MiViews Q3 2018

UNIGESTION

Looks can be deceiving

- The overall macro picture appears similar to the first half of 2018, but upon closer inspection we believe that fundamentals have shifted, and importantly, so have the sources of risk.
- Notably, we see that the drivers of uncertainty and risk have moved from monetary policy to global trade and a rising fragility in emerging economies, hampered by US dollar strength.
- While cautious, we expect growth-oriented assets to benefit from a number of positive market developments, but look to remain well-diversified and dynamic to adjust, if needed, to these evolving risks.

Overview

Market participants often exhibit a bias to extrapolate the past to form expectations about the future, believing trends will persist. Such an exercise can be especially painful when macroeconomic momentum swings, as the business cycle will reinforce these swings due to its inherently cyclical nature. As we have previously communicated, we believe 2018 is a year of transition for the global economy. From the 'goldilocks' period that characterised much of 2017, we have shifted to a period of uncertainty, brought on by the winding down of quantitative easing (QE), rising inflation pressures and the resultant tightening of monetary policy.

As we look ahead, the overall picture looks similar to the first half of this year: global growth is positive and inflation pressures are building; but uncertainty is weighing on markets. If we dig down, however, things look quite different to us. Global growth shows signs of deceleration and the market has largely adjusted inflation expectations to bring them closer in line to the evolving macroeconomic picture. Importantly, the drivers of the uncertainty have shifted from monetary policy to global trade.

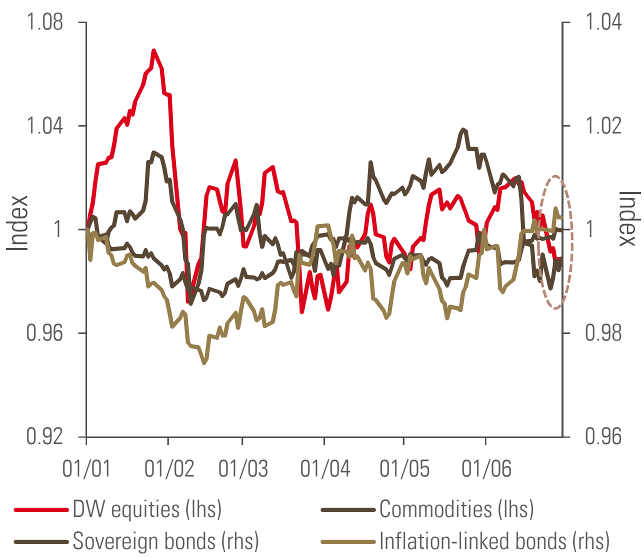
Thus, in our view, the second half of this year will see a shift in markets to the benefit of growth-oriented assets. At the same time, we cannot ignore the major sources of uncertainty and risk, especially the trade war and the health of emerging market (EM) economies. We therefore take our pro-growth view cautiously, looking to remain well-diversified and dynamic to adjust to these evolving risks.

Cutting through the noise

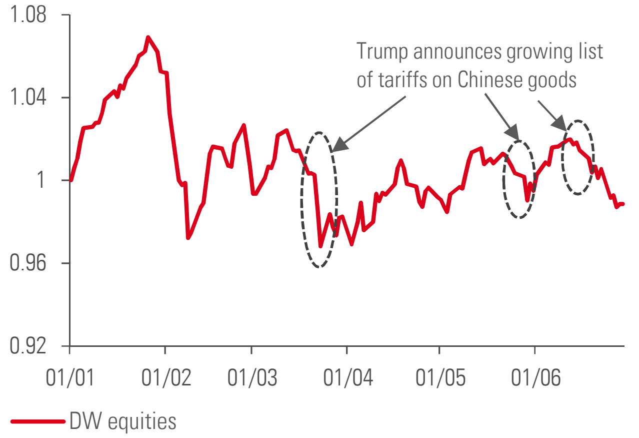
The first half of 2018 bore out the pain of extrapolation, as markets started the year continuing to discount an environment of synchronised, above-potential growth with little likelihood of an inflation surprise, until the February shock. Stirred out of their complacency, investors have largely shifted their allocations from one market to another, leading to the range-bound behaviour we observed for most of the first half of this year across assets (see Figure 1a). Geopolitical risks have ebbed and flowed throughout the year, introducing ever more uncertainty with a potential trade war brought on by US President Donald Trump ratcheting up tariffs, hitting global equities and reversing any short-term momentum (see Figure 1b).

