

Central banks can sustain markets into 2020

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Despite the unwavering commitment from central banks to continue injecting cash into the financial system, investors are worried. The latest IMF report shows global economic growth has fallen to its slowest pace since the financial crisis – evoking ghosts of recessions past.



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While there are legitimate reasons for concern around the fate of the global economy, we believe the time has not yet come for investors to reduce massively their exposure to risky assets, as long as central bank policies are still providing liquidity. Nevertheless, it will be imperative to closely monitor the marginal impact of accommodative programmes to be adequately prepared for the next downturn. By being fully invested into equity markets in periods of lower rates, investors can benefit from lower borrowing costs for businesses, which boost corporate profits. However, the unprecedented length of the current easing cycle has raised fears that the effectiveness of such policies is waning – thereby pushing investors into safe-haven assets, such as government bonds.

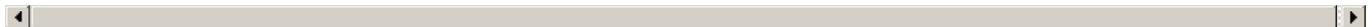
Embrace accommodation

2019 was expected to be a year of monetary tightening but turned into yet another year of accommodation – with the European Central Bank embarking on ‘infinite’ quantitative easing and the US Federal Reserve cutting rates three times. In the lead up to the 2020 presidential election, the US Federal Reserve might adopt more of a wait-and-see approach, with any further accommodative stance seen as supporting a Trump mandate. Still, central banks are locked into current easing measures for the near term.

Moreover, we believe Japan-style low growth and low inflation are here to stay, supporting the case for looser monetary policy. Only extraordinary growth conditions could trigger a sharp rise in inflation – a scenario we estimate at a 5% probability, as structural limitations to growth, such as ageing demographics, persist across the developed world.

However, investors are worried about the price distortions that high levels of intervention are creating, inflating assets across the board. Since the 2008 financial crisis, QE has gone from playing a crucial role in relaunching the economy to providing short-term boosts to market sentiment. While this may contribute to inflating asset prices, investors must recognise that the effects of such support might be limited in time.

Despite an abundance of geopolitical risks, such as Brexit and the US-China trade war, central banks have managed to keep equities rallying – with the decade-long US bull market showing no signs of slowing. Therefore, now is not the time to fight the Fed. The time will come when the impact of central bank policies has noticeably diminished.



Time for fiscal spending

Central banks are not almighty, and in the context of an upcoming downturn, they need to be mindful of maintaining enough ammunition for such a scenario. Given these considerations, pressures are mounting on governments for a fiscal response to alleviate investor anxieties and ease the pressure on central banks. In its latest report, the OECD has urged governments to rethink fiscal policy.

As Germany was very close to a “technical” recession this year, the government is considering a shadow budget to circumvent the strict ‘debt brake’, which prevents borrowing in excess of 0.35% of GDP. This would allow the country to take on debt beyond the €5bn allotted for next year in order to modernise its economy, which is heavily reliant on traditional industry or ‘economies of the past’.

A common fiscal policy for the Eurozone has also been envisaged for some time. We believe a clear policy which acknowledges the relative strengths of the constituent countries would ensure the stability of the region and make for more effective stimulus.

Balance is key

In the meantime, to take advantage of looser monetary conditions, we are targeting a high growth exposure alongside key protection measures to balance downside risk protection with upside risk participation.

We have slightly increased our allocation to equities and to Europe, as macro conditions have improved for the region. Nevertheless, we are mindful of complex sector dynamics which make stock picking tricky. While European banks are trading at attractive valuations, the market lacks 'new economy' sectors driving innovation and technology – in contrast to the US, very few big-name tech firms stand out in Europe.

In addition to equities, our portfolios are invested in bonds in a context where we consider that long-term rates will remain lower for longer. Therefore we have implemented the following barbell approach: at the short end of the yield curve we think that emerging market and high yield credit should offer reasonable returns to both euro and dollar denominated investors. High yield credit remains of course an interesting source of returns since default rates won't go up sharply as macro conditions are no longer deteriorating. At the longer end of the curve, it makes sense to have US dollar and Euro-denominated sovereign bonds in ten-year plus maturities in order to keep a hedge against a deterioration of the macroeconomic context.

In the protection bucket, we also have a modest allocation to gold of about 3-5%, which we have held since May. While the precious metal has suffered recently from the risk-on sentiment, conditions for holding the diversifier have not fundamentally changed.