PACIFIC ASSET MANAGEMENT | MULTI ASSET ACCUMULATOR RANGE

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2018 Global Investment Outlook

4th quarter insights

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Global markets have taken a sudden lurch down, with both bond and equity markets falling in tandem. Although the recent fall has been sudden, last quarter we identified three risks that have been building over the last six months.

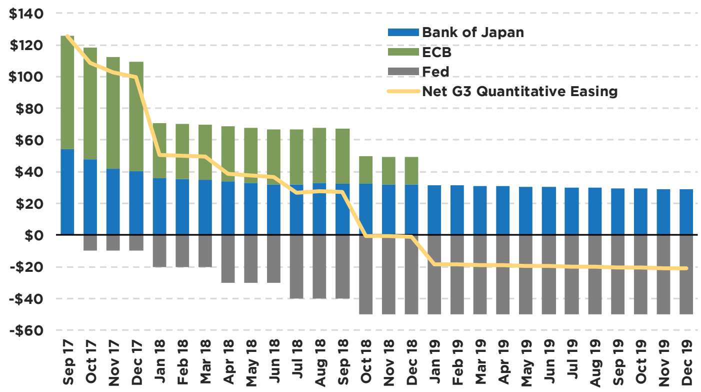
What are the risks to markets?

- Firstly, Central banks have been responding to falling unemployment with tighter monetary policy.
- Secondly, higher bond yields make equity markets look less attractive relative to bonds.
- Finally, trade wars have started to take their toll on economic growth and investors and companies are now acknowledging that the US is not immune to the fallout.

Quantitative Tightening

For most of the last decade, markets moved to the beat of the central banks' drum. Quantitative easing pushed down government bond yields and forced investors into riskier assets to achieve the returns they used to enjoy from cash and government bonds. This pushed down the yields of riskier bonds and pushed up valuations of equity markets. Quantitative Easing started in the US and UK in 2009, followed by Japan in 2010 and Europe in 2015. But since 2016, this tailwind for markets has been fading. This year, there will be $1.2 trillion less QE globally than there was two years ago; October is the first month where there will be no net purchases of bonds by central banks and by January we are likely to find ourselves in an environment of global quantitative tightening.

Net Asset Purchases by Federal Reserve, European Central Bank and Bank of Japan



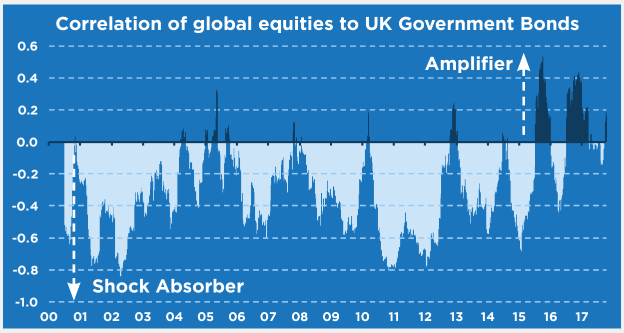
Source: Bloomberg as at 15 October 2018

The net result is that the market must adjust to tightening liquidity conditions rather than an environment of abundant liquidity. The tax cuts in the US have poured petrol onto the fire by boosting growth when unemployment is at a 50-year low. This has allowed Trump to brag about the strength of the US economy, but the risks are that if inflation picks up, the Federal Reserve will need to raise rates higher and faster, thereby slamming on the breaks for the economy. Indeed, the recent sell off started with Fed Chair Jerome Powell stating that the central bank is a "long way" from a neutral level of interest rates, causing President Trump to describe the Fed as "out of control" as he blamed it for the fall in markets.

Portfolio positioning

Bonds – Shock absorbers no more?

We have feared that a key risk to multi-asset funds was a market in which both bonds and equities fell together. For the last twenty years, when equity markets fell, government bonds rose, providing a shock absorber to a multi-asset portfolio. This negative correlation allowed multi-asset investors to hold more in equities than they otherwise would. As the chart below shows, this negative correlation is starting to fade and more recently there have been episodes where both equities and bonds fell together. We saw this in January and again recently when strong US economic data, as well as hawkish comments from central bankers caused bonds and equities to fall together. In this environment, rather than being a shock absorber, government bonds can actually act as an amplifier of losses.

