A Very Simplified Market Outlook 2019 2H

Economic outlook

Growth is slowing. After ten years of expansion, it is to be expected that the global economy should slow down. The slowdown is very tangible in Europe, is evident in China and rest of Asia, and in the US is showing early but significant signs.

The Trade War is a drag on growth. 10 years ago, trade between China and the US began to decline as a share of the economy. This was a) a conscious effort by China to reduce its dependence on exports, and b) a reversal of US trade policy to outsource production. In 2018, President Trump escalated this trade war using tariffs, which are very blunt instruments and are paid by the aggressor nation's people.

Central banks are in expansion mode. Balancing these growth reducing factors is a U-turn in Fed policy. Until October 2018, the Fed was raising interest rates and shrinking its balance sheet. Since then it has paused and there is talk of rate cuts. Two years ago the ECB signaled raising rates in the summer of 2019. Given the weakness in the European economy, it is doubtful if the ECB can raise rates at all and will more likely have to start QE again (via the LTRO). The Chinese central bank, the PBOC is also loosening to try to boost growth.

Credit spreads are tight. Contrary to popular opinion, the corporate sector has not increased its leverage or borrowings out of hand. The bulk of the credit creation has been in the government sector. While corporate indebtedness has risen in the past decade, they remain below pre 2007 crisis levels. In particular the banking system has reduced its leverage and

maintains healthy balance sheets. Credit quality, despite some deterioration in the past few years, remains good. It is valuations that are the issue.

Market Outlook

Equity markets are rising because central banks are cutting rates, not because earnings are accelerating. If earnings slow and markets remain high it means equities are getting more expensive. In the past decade, earnings have been supported by cost cutting and rationalization. Growth cannot be sustained by making less investment and businesses smaller. Be cautious investing in equities.

Bond markets have been supported by the same loose central bank policy. Tactically, buying duration may seem attractive. However, duration (sovereign bonds) is volatile and central banks have used all their tools to support the market.

Within the bond market, *corporate bonds offer the least value* and the most volatility as they are most easily bought and sold by retail investors. This is especially true of the investment grade market, and to a lesser extent the high yield market.

Amid the noise of central bank policy, the *mortgage bond market is interesting and more rationally priced*. On a relative basis, commercial mortgages are more expensive than residential mortgages. Also, household balance sheets look healthier than corporate balance sheets which also favours residential over commercial mortgages.

Loans are the senior most debt issued by companies and because their coupons are floating, they also have no interest rate risk. Central bank policy has shifted investors' interest away from loans to bonds and as a result there is good value in the loan market. Leveraged loans yield on average 3 month LIBOR + 4.5% and have a default rate of about 1.3%.

Bank perpetuals are attractive, especially in Europe. This may seem to be a niche market but banks are one of the largest and most important sectors in the economy. Up until 2008, banks were lightly regulated leading to all sorts of problems. Since then, banks have been tightly regulated, required to raise more capital and make their balance sheets safer. The logical strategy therefore is to buy the riskiest securities ranking just above equity in safety (since capital raising leads to equity dilution).

FX is the most difficult asset class to call. Whereas once FX was driven quite loosely by two competing theories (higher interest rates = stronger currency versus higher interest rates = weaker currency), today FX is driven by politics and central bank policy. Yet FX has important implications for investing. Emerging markets like a weak USD. If you think the USD will be strong, you cannot simultaneously favour emerging markets. In this era of FX inflexion, a good policy is to be hedged all the time. Putting the fundamentals of the economy aside, since they seem to have weak predictive power over FX, the psychology of investors is a reasonable guide. Europe faces much political instability and an inefficient single currency system. Only Europeans would keep EUR and they might keep other currencies as diversifiers. JPY has negative rates and a huge national debt. JPY can look like a haven currency and negatively correlate with markets because it is a funding currency but it is not a haven. That leaves USD. Americans will keep USD but so will Europeans and Asians. What about CNY (CNH)? This could be the reserve currency of the future if China keeps opening up its economy and builds bridges instead of walls, like America. CNY is weak today due to a slowing economy but if China opens it capital account, it will one day reflect the economic fundamentals of the Chinese economy, which are strong.

Strategy:

I am cautious because

a) it has been 10 years of growth and the business cycle is at a turning point,

b) sovereign balance sheets are not very strong anywhere in the world,

c) central bank policy is mostly fully deployed (except for the Fed) and there is not much room for further QE, and;

d) most assets are expensive, especially large liquid markets but also private markets like private credit and private equity.

- Cash is one solution but it is a poor one as inflation risk is rising as countries turn to fiscal policy. Market timing is also a losing game over time. It is better to be fully invested but to choose the risk exposures more carefully and to be LESS diversified. If general conditions are not so good, being more diversified means you guarantee you will earn the average just when the average is poor.
- Loans are attractive as they are the senior most corporate claim, and are often first if not second lien. They are also zero duration assets and are insensitive to interest rates rising or falling.
- Bank perpetuals are good value but market prices are volatile. We will take advantage of that volatility to buy them and as we are long term investors, tolerate the volatility when we hold them.
- US mortgages are stable as despite the slowdown, jobs are growing and wages are stable. Mortgages are getting expensive in some areas so we have to be selective.
- The Euro yield curve is still relatively steep and buying duration on a FX hedged basis is attractive. The Euro investment grade term structure is also steep and buying long maturity investment grade is attractive.
- The USD yield curve is flat but there is a steepening trade in the 5 and 30 year sector. In USD corporate

bonds there is no value and low exposure is warranted.

- Equities are expensive globally and we would be underweight generally unless we had a real reason to be invested.
- Banks are cheap and growth is stable, however, the market is not recognizing the value. A slow accumulation at lower levels across US and European banks is recommended.
- Healthcare has underperformed this year and is good value. The longevity theme is a long term one and we will use this period of underperformance to accumulate exposure.
- Luxury brands is a niche market but an attractive one. The issue here is that brand leadership rotates and active management is important.
- Tech has been the best performing sector in the last 10 years. Banks outperformed from 2000 – 2008 when they were lightly regulated and underperformed from 2008 to 2019 as they were heavily regulated. The fate of tech lies in regulation. It has begun in Europe. If the US also begins to regulate tech, the sector could begin a multi-year underperformance.
- Private equity, credit and real estate: The liquidity premium has shrunk across illiquid markets as too much money has gone in search of a home. We would reduce the pace of investing in anything illiquid for now. The time for illiquid investments is just during (if you are brave) or just after, a recession. We haven't had a recession in 10 years. There are pockets of opportunity or potential we see:
    - Tokyo real estate, specifically office and hotels.
    - London is not yet an opportunity but if there is a Hard Brexit, a London prime office asset could become a bargain.
    - SME lending in frontier markets struggling with Basel banking regulations. This has impact implications for employment and development.

- Non-performing loans in China. The PBOC and CBIRC are cleaning house and banks have begun selling NPLs. The usual approach of sweeping the NPLs under the AMC carpet is longer acceptable to the regulators.
- India’s 2017 bankruptcy code (which is liquidation and not reorganization) creates a gap for a private reorganization solution.
- Financial inclusion. This is related to banking regulation. Banking regulation while making banks stronger is choking the provision of credit to small and medium businesses. Trade finance and other small scale commercial lending activities can become attractive as banks exit from the business.