HBZ Investment Quarterly

A longer cycle

Q2 2017

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Editorial

Dear Reader,

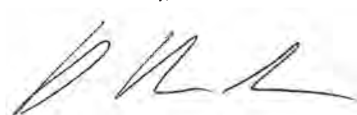
President Trump has been in office for two months now, but he doesn't yet have much to show for it. In particular, the US president's failure to win approval for healthcare reforms has shaken investors' confidence in his ability to deliver on his election promises. While this has unsettled some players, we take heart from the fact that, historically, gridlock in Washington DC has done little to faze financial markets. This said, if Trump indeed turned out to be an ineffectual political leader, we would have to revisit several of our investment theses. At the very least, we would need to revise our expectations of US growth, inflation and rates.

Generally, the global market environment remains positive. For the first time in many years, we are seeing a synchronized uptick of activity in most major economic regions, albeit from a low baseline, and a number of the investment community's biggest fears, such as an imminent implosion of the Chinese credit market, appear unfounded for the time being. We continue to execute a pro-growth investment strategy while remaining broadly diversified in view of the uncertain political landscape.

Diversification is at the heart of this issue's Special Topic, which explores the options available to investors wishing to hedge their portfolios against sharp market reversals.

We hope our publication stimulates reflection and debate and look forward to receiving your feedback.

Yours sincerely,



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The macro backdrop: Synchronized upturn

Global economic activity saw an upturn late last year and this positive momentum has sustained in the first quarter of 2017. Against this backdrop, several central banks are considering ending their extraordinary policy stances. US President Trump's unorthodox approach to politics and policy is the main wildcard.

Table 1: Real GDP growth (y/y in %)

	2016E	2017F	2018F	Short-term trend
United States	1.6	2.2	2.3	→
Eurozone	1.7	1.6	1.6	→
Germany	1.9	1.6	1.6	→
United Kingdom	2.0	1.6	1.3	↘
Japan	1.0	1.1	1.0	↗
China	6.7	6.5	6.2	→
India	7.5	6.8	7.4	→
Russia	-0.5	1.1	1.5	↗
Brazil	-3.5	0.8	2.2	↗

Table 2: Consumer price inflation (y/y in %)

	2016E	2017F	2018F	Short-term trend
United States	1.3	2.5	2.4	↗
Eurozone	0.2	1.7	1.5	↗
Germany	0.5	1.8	1.7	↗
United Kingdom	0.7	2.6	2.6	↗
Japan	-0.1	0.6	0.9	↗
China	2.0	2.3	2.3	→
India	4.9	4.6	4.9	→
Russia	7.1	4.8	4.3	↘
Brazil	8.8	4.8	4.6	↘

Source: Bloomberg, IMF, HBZ

Key points

- Fed tightening to continue
- Elections and Brexit to dominate Europe
- Growth rebounds in emerging markets

Waiting for Trump

While the new US administration's economic agenda has yet to gain traction, the Federal Reserve proceeded to hike its key interest rate for the second time in three months at the March FOMC meeting. Two more rate increases this year have already been priced in by markets and, assuming the US economy maintains its current form, these hikes are indeed likely to be implemented. Talks will soon begin about how best to reduce the Fed's colossal balance sheet and who should replace Janet Yellen when her term ends in February 2018. These factors could generate more market volatility but should not in themselves derail the ongoing, broad-based economic expansion which is supported by a strong labor market, a rebound in manufacturing and generally improved business and consumer sentiment.

Politics dominates European events

The eurozone, and Europe as a whole, has recorded robust economic data for some time now but it is politics that will dominate the news for the foreseeable future – elections (France goes to the polls later this month), the start of the Brexit negotiations, and the unfinished business of the Greek bailout review, to name but a few of the biggest events. Solid economic performance is thus vulnerable to political upsets and any market-unfriendly outcome, such as a surprise win by Marine Le Pen in the French presidential election, could send markets into a tailspin and seriously undermine business confidence. In such a scenario, the ECB would probably rush to stabilize markets, cutting short speculation about an imminent exit from the ultra-loose monetary policy in the eurozone.

