A member of Prudential plc (UK)

2019 MARKET OUTLOOK

AN INTERVIEW WITH COLIN GRAHAM

Colin Graham is Chief Investment Officer, Multi Asset Solutions. His team manages multi asset strategies for third party clients. Below he shares his views on how he is positioned going into 2019.

Q After 2018's volatility, what is on your radar?

Even more volatility. Volatility naturally increases either at the late stage of the business cycle or towards the end of a bull market. As we head into 2019, the still low volatility suggests we are not approaching either scenario yet. Even in October's recent selling, the 'usual' end-of-cycle indicators (i.e. increased futures activity, rising short positions, rallies at the long end of the yield curve, etc.) were notably absent.

Nevertheless, as the expansionary cycle continues, rising volatility seems inevitable not only as investors attempt to identify the end of this cycle, but also as earnings growth peaks. Debate around the re-synchronisation of global growth, forecast to be slower than in 2018, will also weigh.

Q Given this backdrop of rising volatility, is the team sticking with its overweight stance on equities and high yield bonds?

Within equities, we are only overweight US equities. The US output gap is positive, and inflation is contained. Both should provide support.

Elsewhere, we are either neutral or underweight. We would review these positions should the US dollar weaken, thus easing some of the growth challenges confronting the Emerging Markets in particular.

We currently like high yields because they are less vulnerable to rising interest rates due to their shorter duration and higher coupons. In the US, refinancing risks for high yield bonds are low and default rates are expected to edge lower to less than 2% in 2019[1]. We also like Asian high yields for their attractive valuations and higher carry.

Q Global liquidity growth is slowing as the major central banks reverse their QE programmes. The interest rate cycle is bottoming. Will shrinking liquidity growth derail financial markets?

The Federal Reserve's balance sheet tapering is a monetary issue, not to be confused with rising rates that reflect strong US growth and a positive output gap. On these grounds, any messages inherent in the resulting flatter US Treasury yield curve, which historically has signalled a recession, are unlikely to hold any unpleasant surprises. As inflation expectations are anchored, the Fed will likely raise rates gradually.

The European Central Bank (ECB) has announced its intention to stop asset purchases by the end of 2018 and keep interest rates unchanged until the second half of 2019. Thus, we do not see any significant policy changes until the new ECB President is appointed in November 2019.

In Japan, the 2% inflation target remains elusive. Therefore, the Bank of Japan is likely to keep its negative short-term interest rates at 0.1% and long-term rates moving between minus 0.2% and plus 0.2%. It will require a significant depreciation of the Japanese yen to trigger higher inflation and interest rate hikes.

In short, unless there are unexpected significant developments that warrant tighter measures, it's unlikely that shrinking liquidity will derail financial markets.

Q US inflation is not an issue now, but many fear it is creeping closer. How would this scenario impact your positioning?

While it is on our radar, the current signal is not yet flashing red; US oil production, for example, is forecast to be robust, thus capping any extended rise in oil prices. Similarly, despite recent strength in the US jobs and wages numbers, weak labour participation rates and topping house prices suggest future inflation will be contained.

While the Fed's much-looked-for inflation may be just over the horizon, the evidence is insufficiently strong to justify reducing our weighting in US high yield bonds at the moment. But of course, we are monitoring developments closely.

In a worst-case scenario, should oil prices cross USD100 per barrel, real assets – such as gold – could quickly swing into favour.

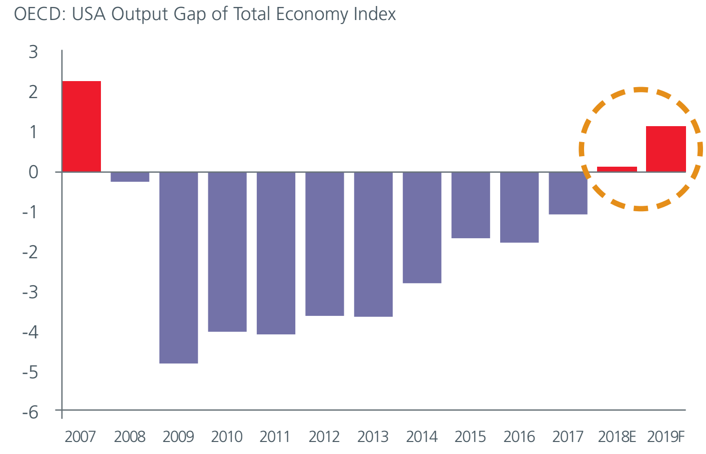
Q To what extent is the impending 'Brexit' influencing your decision to underweight European equities?

Whichever way Britain decides to leave the European Union (EU) – whether to strike a transition deal or not – will nevertheless hurt both parties because of their strong financial linkages. Higher barriers to trade, capital flows and labour mobility after Brexit will affect growth in both Britain and the remaining EU member states, rather than the global economy.

Hence, we remain underweight Europe and short the euro. In short, we are hedged against the risks associated with Brexit and Italian budget.

Any positive surprises in Europe, such as implementing fiscal stimulus as in the US, might prompt us to revisit our positioning.

US output gap turns positive in 2018[2]



Q Geopolitical fears and a stronger US dollar have driven many Emerging Market (EM) valuations to rock bottom. How far would EM valuations have to fall for you to move from a neutral to overweight positioning?

EM sentiment is still quite fragile; higher US interest rates have left those EM countries with large current account deficits more vulnerable. That said, we do expect the EM backdrop to improve as we look towards 2019. If the US dollar were to weaken, it would alleviate the selling pressure and improve momentum. This could encourage US investors seeking better returns to invest overseas, thereby narrowing the gap between US and EM equities.

Q Given that the US economic cycle could extend into 2020, what is the likelihood that US equities 'melt-up'?

In this case, the degree of 'melt up' is the question; a mini-version of the late 1990s is increasingly plausible, though it is unlikely to become as bullish or frothy as it was back then. 'Melt up' could simply mean price-to-earnings (P/E) multiples expand by a couple of points next year. Even if earnings growth does not meet the consensus (which is not unusual), equities can often rise in the face of some earnings downgrades.

We expect to see more down months in 2019, amid rising volatility, and particularly after the unprecedented streak of 15 positive months (total returns) that ended in January 2018.

In addition, investors should be aware of the new privacy rules affecting US technology companies. Such regulations, if really enforced, would inevitably impact the financial performance of many tech companies, and the US equity market.

Having said that, US equity valuations, while high, are not at extreme levels.

Q Within the developed markets, Japanese companies are registering stronger earnings and paying more dividends as corporate restructuring pays off. Yet you are neutral on the market. What would restore your interest?

The relationship between China's exports to the US and Japan's exports to China have made Japanese exports and production more susceptible to trade conflicts between China and the US. However, we believe that the best opportunities in Japan are to be found within individual stock picking. Longer term, we can see upside potential at the overall market level; and stronger Emerging Market growth – a key driver in the demand for Japan's exports – could be a catalyst for Japanese equities.

Sources: [1]ICE Data Services and Moody's data as at 30 September 2018. [2]Bloomberg, citing OECD Economic Outlook: USA Output Gap of Total Economy Index, extracted on 15 November 2018. E stands for estimate, F stands for forecast.

eastspring investments

A member of Prudential plc (UK)