Figure 1: Asset performance year–to-date 2018

1a: Range-bound movement across asset classes



1b: Impact of growing geopolitical risk on developed market equities



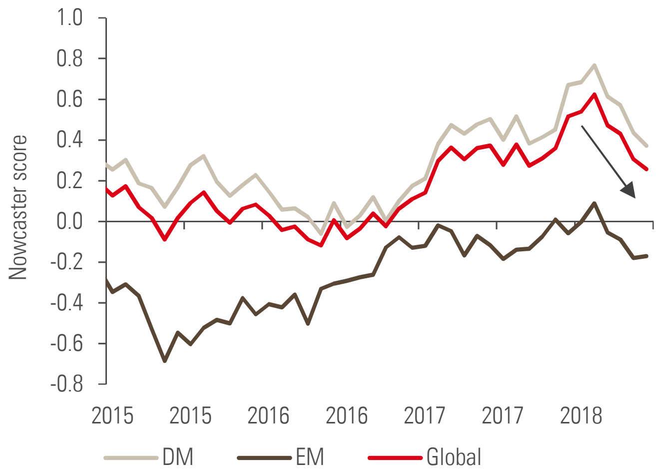
Source: Bloomberg, Unigestion calculations as at 29 June 2018. Indexed to start of 2018

Our approach to cut through the noise – and to ensure we are not simply extending the past forward – is to go to economic fundamentals. We do so by observing global economic developments via our proprietary Nowcasters, placing the dynamics we see in the broader macroeconomic and market context. While our Nowcasters that focus on an inflation surprise and market stress have not changed much over the last few months (both remain high), our World Growth Nowcaster has seen a significant fall (see Figure 2a). Although it remains elevated, signaling the global economy is growing faster than potential, there is obvious dispersion in the developed versus emerging world. Developed economies are primarily responsible for the level of global growth, as they remain growing comfortably above potential. Emerging economies, however, are now growing below potential, after having steadily marched closer to their natural rate of growth since mid-2015.

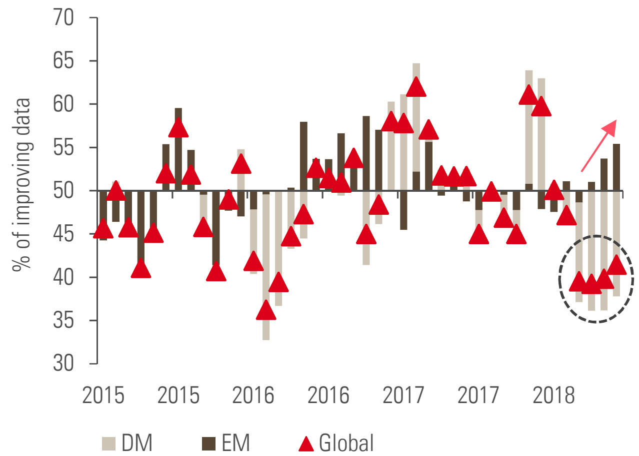
On the other hand, the Diffusion index (see Figure 2b) tells quite a different story. Whereas the trend we see in developed economies will probably continue (most economic data there is declining, although we have seen some recent improvement), growth in the emerging world is likely to recover going forward as most of their economic data is improving and the proportion that is improving has been rising steadily for the last few months. We are monitoring this closely to see if this trend in developed economies will be reinforced, or reversed.