Growth recovery across EM

Leaders around the globe, but especially in emerging economies, await with some trepidation concrete announcements from the Trump administration on foreign trade. India stands out as one of the economies that would be least impacted by any return to protectionism. Having weathered last year's demonetization remarkably well, the country is expected to retain the crown as the fastest growing large economy in the world. China meanwhile is focused on its 19th Party Congress, which is scheduled to take place in the fall. As a result, policymakers will spare no effort to keep the economy on an even keel at least until after this five-yearly event.

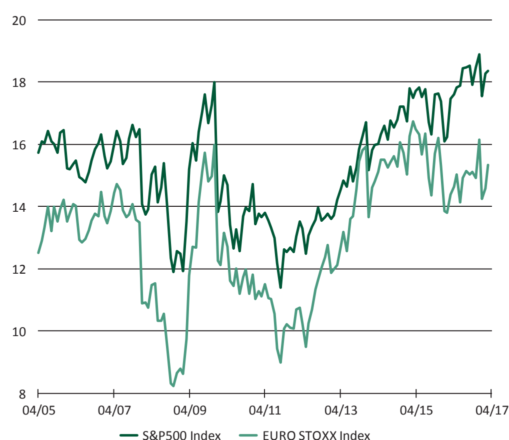
Investment strategy: Extending the cycle

Political events will continue to dominate the headlines in the second quarter and investors will have to assess whether the rally in risk assets has further to run. We are confident that improving global growth will provide further tailwinds, albeit in a more volatile environment.

A watershed moment ahead?

Market commentary is dominated by concerns about the valuations of many risk asset classes. While US equities and high-yield bonds in particular have indeed become rather expensive, it is important not to lose sight of the fact that valuations alone have rarely caused a market reversal. Historically, major corrections have typically been triggered by a change in global liquidity due to monetary tightening, or a sudden deterioration in fundamentals (i.e. growth and earnings). Despite tighter US Fed policy, global liquidity will remain ample and both global growth and corporate earnings are actually expected to improve. The backdrop thus continues to support risk-taking. At the same time, we concede that markets remain vulnerable to political events – the risk of an upset in the French elections or a disappointing performance by the Trump administration, for instance – and investors will have to be willing to react to the associated news flow. Another open question is whether US equities can maintain their leadership. Many strategists have been arguing for a rotation into eurozone assets (especially equities) for some time. While we are sympathetic to this view based purely on valuations and earnings, we fear that politics, which has held back the performance of eurozone equities (in USD terms) over the past three years, will once again put a spanner in the works. Elections may be binary events, but they are not a reliable basis for major asset allocation decisions.

Chart 1: Eurozone stocks with a valuation advantage (forward P/E)



Source: Bloomberg, HBZ

Current positioning

We continue to favor risk assets but have pared back the duration in our multi-asset portfolios given the upside risk to rates. Furthermore, we have initiated exposure to inflation-linked securities in response to more material risks of higher inflation readings associated with the advanced stage of the business cycle.

What to watch

With solid Q4 earnings squared away, we are looking to decisions from the Trump administration as a potential trigger for the next significant market move. In particular, lower corporate tax rates could reignite demand for US equities. More broadly, national and global politics will continue to shape market developments this year.

Key points

- Stretched valuations but positive earnings momentum
- Global liquidity to remain ample
- Political risks unusually high

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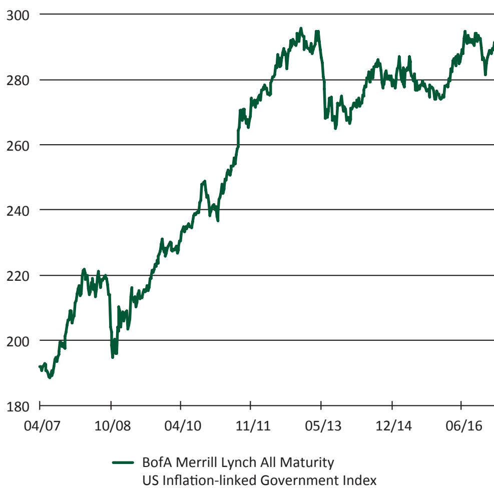
Fixed income: Back to coupon clipping

There is limited room for spreads to tighten further and the most attractive fixed-income sectors are financials, global high yield, corporate hybrids, and selected emerging-market bonds. With higher inflation possibly looming on the horizon, inflation-linked bonds could provide some protection for portfolios.

