Portfolio Management Monthly Update

September 2019

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Pessimism is in the air, but reasons for hope still remain

- Equity markets dropped in August as trade war between USA and China has intensified;
- Upside in September to large extent would depend on more stimulus announced by central banks and potential trade talk improvements;
- As volatility remains high we continue to hold conservative exposure to risky assets.

After relatively quiet July, August turned out to be rather rich month both in terms of events and price movements. In the very beginning of the month, equity markets experienced real panic as prices of global indexes on average fell by more than 5% in less than a week. Such drop was triggered by new tariffs announced by USA towards China, and realization that trade war is likely to escalate going forward, as both countries seem to be unwilling to find compromise, despite some of their statements made previously.

Indeed, later during the month, more negative statements by both countries have followed. China announced that as a retaliatory measure to new US 10% tariffs on $ 300 billion of Chinese goods it would also introduce 5-10% tariffs on $ 75 billion of US imported goods, including commodities such as soya beans and crude oil. Trump reacted to Chinese news almost immediately, tweeting that new 10% tariffs would be raised to 15% and existing 25% tariffs would also be raised to 30%.

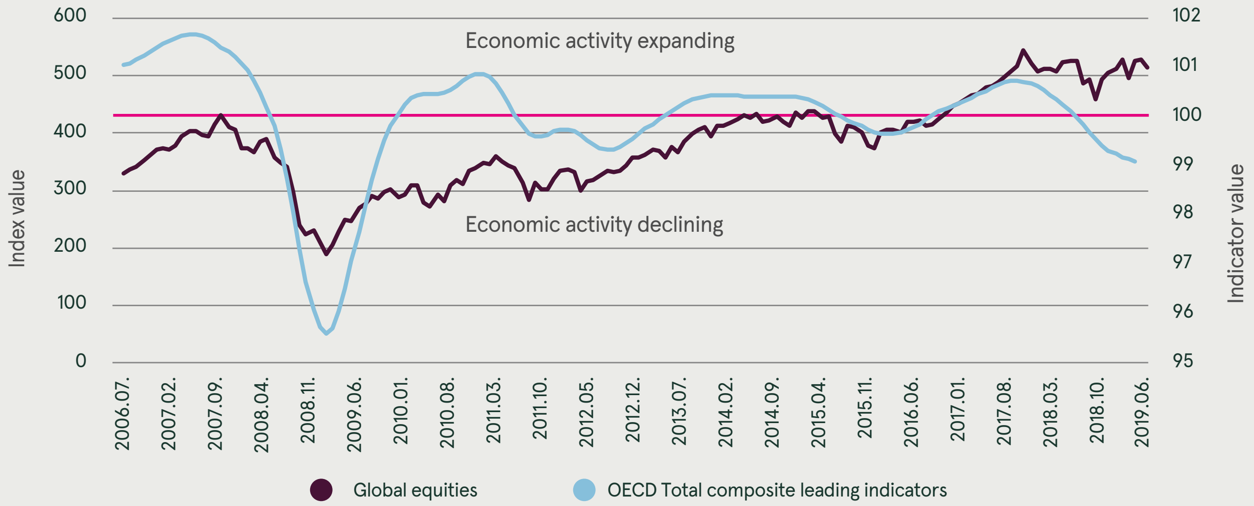
In parallel to blaming Chinese, Trump was also very harsh in relation to FED, at one time even asking if Chairman Powell is the bigger enemy to US interests than Chinese president Xi. Major reason for Trump's concern, is that USA right now has one of the highest interest rates among all developed countries in the world.