Figure 2: Unigestion World Growth Nowcaster and Diffusion index

2a: While our World Growth Nowcaster shows DM growing well above EM …



2b: … Our corresponding World Growth Nowcaster Diffusion index indicates that this trend looks to be reversing



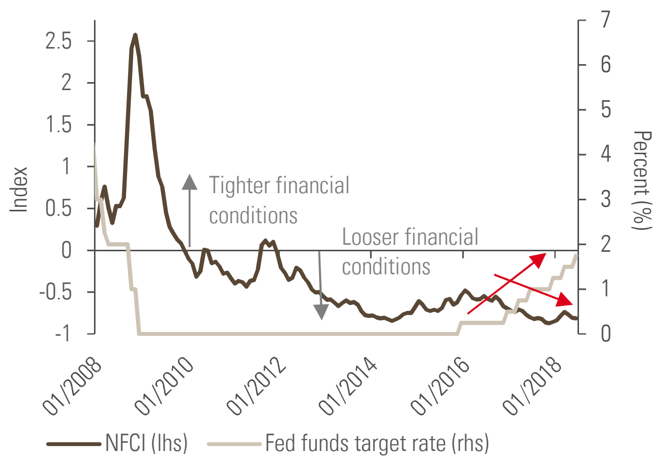
Source: Bloomberg, Unigestion calculations as at 29 June 2018. Nowcaster score is an aggregate z-score of individual components.

In our view, one of the critical risks for the global economy has largely receded: monetary policy uncertainty. Following the June meetings of the US Federal Reserve (Fed) and the European Central Bank (ECB), we now have significantly better clarity on the path of monetary tightening (or lack thereof, in the case of Europe) for the world's two largest economies for the next 12-15 months. In the US, interest rate hikes will be gradual and well communicated. While we expect inflation to more likely surprise to the upside than downside, we do not expect it to derail the Fed's policy path. In Europe, easy monetary policy will likely continue until at least September 2019 as the ECB has no plans to raise interest rates before then. Although net asset purchases are expected to finish at the end of 2018, payments from maturing securities will be reinvested for as long as is needed to "maintain favourable liquidity conditions and an ample degree of monetary accommodation," according to the ECB.

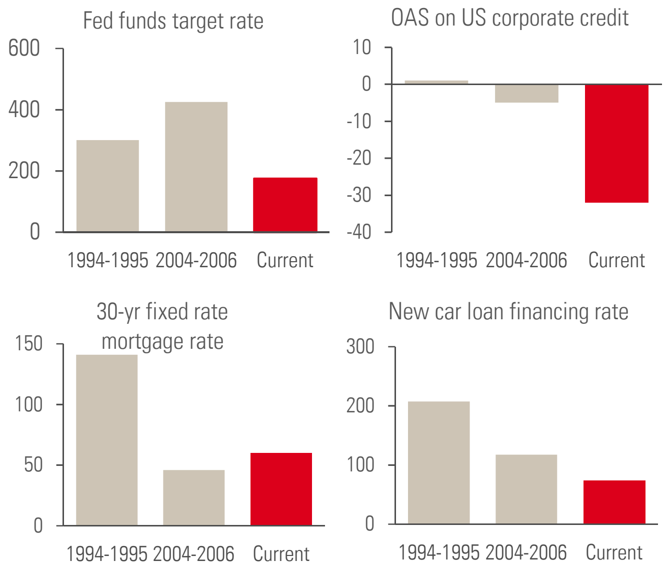
Taken together, it seems to us that liquidity to the real economy remains quite healthy and will not see any significant contraction in the short to medium term. This should support global growth. Indeed, when we look at the US, where monetary normalisation is furthest along, we see that financial conditions, despite rising interest rates, are still quite favourable, especially when compared to previous tightening cycles (see Figure 3).

Figure 3: Financial conditions in the US remain easy

Historical US financial conditions (March 2008 – June 2018)



Changes during periods of Fed tightening (in basis points)



Source: Bloomberg, US Federal Reserve, Unigestion calculations as at 30 June 2018; NFCI: National Financial Conditions Index, which provides a comprehensive weekly Fed update on U.S. financial conditions in money markets, debt and equity markets and the traditional and "shadow" banking systems. OAS: option-adjusted spread