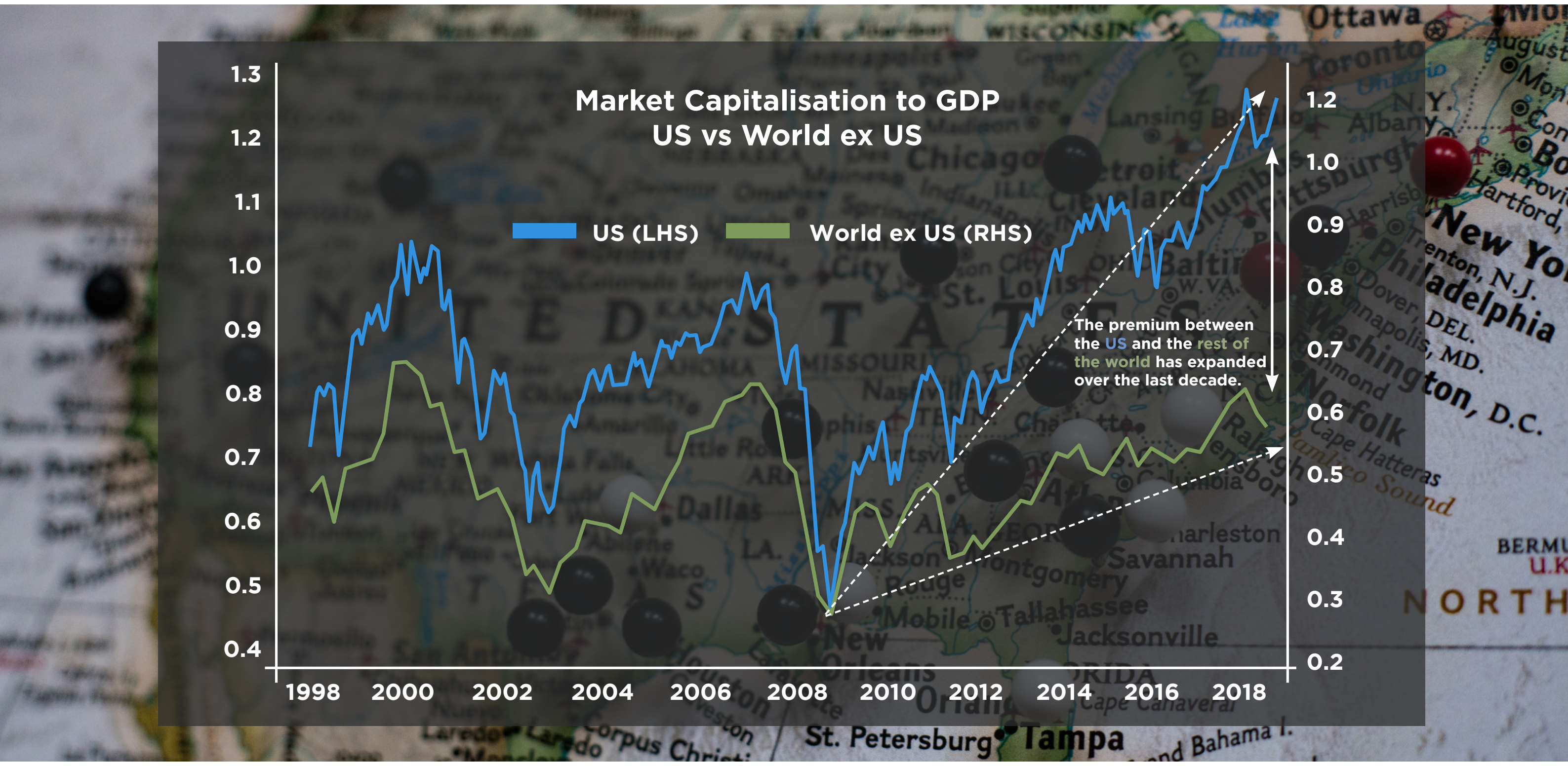


Source: Bloomberg as at 15 October 2018

Given this potential shift and historically low government bond yields, we have a large allocation to short dated investment grade bonds which have very low sensitivity to rising bond yields. Within equity markets, low interest rates have pushed up the valuations of growth stocks to levels where any disappointment in earnings is met with a sharp fall. Even without a profit warning, higher interest rates make future earnings less valuable. As a result, we have limited our exposure to growth stocks which are expensive relative to their own history and show signs of exuberance: internet commerce stocks doubled in the two years to July. Our focus is on value stocks which are trading at wide discounts to the rest of the market, offering a significant margin of safety. These stocks have held up well in the recent market sell-off.

Valuations – Buffett's Favourite Metric

America accounts for one quarter of global GDP and yet its stock market makes up more than half of the world's market capitalisation. The chart below shows what Warren Buffett has described this as his favourite valuation metric: the ratio of market capitalisation to GDP. Here we compare the US stock market to US GDP with the same measure for the developed world excluding the US. **The US stock market has typically traded at a premium to the rest of the world but what is notable is how much that premium has expanded over the last decade.** We think this leaves it most vulnerable to shocks – either from an economic downturn or a market event such as a surge in government bond yields.



Source: Ned Davis Research

China Trade Wars

Over the last quarter we have seen the US increase tariffs from 50bn to 250bn and threaten to impose tariffs on the full 500bn that the US imports from China. Although the market has taken some solace from the renegotiation of NAFTA with Mexico and Canada, there are increasing concerns that the trade war with China won't be resolved quickly. We think that the rivalry between the US and China, particularly over technology, is a long term phenomenon. The impact of trade disputes has already been felt by the global economy, with growth starting to slow in many parts of the world.

Conclusion

Risks have been building over the last few months as liquidity is withdrawn from global markets by central banks. The US tax stimulus, coming so late in the economic cycle when unemployment is at a 50-year low, risks pushing up bond yields, causing both equities and bonds to fall. In this environment, we have been holding significant amounts of cash. We hope to take advantage of this sell-off by putting some of this dry powder to work over the coming weeks.

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