Interest rate in selected developed countries	
Hong Kong	2.50%
United States	**2.25%**
Canada	1.75%
Australia	1.00%
New Zealand	1.00%
United Kingdom	0.75%
Eurozone	0.00%
Japan	-0.10%
Sweden	-0.25%
Switzerland	-0.75%

Source: Ned Davis Research

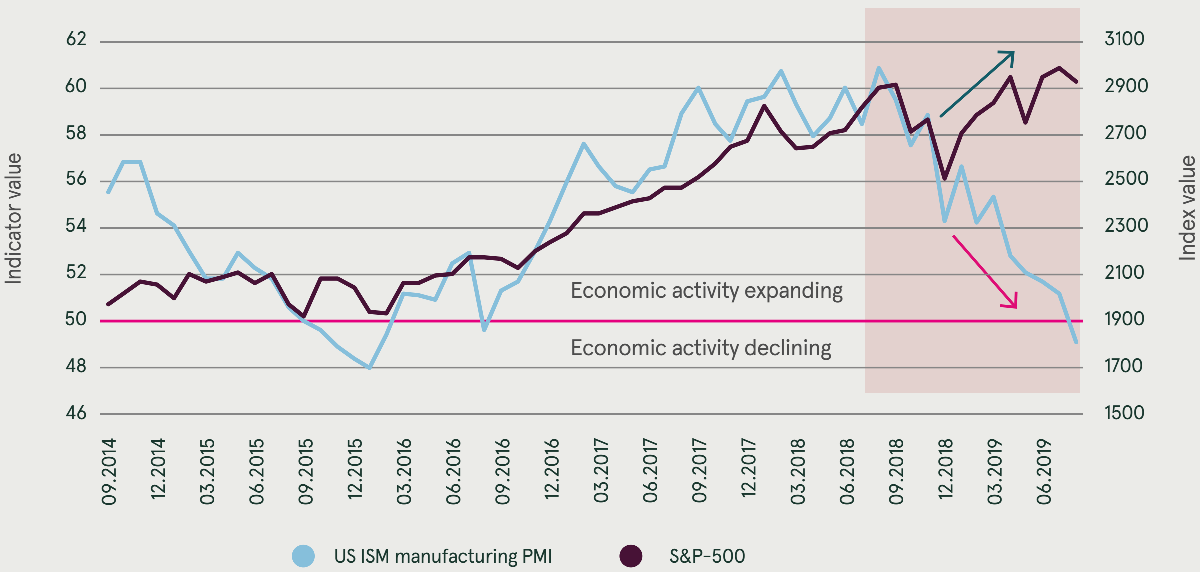
Global economic slowdown and weakness in some leading US macroeconomic indicators, indeed, point to possibility that first interest rate cut in 11 years implemented by the FED in the end of July might not be enough. And if FED continues to be reactive, as it did in 2000 and 2007, Central bank might again be too late to prevent recession, as local companies would not be able to get stimulus when it would be needed the most.

OECD total composite leading indicators vs global equities



Source: Bloomberg

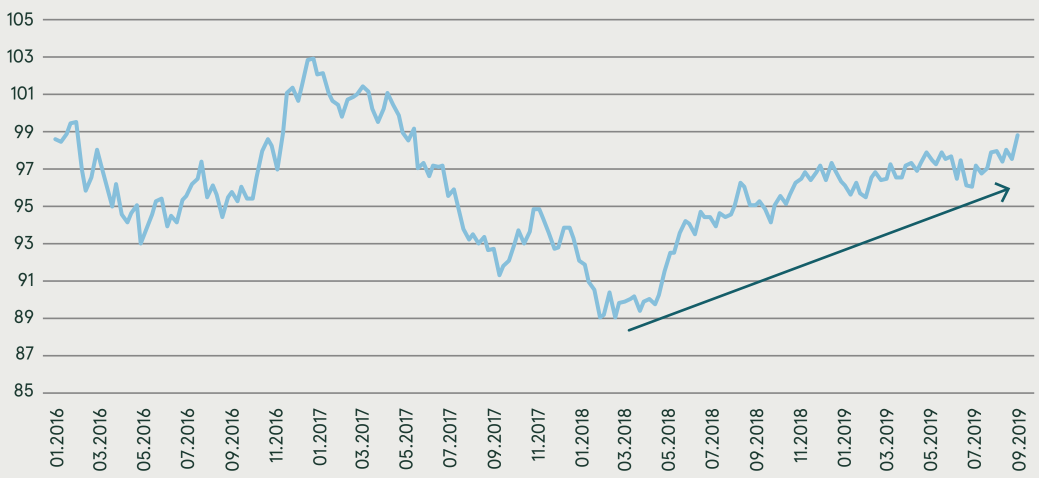
US Manufacturing PMI vs S&P-500



Source: Bloomberg

Another channel through which high interest rate may potentially hurt US economy is through rising US dollar. For already 1.5 years dollar is trending higher as more investors in search for yield find US assets to be more attractive, especially given that US economy is still holding relatively well compared to vulnerabilities elsewhere around the globe. Expensive dollar makes exporters less competitive and also may lead to lower revenues realized by large multinational firms, as they receive large share of their income from abroad. So if appreciation of USD continues going forward, it might become a serious issue for USA indeed.