Chart 2: Attractive entry point for inflation-linked bonds (total return index)



Source: Bloomberg, HBZ

Key points

- Yet higher USD yields expected
- Hybrid bonds offer interesting risk/return profile
- US TIPS protect against risk of higher US inflation

Glossary

TIPS – Treasury Inflation Protected Securities. A US Treasury security that is indexed to inflation in order to protect investors from the negative effects of inflation.

Credits retain their appeal

We expect USD interest rates to trend gradually higher this year. In this context, credits are attractive although most of their return will come from coupons, as any further spread-tightening will be limited. One of the most attractive sectors is currently financials. We favor bonds lower down the capital structure, which should benefit from ongoing capital accumulation, better asset quality and positive regulatory developments. For example, we prefer Swiss and UK banks, as they have some of the highest levels of capital. High-yield bonds are another asset class which we still view favorably, but as valuations in Europe and emerging markets look more compelling than in the US, we recommend a globally diversified exposure.

Mexican local currency bonds attractive

Hard currency emerging-market sovereign bonds generally still offer reasonable returns, although spreads are below their long-term average. Spreads could stay at these levels for some time as many issuing countries' ratings have improved considerably. We see more potential in local currency bonds. They generally offer higher yields and in some countries, such as Mexico, we expect exchange rates to normalize even further. At the same time, investors should be aware that this is a volatile asset class.

Favorable risk/return profile of hybrid bonds

Hybrids are long-dated, callable subordinated bonds. Normally issued by investment-grade entities, yields on these instruments are significantly higher than on senior bonds issued by such companies; corporates issue these instruments as they are a cheaper source of funding than equity. Most hybrids receive a 50% equity credit from rating agencies at issuance and their coupons are tax deductible. Furthermore, most are also expected to be repaid on their first call date, so their duration risk is limited.

Protection against inflation

Persistently low inflation over the past years has driven down inflation expectations. We believe that longer-term inflation risks, particularly in the US, are skewed to the upside. While US TIPS have repriced somewhat following the election, we think they still offer an attractive entry point and a hedge against higher-than-expected inflation outcomes.

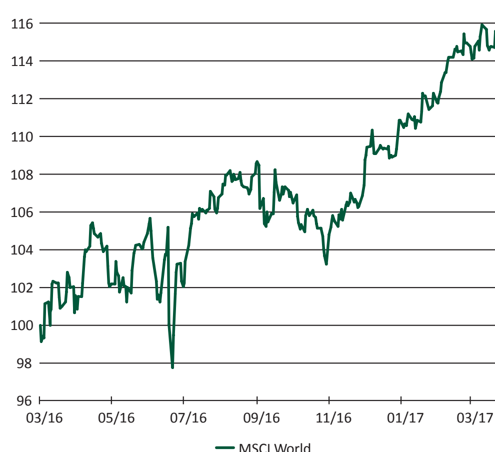
Equities: The air is getting thinner

The surge in equities following the US elections seems to be facing a reality check. Doubts about President Trump's policy implementation as well as higher real interest rates and valuations are curtailing investors' risk appetite. Nevertheless, global equity markets still offer some opportunities.

Reassessing President Trump

Equity markets have started to move sideways yet sentiment indicators still appear extended. This has led to a rotation into defensive sectors with only IT, an all-time investor favorite, bucking the trend. Energy stocks in particular suffered from the drop in oil prices. Financials, especially banking stocks, also experienced a setback following their sharp rise in anticipation of deregulation. Investors should bear in mind that we are in the middle of a rate-hiking cycle, which is why high-dividend and interest rate-sensitive stocks are facing a difficult environment. Since two more Fed hikes are expected, renewed pressure on many defensive stocks is likely; they really should not be considered 'safe'. Investors have also started to reassess the prospects of the Trump administration's ambitious policy pledges, many of which seem either ill-defined or unlikely to come to fruition. At the same time, other headwinds for stocks are already building: a gradually rising USD will limit the earnings power of US corporations operating internationally and higher real rates will mean higher discount rates for equities in general. In addition, since the US economy is already running at a healthy clip, there is little room for big surprises on the upside.