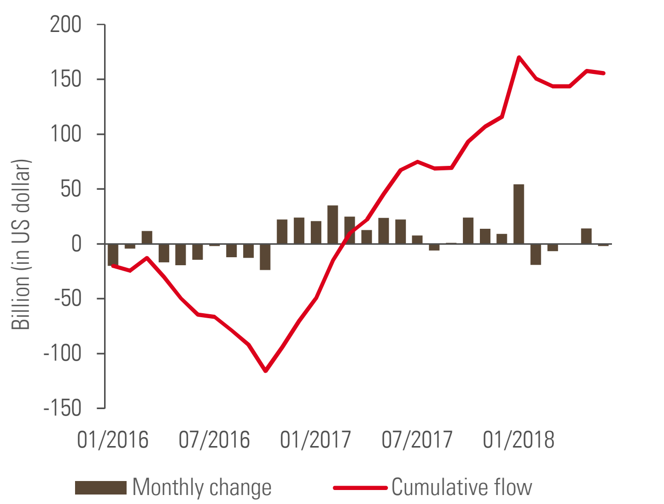
The second half of 2018 looks better to us

Given the current macro backdrop, we have a more positive view on growth-oriented assets looking ahead:

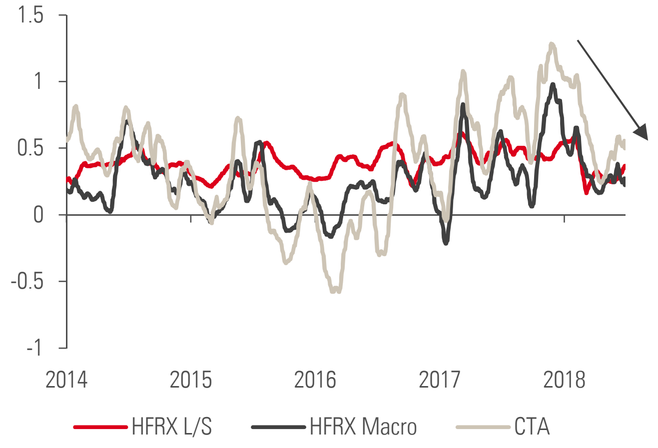
- As mentioned above, global growth remains above potential and, while its deceleration is concerning, our baseline view - although cautious - remains for growth to be supportive for the global economy.
- Inflation pressures are building, but after the market adjusted its expectations over 2018 to bring them closer in line to the macro picture, we believe any further surprises will be modest.
- Two of the key providers of global liquidity – the ECB and Bank of Japan – remain fairly accommodative, and the Fed's tightening will likely be gradual, telegraphed and responsive to economic conditions.
- Positioning is favourable, as multiple measures point to investors having stabilised or reduced their exposure to mutual funds and ETFs year-to-date (YTD) 2018 (see Figure 4)
- Equity valuations, while still high from a cyclical perspective, have retraced since the start of the year and are broadly back to their levels as at the end of 2016 according to our calculations (as at 30 June 2018).

Figure 4: Equity positioning

Flows into equity mutual funds and ETFs



Implied equity beta of investment funds



Source: Bloomberg, Investment Company Institute (ICI), Unigestion calculations as at 6 July 2018; June 2018 equity flow data based on weekly estimates): For the most up-to-date figures about the fund industry, please visit ICI at www.ici.org/research/stats.

We have a positive outlook for growth-oriented assets …

However, there is dispersion in our assessment of global markets, reflecting the dispersion we see in the macroeconomic fundamentals, monetary policy and pricing of each of these markets. We continue to keep a keen eye on diversification, and our views, although cautious, are consistent with a positive outlook for growth-oriented assets.