US dollar index



Source: Bloomberg

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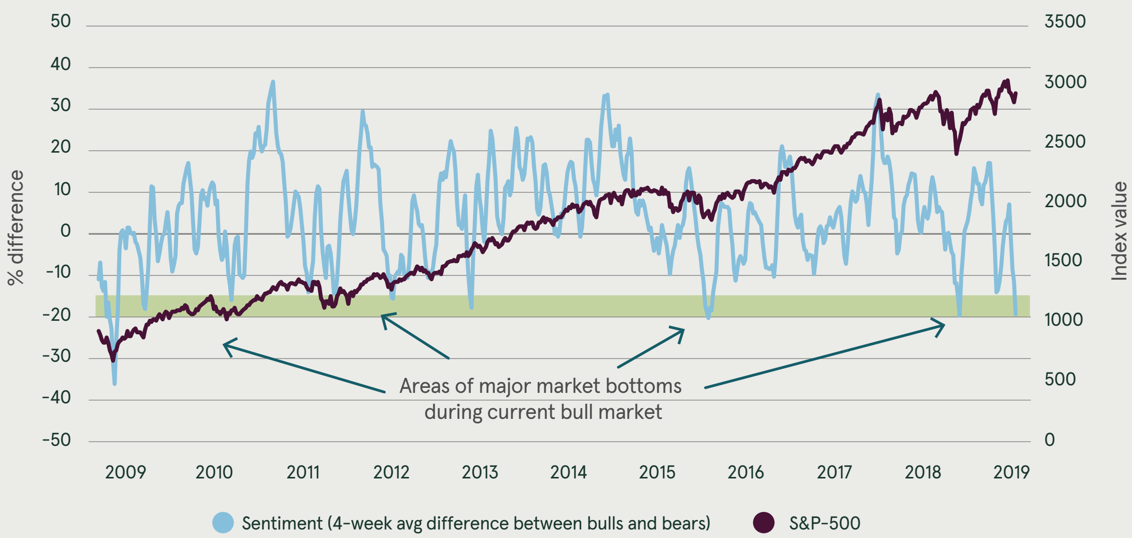
In addition to US related issues, news from other countries were not particularly bright either. Negative GDP print in Germany for second quarter 2019; rising chances of hard Brexit in UK as newly elected Prime Minister Boris Johnson seems rather determined to make no deal with EU, unless terms become more favorable for the UK; and short-term government crisis in Italy as break down of existing coalition and resigning of prime minister raised new concerns about political risks in Europe – all these factors led to additional rounds of uncertainty throughout the month.

Also it is worth mentioning development in Argentina. First round of presidential elections led to surprising results as populist, left wing candidates gained majority there. As a result Argentine stock market dropped by 48% in one day, which according to Bloomberg is the second biggest one-day drop in 70 years experienced by any country[1]. And though Argentina does not have much impact on global affairs, it proves the point that we are operating in quite nervous times.

Not surprising, that given rather negative background, majority of investors were becoming more and more pessimistic throughout the month. As a result, by September some sentiment measures became rather extreme in terms of where investors believe the markets are headed next. For example, difference between bullish and bearish investors as measured by US AAII[2] sentiment survey approached similar level as in late December 2018, which coincided with major market bottom. Furthermore, if we take 4-week average of such readings (as a proxy for average sentiment throughout the month), the only other time when there was more pessimism during last 10 years was February 2016, which was yet another major market bottom.