Chart 3: Equity advance is still uninterrupted



Source: Bloomberg, HBZ

Where will earnings come from?

Earnings trends will become more important for investors as the latest bull market leg has been driven almost entirely by multiple expansion. That is to say, stocks rose on sentiment rather than earnings, pushing up the valuation of the S&P 500 Index to a new all-time high. As the USD will hold back the earnings growth of many corporations, any additional growth will depend on better US domestic growth. Small and mid-sized companies in particular stand to benefit from lighter regulation and less red tape, which in turn will strengthen their ability to compete with larger peers. Against this backdrop, other economic areas – especially those with loose monetary policy and a track record of political stability – will become more attractive. While European stocks could rally once key elections in the region are behind us, negative sentiment could still prevail on the continent. In short, Japan and emerging markets offer better alternatives.

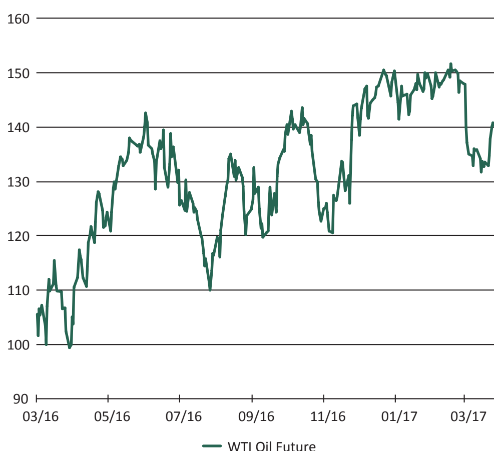
Key points

- Equities in consolidation mode
- Strong USD and higher real rates limiting US earnings
- Uncertain outlook for Europe, opportunities in Japan and emerging markets

Commodities and FX: In flux

In recent months, investors have seen a partial reversal of 'Trump trades', which had priced in a more reflationary environment for commodities and FX. Energy prices in particular came under pressure despite OPEC's production cuts.

Chart 4: Oil falls on supply glut (index)



Source: Bloomberg, HBZ

The oil challenge

The advance of energy prices triggered by OPEC and Russia's earlier decision to trim oil production was thwarted by rising US output and crude reserves, which have reached record levels according to official data. In addition, the number of active drilling rigs is increasing again as new production sites are being developed and production costs for US firms have fallen dramatically due to steady productivity gains. Currently, many US firms are able to produce oil at conditions similar to those of their low-cost counterparts in the Persian Gulf. Analysts therefore project that a more pronounced – or at least a more sustained – production cut would be required to lift the crude price substantially above its current level. Gold and other metal prices have dazzled over recent months despite the Fed's latest interest rate hike, with gold, silver and platinum rallying by over 10%. Palladium leapt ahead over 20% due to the structural supply deficit, with a majority of the demand coming from China and emerging markets where it is mainly used in catalytic convertors for cars.

Key points

- Energy prices down on oversupply
- Gold and other metals have rallied on inflation expectations
- USD to trade sideways against majors, with downside against some EM crosses

FX: Quite a move

The main reflation trade in currencies, namely the advance of the greenback, hit a roadblock in the first quarter. Profit-taking, emerging doubts about the implementation of key elements of the new US administration's economic agenda and declining long-term rates undermined the case for a strong USD. Investors consequently started unwinding their dollar bets, which remain among the most crowded trades. While we expect the USD to trade sideways against most low-yielding majors, there is room for a further drop against some EM currencies such as the Mexican peso. The peso has risen thanks to the tapering-off of political pressure created by the US president's aggressive rhetoric and supportive monetary policy. The Mexican central bank increased rates at the end of March although the pace of tightening could slow in light of the latest inflation data and the peso's rebound. The South African rand rallied strongly early in the year only to reverse its course sharply after the surprise dismissal of the finance minister. Now more downside to the currency appears likely, this, intern, could be further aggravated by a more accommodative monetary policy.