- **Nominal bonds:** Given the low yields across many markets, rising inflation pressures and a slow move towards global monetary policy normalisation, the risks certainly look to the downside for sovereign bond pricing. Our expectation is for yields on 10-year government bonds to end 2018 higher across the major economies. Notably, besides the US, the current low level of yields offers limited protection against market turmoil. In our view, finding diversification via other assets will be key for the rest of 2018.
- **Breakeven inflation:** Although the market has adjusted up its inflation expectations, we still believe there is a strong likelihood that inflation will surprise even further, especially given the dovishness of the ECB. Thus, we will remain overweight breakevens until the market reprices further.
- **Equities:** Our baseline scenario is for global equities to broadly rally over the second half of 2018. However, there are three important points worth mentioning:
  1. The US-led trade war could escalate further, and while pockets of the market most exposed to it have adjusted their pricing to a significant escalation, the broader equity market has not.
  2. Though EM equity valuations have become attractive after the extended decline starting in February of this year, there are significant headwinds facing EM corporates. Hence, we are taking a cautious view on EM and prefer DM.
  3. Given our read on inflation and stress in the market, we are applying adequate hedges to our equities exposure.
- **Corporate credit:** One example of such hedges is in corporate credit, where we also expect to see first the impact of a shift from easy to tighter financial conditions. Importantly, valuation is key, as there has been a meaningful divergence between investment grade (IG) and high yield (HY) spreads: IG spreads are up about 25 basis points (bps) on the year, but HY spreads are up closer to 80 bps. Given this pricing, we believe an underweight in IG corporate credit provides a good hedge to our baseline scenario, whereas we take a positive view on HY credit.
- **Currencies:** While the US dollar faces secular headwinds from a prolonged current account deficit, declining potential growth and a shift in the composition of foreign exchange reserves, it has rallied since April this year. The rally drew support from monetary policy divergences, a strong US growth picture and idiosyncratic factors (such as political uncertainty in Europe, the UK and some EM countries). While we expect the greenback to stay strong in the second half 2018, the current positioning among investors has reduced the risk-reward trade-off of a broad long US dollar position. Rather, we will be looking at individual pairs to find attractive risk-reward profiles.

… But we see the trade war and EM fragility at the forefront for uncertainty and risk

In our view, the possibility of an escalating global trade war represents the most impactful source of uncertainty for the coming months. From statements made by various heads of state, it seems that such a trade war would be bilateral, with the US taking on perceived economic enemies as well as allies, and not a multilateral war where trade barriers rise between many countries. Nonetheless, a bilateral trade war with the world's largest economy taking aim at the next two largest economies (Europe and China) would certainly entangle other nations, given the breadth and depth of the global supply chain

So, what is the likelihood of an escalating trade war?

If you had asked us last quarter, we would have said the likelihood of a real escalation was low and that most of the noise was just that, noise. However, the last few months have seen the White House shift to a more bellicose tone, which has been met in kind by other world leaders. This change in tone is reflective of the rise and fall of particular advisors to Trump (see Figure 5), with more pragmatic, moderate voices, such as former Director of the National Economic Council Gary Cohn, having left the administration or lost influence.

Figure 5: Voices on international trade in the Trump administration

Name	Position	Notes
Wilbur Ross	Secretary of Commerce	Officially recommended steel and aluminum tariffs to Trump as head of Commerce Department
Steven Mnuchin	Secretary of the Treasury	Considered more moderate among the administration, nonetheless pushed G20 to remove language opposing protectionism in their official March 2018 statement
Peter Navarro	Director of the National Trade Council	Author of "*Death by China*", highly critical of German and Chinese trade and currency policies, has advocated for high tariffs and repatriating global supply chains, influence has grown significantly since February this year
Larry Kudlow	Director of the National Economic Council (NEC)	Formerly supported free trade, but after his appointment has become an advocate for Trump's protectionist policies, considered a 'placater'
Gary Cohn	Former Director of the NEC	Strong supporter of global trade, resigned after Trump rejected his attempts to stop steel and aluminum tariffs
Rob Porter	Former Staff Secretary	Was responsible for trade policy meetings and processes, resigned following domestic abuse claims leaving vacuum of policy coordination

Source: New York Times, Politico

Such a game of 'palace intrigue' does not bode well for de-escalation – but there are political pressures we believe will restrain the warmongering voices coming from the White House:

- Implemented tariffs are now starting to hit, and high profile firms, such as GM and Harley Davidson, have spoken in clear tones about the negative impact of these and potential new tariffs on US companies and jobs. Surveys on forward-looking business sentiment have also meaningfully declined over recent months.
- Retaliatory tariffs are surgically aimed at Trump's base, and would make an abstract trade war very real for his supporters.
- US mid-term elections are approaching in November 2018, and most Americans do not support these protectionist policies: recent polls show only about 25% of Americans support imposing tariffs (Politico/Morning Consult poll conducted from 31 May to 4 June 2018, CNN/SSRS poll conducted from 14-17 June 2018).

Overall, we believe the political realities will likely prevent a meaningful escalation of the trade war. But given that Trump himself is not up for re-election, his predilection for confrontation instead of compromise and the desire of ideologues in his inner circle for escalation, we cannot discount this risk.