AAII Investor sentiment vs S&P-500



Source: Bloomberg

[1] Worst decline was -61.7% in one day experienced by Sri Lanka in 1989

[2] American Association of Individual Investors

At the same time, despite all the pessimism and aforementioned news items, equities held relatively well throughout the August after initial decline early in the month. Moreover, if we exclude the first three trading sessions in August, results for the rest of the month would actually turn out to be positive. This is indeed surprising, as usually we should expect much stronger drop in equity prices given sentiment and level of risks. So what positive factors still continue to support the market and prevent it from falling further?

First of all, there is good chance that USA and China would again become softer towards each other and will be able to resolve existing disagreements. Subtly we can see that both parties are still willing to find the solution. For example, on September 1st new tariffs were introduced only for about $ 110 billion out of planned $ 300 billion of Chinese goods, while the rest impact was postponed until the mid-December. At the same time, Huawei, which also was expected to receive full ban on doing business with US companies in August actually received another 90-day delay until the November. Move by Chinese which imposed smaller tariffs of only 5 to 10% and also postponed large part of it till December also may be considered as forced measure, in order not to look completely weak, but that country is still willing to resolve issues with USA.

Next, in middle September there would be another ECB and FED meetings, where both banks are expected to cut interest rates further. Hard to judge how financial markets would react to these events, but if some additional stimulus measures would be announced, price movement may turn out to be quite bullish, just as it already happened several times earlier this year.

Finally, if majority of investors right now are bearish, they have already most likely acted on their view and there are not many sellers left in the market. Few good catalysts might return appetite of the bulls, and at least for a while there might be decent technical bounce.

So all in all, our view for September is rather balanced; there are good factors to be found for both downside and upside. From long term perspective, however, we still believe that volatility would remain high unless global macroeconomic indicators would finally start to improve more reliantly and political risks would stop rising and be finally subdued. That is why in August we once again made no changes to our allocation which continues to remain relatively defensive.

Market performance	August		2019 YTD	
	EUR	USD	EUR	USD
Global equities (MSCI ACWI TR Net)	-1,1%	-2,4%	18,6%	13,8%
North America equities (MSCI NA TR Net)	-0,5%	-1,8%	23,1%	18,1%
European equities (MSCI Europe TR Net)	-1,4%	-2,7%	14,9%	10,3%
Pacific developed markets equities (MSCI Pacific TR Net)	-1,4%	-2,7%	12,6%	8,0%
Global Emerging Market equities (MSCI EM TR Net)	-3,7%	-4,9%	8,3%	3,9%
Government bonds (Bloomberg Barclays - Euro govt TR / US treasuries TR)	2,5%	3,4%	10,4%	8,6%
Investment grade corporate bonds (Bloomberg Barclays - EUR Aggr Corp TR / US corp TR)	0,6%	3,1%	7,6%	13,9%
Global high yield bonds, hedged (Bloomberg Barclays - Global HY TR index)	-1,6%	-1,4%	7,0%	9,3%
Emerging Market bonds, hedged (Bloomberg Barclays - EM hard currency Aggr TR hedged)	-0,1%	0,2%	8,2%	10,5%
Oil (WTI)	55,1			
Gold	1520,3			
EUR/USD	1,0982	EUR: -0.8%		EUR: -4.2%

Positioning September 2019

Asset Allocation	–			N			+
Equities			◆				
Fixed Income			◆				
Cash						◆	

Bond Markets	–			N			+
Government		◆					
IG corporate (EUR)				◆			
IG corporate (USD)			◆				
High yield				◆			
EM debt					◆		

Equity sectors	–			N			+
IT			◆				
Financials				◆			
Cons. Discretionary				◆			
Industrials				◆			
Healthcare				◆			
Cons. Staples					◆		
Energy				◆			
Materials				◆			
Real estate				◆			
Utilities					◆		
Communication			◆				

Equity regions	–			N			+
North America				◆			
Europe				◆			
Eurozone			◆				
UK				◆			
Switzerland					◆		
Nordics				◆			
Pacific				◆			
Japan			◆				
Pacific ex. Japan					◆		
Emerging Markets				◆			
Emerging Asia			◆				
Latin America					◆		
EMEA				◆			

◆ current allocation
◇ previous allocation

favor gold producers

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