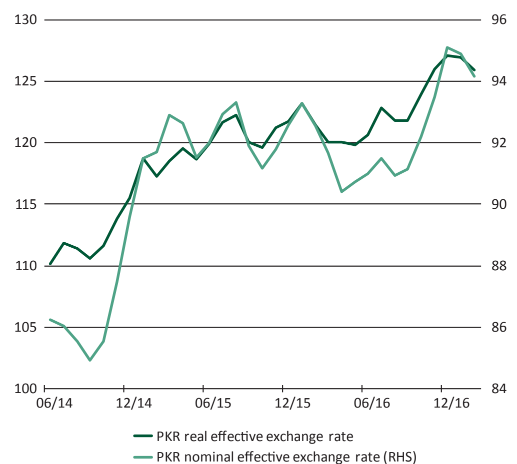
Key markets: Testing times ahead

Our key markets were remarkably resilient last year but this may be tested soon, especially in Pakistan with its overvalued currency and in the UK where the countdown to Brexit has started in earnest.

Pakistan: Watch the currency

Economic growth remains well supported by rising manufacturing and agricultural output, higher private-sector credit and a strong pull from investments in the context of C-PEC, all of which is aided by a very favorable monetary setting and still-low inflation. The key problem is obvious: a sharp rise in imports coupled with a precipitous fall of exports have led to a deterioration of the current account. The main culprit is the overvalued currency, which has been trading within a narrow range against the US dollar since August 2015. The government has so far been able to shore up the foreign reserves, which reached record levels last year. However, slowing remittances and rising foreign maturities will at some point start to strain the country's ability to service its external debt. In this context, the stock market is treading water, waiting for improvements on the external front but also for cues from the pending Panama leaks investigation. The Pakistani rupee needs to depreciate at some point, and this may force the State Bank to apply the monetary brakes.

Chart 5: PKR: overavalued whichever way you look at it



Source: State Bank of Pakistan, HBZ

UAE: On firmer ground

Economic activity continued to accelerate in the Emirates at the beginning of the year. The recent dip in crude prices will slow the recovery but will not derail the government's effort to put the public finances on a more solid footing over the medium term. Real estate prices are expected to rise later this year as investment is ramped up ahead of Expo 2020 Dubai.

UK: Countdown to Brexit

Prime Minister May delivered on her promise and triggered Article 50 of the Lisbon Treaty on 29 March. The UK is thus set to leave the EU within two years. Given how complex the issues are and how high the risk of acrimony is, these 24 months might end without a complete agreement in place. Leaving the EU without at least an interim agreement would be the worst possible outcome, as this would cripple trade, among other things. For the time being, investors assume that common sense will prevail. However, the rise in uncertainty will in due course take its toll on the UK economy since the sharp depreciation of the GBP will curtail the purchasing power of consumers. Second-round effects on UK assets and a still weaker GBP are almost inevitable.

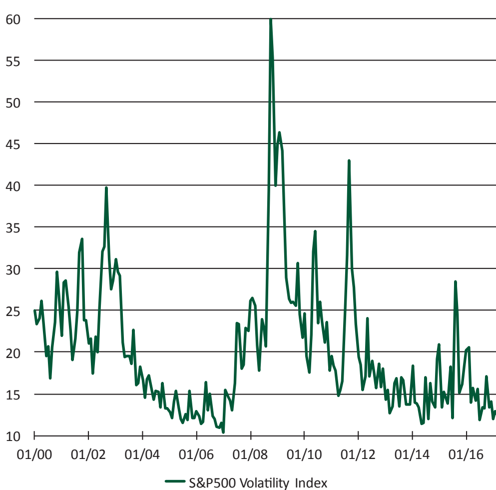
Key points

- PKR needs to adjust
- Lower oil price to delay but not derail UAE's recovery
- Uncertainty rises as UK government triggers Article 50

Special topic: Hedging strategies for uncertain times

The global cycle is well advanced and numerous political events pose unusually high risks this year. So how can investors mitigate such risks – especially those associated with sudden market reversals?