What would be the impact of a meaningful trade war escalation on financial markets?

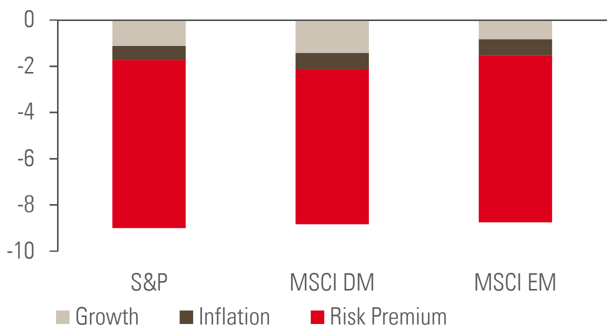
We estimate that the direct cost of the US implementing a 10% tariff on all imports (a significant increase of the 1.6% total for announced tariffs), and other countries responding in kind, would be roughly a 0.23% loss to global real GDP over two years. We would also expect higher inflation as input costs rise and are eventually passed on to consumers, estimating the impact to be about 0.15% on the consumer price index (CPI). Of course, depending on the response by central banks to such a rise in global prices, growth may be further hampered by additional monetary policy tightening.

Taking the direct impact of a contraction in real GDP and a rise in inflation, we expect such a shock to macro fundamentals would reduce global equity prices by about 2%. However, if we consider historical cases, where there was an exogenous shock similar to a tariff hike such as the Smoot-Hawley Tariff Act of 1930 (which raised tariffs 20%) and the oil shocks of 1979 and 1990, we estimate an expansion in the equity risk premium would cut another roughly 7% from equity prices. In combination, this would represent a toll loss of 9% (see Figure 6a).

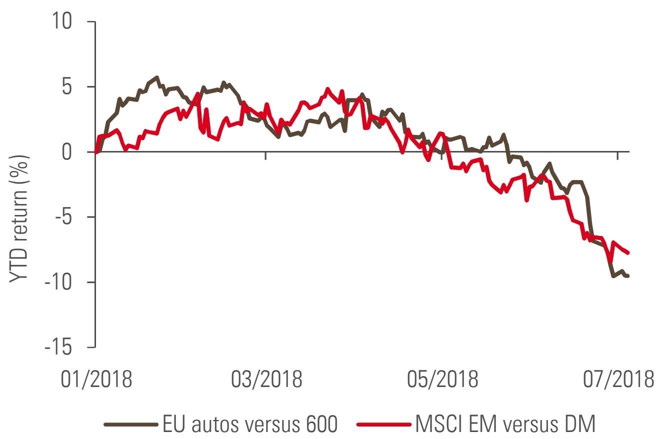
Thus far, it seems to us that the parts of the market that would be most affected by the tariffs have roughly priced in such an event (see Figure 6b). However, bear in mind this is quite a significant escalation, and not our baseline. This would suggest that, so long as the trade war does not spiral out of control, parts of the market have actually over corrected.

Figure 6: The impact of a significant escalation of the trade war and current market pricing

6a: Impact of trade war on equities (in %)



6b: Tariffs have already been roughly priced in by affected segments of the market (in %)



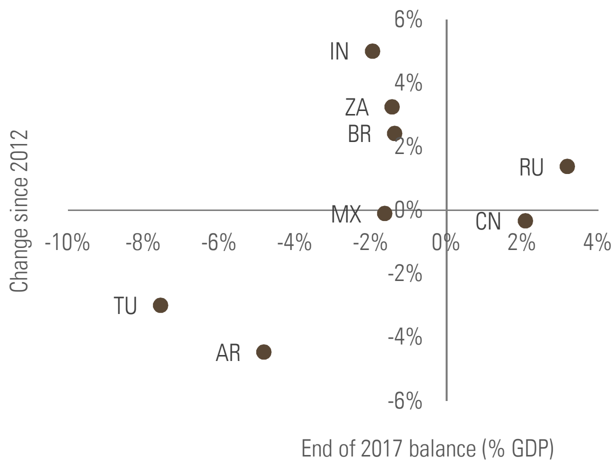
Sources: Bloomberg, Unigestion calculations as at 2 July 2018

