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2019 MARKET OUTLOOK

AN INTERVIEW WITH KELVIN BLACKLOCK

Kelvin Blacklock, Chief Investment Officer of Global Asset Allocation, manages money for internal clients who focus on long-term asset and liability matching and management. Kelvin discusses why he likes US equities and high yield bonds. He sees the attraction for the Emerging Markets but feels it far too early to buy.

Q How has 2018 played out for you?

We started the year with a maximum risk-on position for most portfolios. These overweight positions were trimmed early in the year following a marginal deterioration in the economic fundamentals – markets typically trade on marginal changes. We are entering 2019 with a neutral allocation to risk assets.

Q Your exposure to US assets is high even though the economy is entering the late cycle stages of its extended recovery. What attracts you to this market?

The US economy is in good shape, and many of the 'traditional' indicators of a slowing economy are not present. The rise in US rates has been at a measured, well-telegraphed pace. Moreover, the US, generally, seems to be absorbing their impact easily. We expect this situation to continue into 2019 and beyond.

Corporate America has been also delivering strong profit growth. At the margin, the sustainability of this growth may get harder as the labour market is tight and wage costs could rise (although it is possible that companies overcome this constraint with more capex/automation).

On balance, it seems too early to call an end to the US corporate profit cycle.

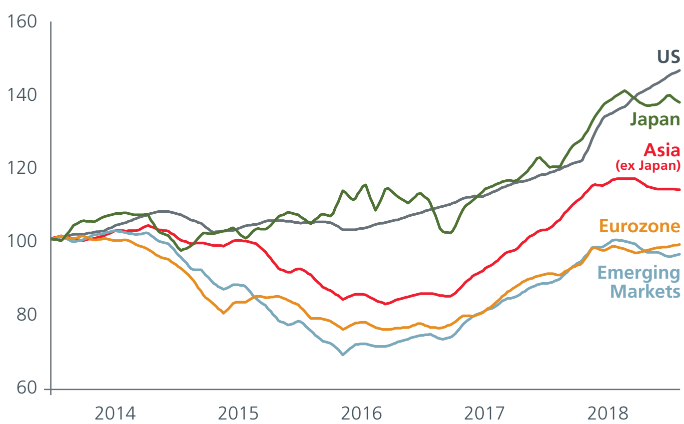
Q A strong US economy with its concomitant strong currency and rising interest rates is not necessarily good news for everyone. How are you factoring this into your investment stance?

The strong US economy, the rising dollar, and rising interest rates all combined with the consequences of the ongoing US led 'trade war' can, and will, lead to problems elsewhere.

The economies particularly exposed are those in which trade is a key growth driver and those that have relied on US dollar debt to fund growth over the past 5 years. We have already seen a visible weakening of growth and profits in many economies, notably the Emerging Markets. This will likely continue over 2019.

China, clearly a large part of this equation, is not that exposed to either US rate hikes (they largely borrow in RMB) or the trade war (trade

US equities rise on a strong profit outlook[1]



is a smaller growth contributor than it was). Nevertheless, we expect growth to slow and thus remain underweight.

When we incorporate the above into our balance-of-indicator approach to investing, the outcome remains a strong preference for US assets.

Q Pulling all these strands together, what are the implications for your portfolio construction?

Apart from the US, where the economy is generally in good shape, the fundamentals elsewhere have been notably weaker, a development that is generating increased nervousness and higher volatility.

Our base case, therefore, is that the US will probably be fine this year. But it is this very fact that will likely result in an ongoing rise in US rates, which, of course, could well be to the detriment of much of the rest of the world.

As such, we have a strong preference for US equities over both other Developed Market and Emerging Market equities. Within the bond universe, this translates into a preference for US high yield. Overall, our portfolios remain risk neutral.

Q Given their sharp 2018 falls, are Emerging Markets approaching attractive valuation levels?

Many of the factors that led to 2018's sharp falls (e.g. rising US rates etc), have yet to fully run their courses, in our opinion. We do not envisage this changing in the immediate future.

Emerging Market valuations, while cheap, need to fall much further before we would consider increasing our exposures. We would also need to see fundamental indicators (such as the Purchasing Managers' Indices) stabilise.

Q Yet you have conceded that China has many positives. Are valuations the only restraint?

While China's valuation (at the aggregate level) is not obviously cheap in the Emerging Market universe, valuation is not our only source of concern.

Consumer confidence, for example, is rolling over as are the profit growth forecasts. In the current environment, it is quite unclear how much further these could ease particularly as the potential fallout from the unprecedented trade war is posing a policy dilemma.

We remain unconvinced that policy makers have identified the correct 'balance' between their medium-term deleverage plans and short-term financial stability.

China's long-term potential cannot be ignored, but it is still too early to buy the market, in our view.

Q What is the likelihood of US inflation surprising on the upside given both late cycle and rising oil price concerns?

Having slumbered so long, one must consider the possibility that inflation could spring back to life. While we think this probability is low, the cost of getting it wrong is high.

We thus felt it prudent to add some 'insurance' to our portfolios by increasing our exposures to uncorrelated sources of risk. A concrete example is the recent increased exposure to US utilities and consumer staples. We remain overweight European bonds (where inflationary pressures remain low owing to the weak economic fundamentals) despite historically low yields.

Q You are underweight Europe. Does 'Brexit' feature in this underweight?

Several factors (including weak fundamentals) underscore our European underweight, but these factors do not include any 'Brexit' fallout. We do not envisage any tail risk per se. In addition, since the Global Financial Crisis, the rise in the equity market has far outstripped the rise in profits. One could argue that if there is a recovery, it has been discounted.

Our Eurozone concerns stretch beyond the current weak fundamentals. Many of Europe's banks, for example, have not undergone the same balance sheet restructuring undertaken by US banks since the Global Financial Crisis; they are ill-positioned to finance any recovery.

Q Japan's equities look most attractive amongst the Developed Markets, and yet you are underweight. What developments would stimulate renewed interest?

The short and simple answer would be, '2% inflation – not resulting from rising import costs'. With core inflation still hovering just above 1% (despite the best efforts of 'Abenomics'), it is apparent that Japan Inc. is having great difficulty in shaking off the deflationary pressures being exerted by an ageing population.

So overall, we prefer to overweight the US, which is more obviously supported not only by ongoing profit growth but also by a buoyant economy.

Sources: [1]MSCI Indices from Thomson Reuters Datastream as at 31 October 2018.

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