Chart 6: Be prepared: risk will not always stay this low



Source: Bloomberg, HBZ

Key points

- Diversification is the best risk hedge
- Active management provides an additional element of protection
- Active hedging also helps to shield assets against risk but itcomes at a cost

Diversification as the first line of defense

In risk management, asset diversification is the key to maximizing a portfolio's resilience. The combination of assets with different risk properties (e.g. volatility and correlation) should reflect the investor's risk tolerance as accurately as possible. These days, diversification involves investing not only in different asset classes but also in different types of risk premia within individual asset classes (e.g. size, value, yield, etc.), thereby expanding the opportunity set and increasing the potential benefits. Moreover, including assets and strategies with asymmetrical pay-off characteristics (e.g. convertible bonds and managed futures) allows the portfolio manager to skew the distribution of expected returns positively and to reduce the magnitude of any drawdown.

Active asset allocation

Active management is another key strategy for hedging against undesirable outcomes. This involves a broad array of decisions, ranging from applying simple portfolio management rules (position sizing, regular profit-taking, etc.) to establishing mechanisms for shifting allocations (e.g. by varying exposure to asset classes, geographies and other factors). Such decisions, which typically lead to temporary deviations from long-term strategic goals, are generally referred to as 'tactical asset allocation'. This process can be based on a set of predetermined rules, qualitative assessments or 'technical signals'. Not least because tactical asset allocation is usually closely linked to short-term market developments, such moves must be planned with great care and within a well-established decision-making framework.

Active hedging

Investors can also hedge their portfolios by taking permanent or temporary positions in certain financial products (options, forwards, etc.), which offer downside protection or eliminate exposure altogether. Since such positions usually entail a financial cost, be it in the form of option premia paid upfront or locked-in returns, they perform an economic function similar to that of insurance. Just like an insurance policy, such positions will often not be triggered. The upside is protection in the event of a sharp market reversal and peace of mind. One of the most significant downsides – aside from cost – is that timing is critical to the success of any such hedging.

Market data summary

As of 3 April 2017

Equity indices	Last	-3M %	YTD %	-3YR %
MSCI World USD	5'152.4	6.0	6.4	16.7
S&P 500	2'362.7	4.6	5.5	25.1
EuroStoxx 50	3'500.3	5.6	6.4	9.2
FTSE 100	7'334.5	2.2	2.7	10.3
SMI	8'666.6	4.2	5.4	1.7
Nikkei	18'983.2	-0.7	-0.7	26.0
MSCI EM USD	423.3	10.7	11.4	2.9
Sensex 30	29'830.3	12.0	12.0	32.5
KSE 100	48'187.8	-1.3	0.8	70.1
Hang Seng	24'226.7	9.4	10.1	7.4
Russia RTS	1'124.8	-5.4	-2.4	-7.1
Brazil Bovespa	64'984.1	5.1	7.9	26.4

Bond indices	Last	-3M %	YTD %	-3YR %
Citi US gov	1'451.70	0.7	0.7	6.1
CIti US HY	2'078.99	1.3	1.3	11.3
CIti US Corp	950.49	2.4	2.4	12.7
Citi Euro gov	227.28	-1.3	-1.3	11.9
CIti Euro Corp	233.97	0.1	0.1	10.1
CIti EM Sov	785.30	4.1	4.1	18.6
DB EM Local USD	156.97	7.6	7.6	-6.2

Currencies	Last	-3M %	YTD %	-3YR %
DXY	100.35	-2.6	-1.7	24.9
EUR/USD	1.07	2.5	1.4	-22.3
USD/CHF	1.00	2.6	1.7	-11.1
GBP/USD	1.26	2.4	1.5	-24.5
USD/JPY	111.39	5.7	5.0	-6.7
AUD/USD	0.76	5.3	5.5	-17.6
USD/CAD	1.33	0.7	0.8	-17.2
USD/ZAR	13.41	2.2	1.5	-21.4
USD/INR	64.85	5.3	4.7	-7.3
USD/PKR	104.83	0.0	-0.4	-6.3
Gold oz	1'249.35	7.5	8.1	-3.2

Interest rates	3M interbank %	10YR government %
USD	1.15	2.40
EUR	-0.33	0.32
GBP	0.34	1.14
CHF	-0.73	-0.10
JPY	0.03	0.08
AUD	2.96	2.68
CAD	1.17	1.63
ZAR	7.36	8.95

For your notes

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