We should mention that our estimates are based on a stylised model and do not account for the myriad intricacies of the global economy, including other potential actions such as currency devaluation or selling of US Treasuries on the part of China. We also look at the aggregate picture, which belies pockets of stress for particular regions and industries that will disproportionately bear the brunt of protectionist measures. The secondary impacts from these micro effects can be large and difficult to quantify. For example, if we consider towns heavily focused on soybean farming, what would a contraction of that industry mean for those industries that service soybean farmers? These complex dynamics add yet another layer of uncertainty on top of the political machinations.

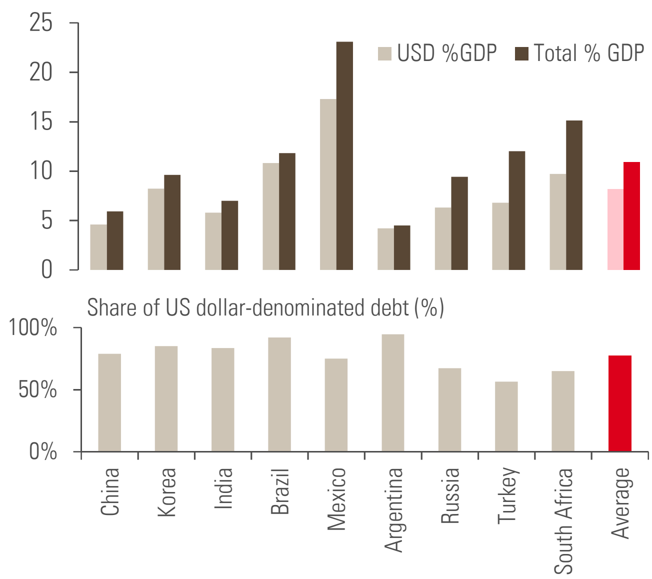
Beyond the adverse impact of an escalating global trade war on EM countries, which rely on their place in the global supply chain, many have left themselves vulnerable to a stronger US dollar. Following the taper tantrum of 2013, some have improved their current account balances, but most remain in deficit (see Figure 7a). They are thus reliant on external financing, with most of the debt financing denominated in US dollar, to support their domestic economies (see Figure 7b). Thus, if the US dollar continues to rally against EM currencies, which certainly seems plausible given rising US yields and the earnings picture of US corporates, a balance of payments crisis could be on the cards.

Figure 7: EM economies are vulnerable to a rising US dollar

7a: Current account balance and change



7b: Non-financial private external debt (as of Q4 2017)



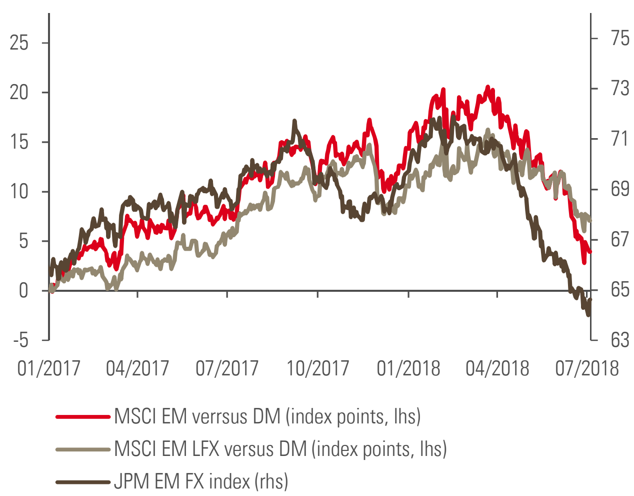
Source: Bloomberg, International Monetary Fund (IMF), JP Morgan, Unigestion calculations as at 30 June 2018

In such a scenario, we would expect to first see local EM currencies weakening significantly against the US dollar, as external investors pull back on their funding the current account deficit. In response, EM central banks would start selling reserves to support their currency. As this is a finite resource and does not encourage investors to reverse their outflows, central banks would eventually be forced to raise interest rates in order to constrain demand for imports as well as attract investors looking for yield. The domestic economy would contract, and equities would suffer, even in local currency terms.

