lid on the EM rally, especially in currencies, which tend to be more sensitive to short-term rate differentials and concerns over growth and trade. As in earlier episodes of such re-pricing, those markets with strong fundamentals should outperform, but weaker economies may see their summer turning into a rainy autumn.

Figure 2: EM assets pre and post Fed pivot



Rising lines indicates positive performance. Rebased to 100 in November 2018.
Source: Bloomberg.

Lars Kreckel
Global Equity Strategist

EQUITIES AND BONDS UNITED

The notion that equity and bond investors could be pricing in different scenarios for the future has received a lot of airtime of late, as Emiel points out. This suggests that only one asset class can be right and the other needs, at some point, to re-price aggressively. We do not see this disconnect, however.

The reason for the move in bond yields is more important than the direction of the move. Above all, it is growth that matters. More often than not, lower yields are a reflection of the market's declining growth expectations. But there can be other reasons for declining yields.

Over the past few months we have been dealing, at least in part, with a change in the Fed's reaction function. From an economist's perspective, this has shifted because policy makers are putting a greater weight on the drop in inflation expectations. From an equity investor's perspective, this shift means lower rates for a given amount of growth than before – a net positive.

The confusion appears to have stemmed from the multiple drivers behind the recent decline in bond yields – some bad for equities, some good.

Equity pricing confirms this. For most of the time since late January, stocks performed well, but market leadership flipped to bond-proxy, defensive sectors. An unusual pattern, but one consistent with equity investors re-pricing to a more dovish Fed reaction function. May was different. Following a spike in fears over the trade war, and a related downgrading of growth expectations, equities fell in lock-step with bond yields.

Assuming the Fed's reaction function does not continue to shift, growth should begin to dominate equities again. If PMIs jump or there is a trade deal, we would expect equities to rally, regardless of Fed rate cuts being priced out. At the same time, further fears over the trade war, and increased recession risk, would be bad for equities – even if the Fed were to start easing again.

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