Multi Asset
Navigator
WEEKLY STRATEGY

UNIGESTION
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LOST IN TRANSLATION Logic, 2019

Welcome to uncharted territory. A combination of rising recession fears and trade war concerns have pushed sovereign bonds yields to new lows in August. Over the month, most safe haven assets performed very well, reflecting a change in market sentiment. If the current US yield curve is really heralding a recession, it would be the first to begin at a time when nominal bond yields are so low and central banks have such limited ammunition to smooth the negative impact. What does this situation mean for asset allocation?

WHAT'S NEXT?

'Flight to quality' month

As usual, August was a volatile month. Tweets from the US President prompted new tariff increases, risky assets suffered and safe haven ones posted positive returns. Over the month, global equities declined, with the MSCI World and MSCI Emerging Markets indices falling -2.4% and -5.1%, respectively. Emerging currencies also fell: -8.7% for BRL, -7.3% for ZAR, -5.6% for MXN and -3.9% for CNH versus the greenback. Energy prices followed growth-oriented assets with a decline of -5.7% for the Bloomberg Energy index. Rising uncertainties about the global economy and the extent of the trade war pushed risk aversion higher with a sharp rise in both realised and implied equity volatility. As a result, sovereign bonds, gold and safe currencies performed well. In August, sovereign bond yields reached a record low and the Barclays Global Treasuries USD hedged index posted one of the best monthly returns ever (2.6%), similar to those seen in November 2008. In terms of style, unsurprisingly, Low Volatility, Momentum and Quality factors outperformed Value and Size.

How should we interpret these performances? Is it a new market stress episode, amplified by poor liquidity, stretched valuations ahead of earning seasons and high expectations around monetary easing? Does it reflect a new deterioration in the economic cycle as indicated by the inverse US yield curve? In this challenging macroeconomic scenario, it is essential to dissociate noise from fundamentals, short term from long term, and expectations from surprises. To do this, we allocate risk dynamically by monitoring the three main factors that drive asset return over the medium term: 1) macroeconomic factors (economic cycle and inflation), 2) market sentiment and 3) valuation. Where are we currently and what has changed over the last twelve months?

A lot can change in 12 months

According to our Nowcasters that track in real time a large spectrum of macroeconomic data covering all economic sectors and most emerging and developed countries, risk of recession is neutral and risk of inflation surprise is very low. Compared to a year ago, the economic environment has clearly deteriorated. Nevertheless, the trend is much more alarming on the inflation front than on the activity side. Over the last twelve months, our Global GDP Nowcaster declined from 0.33 to 0, while our Global Inflation Nowcaster fell from 0.45 to -0.3. In our view, investors should be more worried about returning deflation risk and its consequences than a sharp economic downturn. Below-target inflation is the main reason why central banks have turned from normalisation to easing mode over the period. While major central banks have already cut, or will cut, their rates in 2019, we consider that this monetary policy shift has more than offset the deterioration in the economic cycle. It also explains why risky assets and safe assets have delivered extraordinary returns this year. Regarding valuations, lower bond yields have dramatically changed asset rankings. One year ago, most assets were attractive except real assets. Today, sovereign bonds and real assets are now extremely expensive while growth-oriented assets look fairly priced. Regarding market sentiment, one year ago, positioning in global equities was close to extreme, momentum supportive for risky assets and risk aversion tracked by our Market Stress Nowcaster a bit muted. As a result, leverage and risk concentration was high ahead of the October 2018 market turmoil. Today, positioning seems safer as exposure to growth-oriented assets has been reduced. Nevertheless, uncertainty has increased, mainly driven by geopolitical tensions: higher tariffs and political instability in the UK, Iran, Hong Kong and Italy.

Back to 2016?

Overall, in our view, the current situation looks like 2016 when global growth was slowing following the Chinese downturn, raising questions about risk of a US recession and the sustainability of the economic cycle. Deflation risk was rising, mainly in Europe. Market sentiment remained fragile, led by a sharp decline in energy prices and weakness in the commodities complex. At this time, the Fed had delayed its normalisation from March to December 2016 and China had deployed stimulus to support its economy. Consequently, emerging countries recovered, followed by Europe. At the end, the global economic cycle was saved and growth continued for some years. We do not believe the current economic cycle will extend by several years. Nevertheless, we estimate that the concerns about upcoming recession triggered by the inverted yield curve in some countries are overstated and overestimate the risk of economic downturn in the short term. Therefore, we continue to overweight risky assets with some hedges rather than cut the overall risk of the portfolio by increasing cash exposure.

Welcome to the "Great Japanisation"

Since the financial crisis, we have been in a 'new normal' era, called 'secular stagnation[1]'. Although the causes are a source of debate, the current environment is characterised by low global growth and muted inflation pressure with rising deflation risk in some developed countries. Japan has experienced this economic context for more than twenty years. Over the period (2000-2019), the Barclays Global Aggregate Japan index has delivered an annualised performance of 2% with a 2.2% realised volatility, more attractive than Japanese equities that delivered higher annualised performance (2.9%) but with much higher risk (19% realised volatility). One lesson we should learn from Japan in order to be ready for the 'Great Japanisation' is that, despite very low or negative yields, the total return performance of sovereign bonds has remained positive and provided an attractive Sharpe ratio. This could be counterintuitive but helpful to know to avoid being "lost in translation" in the future and in uncharted territory.

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[1] Larry Summers, "The Age of Secular Stagnation : What it is and What to do about it » Foreign Affairs 2016

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