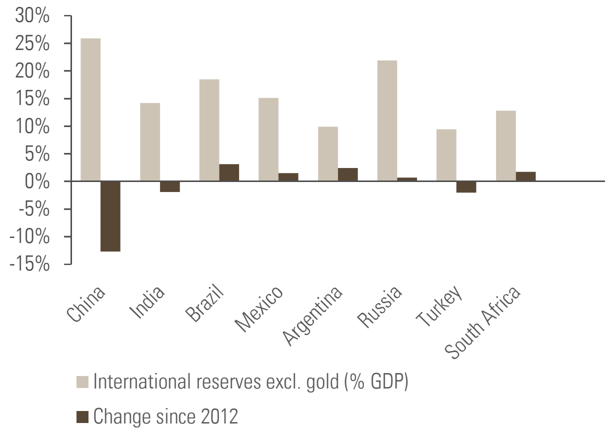
We have already seen the first salvo of this dynamic, as EM currencies have weakened against the US dollar over the second quarter this year and brought down EM equities, even in local currency terms (see Figure 8a). While central bank reserves in the EM are healthy (see Figure 8b), their selling is essentially a temporary measure and cannot stem the loss of external financing. Though we think EM central banks have enough ammunition to deal with a moderate balance of payments crisis and global liquidity remains healthy, we cannot ignore the precarious position EM economies find themselves in, especially in the context of the trade war. This motivates our neutral stance on EM equities and preference for DM equities to express our pro-growth assets view.

Figure 8: First signs of EM stress visible in foreign exchange and equities, though central bank reserves are healthy

8a: Impact of US dollar strength on EM equities



8b: Central bank reserves across EM



Source: Bloomberg, IMF, Unigestion calculations as at 4 July 2018; LFX: return in local currencies

Conclusion

Shaking off the range-bound behaviour we have seen in financial markets this year so far and taking a fresh look at the macro fundamentals and pricing, we believe there is positive upside for growth-oriented assets to outperform over the rest of 2018. We would be kidding ourselves if we ignored the US-led trade war and the fragility of EM economies in the face of a rising US dollar. But we think it is better to hedge these risks via asset allocation to ensure diversification or to apply dynamic risk management via optional strategies that improve convexity, as they are not part of our baseline scenario.

Our key message for the rest of 2018 is quite simple: do not rely on the past six months as a guide for the next six. The fundamentals have shifted, and importantly, the sources of risk as well.

Important information

Past performance is no guide to the future, the value of investments can **fall** as well as rise, there is **no guarantee** that your initial investment will be returned.

This document has been prepared for your information only and **must not** be distributed, published, reproduced or disclosed by recipients to any other person.

This is a promotional statement of our investment philosophy and services **only in relation** to the subject matter of this presentation. It constitutes **neither** investment advice nor recommendation. This document represents **no** offer, solicitation or suggestion of suitability to subscribe in the investment vehicles it refers to. Please contact your professional adviser/consultant **before** making an investment decision.

Where possible we aim to disclose the material risks pertinent to this document, and as such these should be noted on the individual document pages. A complete list of all the applicable risks can be found in the **Fund prospectus**.

Some of the investment strategies described or alluded to herein may be construed as **high risk** and **not readily realisable investments**, which may experience **substantial and sudden losses** including **total loss** of investment. These are **not suitable** for all types of investors. To the extent that this report contains statements about the future, such statements are forward-looking and subject to a number of risks and uncertainties, including, but not limited to, the impact of competitive products, market acceptance risks and other risks. As such, forward looking statements **should not be relied upon** for future returns.

Data and graphical information herein are for information only and may have been derived from third party sources. Unigestion takes reasonable steps to verify, but does not guarantee, the accuracy and completeness of this information. As a result, no representation or warranty, expressed or implied, is or will be made by Unigestion in this respect and no responsibility or liability is or will be accepted. All information provided here is **subject to change without notice**. It should **only be considered current** as of the date of publication without regard to the date on which you may access the information. Rates of exchange may cause the value of investments to go up or down. An investment with Unigestion, like all investments, contains risks, including **total loss** for the investor.

Document issued on: 23.07.2018