

Strategic Relative Value Q3 2017

A quarterly look at how macro events are driving relative value around the globe.

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A Goldilocks environment of positive and stable growth can extend the equity and credit market cycles – as long as central banks normalize policy without haste

Key Themes:

- The synchronized global recovery is coasting along with little sign of overheating. This environment of not-too-fast, not-too-slow growth (the “Goldilocks” scenario) should extend the economic upturn, so I still **prefer equities over fixed income**. However, modest growth means modest capital gains and I see reason to slightly reduce exposure to equities.
- Subdued inflationary pressures will permit the Federal Reserve (Fed) to raise policy rates gradually, and the European Central Bank (ECB) and the Bank of Japan (BOJ) to reduce monetary stimulus without haste. **The policy outlook supports risk-taking.**
- True - valuations are tight across risk assets. Yet risk-free assets themselves are not particularly cheap and are also vulnerable to disruption from central bank policies. **I prefer credit to government bonds.**
- In the current low but stable growth environment, investors should consider focusing on higher-income assets. This implies a **preference for high-dividend equities, high-yield credit, and emerging market debt**. I would, however, take consideration of the risk that central banks raise rates faster and sooner than the market expects.
- **European equities should outperform U.S. equities** because of strengthening growth, more accommodative monetary policy, and diminishing political risks. By contrast, heady valuations mean that **European credit is marginally less attractive than U.S. credit.**
- Markets are pricing in a slower policy rate path than the Fed’s own policy projection, leaving investors exposed to faster rate hikes. Robust economic fundamentals suggest that this would trigger consolidation, not a correction. But with valuations so stretched, **if faster rate hikes are considered harmful to U.S. growth prospects, investor confidence would unravel sharply.**
- In the current environment of stretched valuations and low volatility, investors need to be aware that **equity and credit bull markets are potentially running out of steam**. Modest economic growth means high-income assets should take up a sizeable portion of portfolios.

Relative value in... Equities

Equity valuations are becoming stretched but, as long as global monetary conditions remain favorable and global growth is stable, sentiment should be supported. I think the equity rally has further to go, although gains may be slower.

European equities over U.S. equities: The U.S. economic outlook points to positive earnings growth. But most U.S. equity valuation readings now stand above historical averages, while broader global metrics remain reasonable. European equities could continue to outperform given relatively attractive valuations; stronger earnings-per-share growth; lighter investor positioning; and continued, albeit declining, ECB asset purchases.

Japanese equities also hold value: Lower profit margins, an improving growth picture, and exceptionally loose monetary policy provide catch-up room for Japanese equities.

Value stocks over growth stocks: The runaway success of technology shares in recent months has left value stock valuations considerably more reasonable. Note that in an environment where economic momentum has peaked and the yield curve is flattening – as is currently the case in the United States – growth stocks tend to do well, so I do not expect a runaway outperformance of value stocks.

European small-cap over large-cap: European small-caps have performed well this year and I expect this to continue. They offer exposure to the strengthening European economy, so margins and earnings-per-share growth will be greater. Balance sheets are also stronger, while valuations are more attractive.

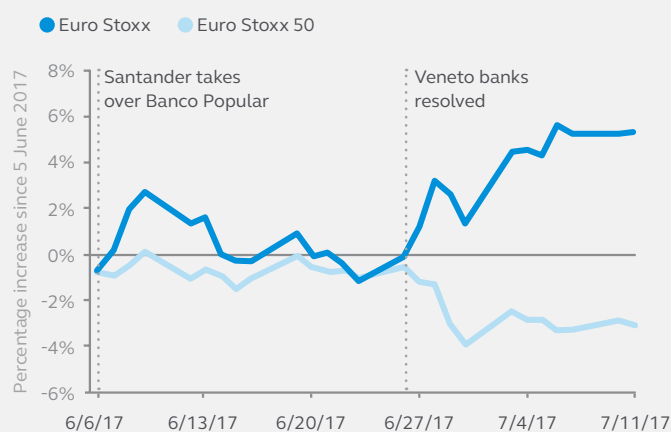
Reduce exposure to cyclicals: Given low, stable growth, as well as caution surrounding the Fed's forthcoming balance-sheet reduction, I see cause for reduced exposure to cyclicals. However, there's also logic in maintaining some tilt towards cyclicals on prospects for fiscal upside.

Financials, especially banks, are a favored sector: In the United States, the latest Fed stress test and potential regulatory change reinforce positive

fundamentals for the financial sector. In Europe, the swift resolution of Banco Popular, without requirement of state aid, reflected well on the ECB's toolkit and has strengthened confidence in the sector.

➤ Exhibit 1: European banks have performed well as peripheral risks are resolved

Positive developments in the European peripheral banking sector, with Banco Santander taking over Banco Popular, Italy committing to clean up two failed banks, and the EU approving state aid for Banca Monte dei Paschi di Siena, have pushed European bank shares higher - even as the broader market declined.



Source: Bloomberg

European banks over U.S. banks: European banks offer more attractive valuations. European loan growth is stronger. The U.S. yield curve has flattened, with the Fed hiking cycle underway. By contrast, with the policy tightening cycle still to come in Europe, the euro-area yield curve is steepening. This should help European bank earnings.

Emerging market equities will outperform U.S. equities: Emerging market equities will likely benefit from strong flow momentum, positive macro fundamentals, and the weaker outlook for the U.S. dollar. Reform progress in countries such as India has been positive, while contagion from Brazil's political turmoil was less extensive than in previous episodes. However, only a modest overweight seems appropriate given the headwinds from weakness in commodity prices. Caution and selectivity is still warranted for countries with high current-account deficits and external funding.

Relative value in... Fixed Income

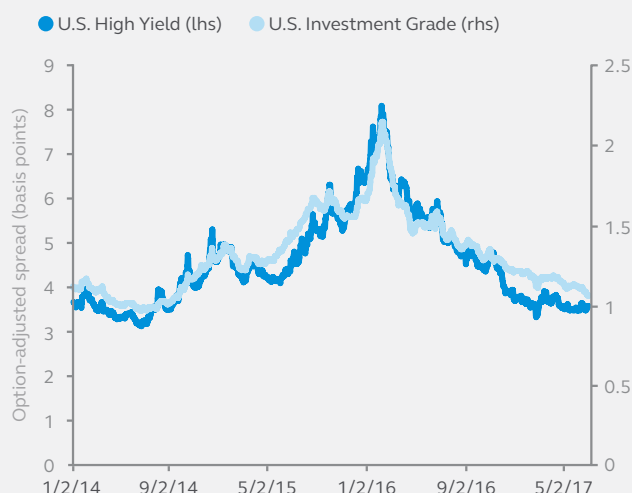
Valuation measures across credit are extremely tight but, in a low-yield world, exposure to credit enables you to earn income. What's more, credit spreads are inversely correlated with rising yields, providing some protection again central bank tightening.

High yield over investment grade: High yield default rates have fallen sharply and are expected to remain low, and a record refinancing wave means that maturities are limited. Energy companies have improved their production inefficiencies and balance sheets, so U.S. high yield is better positioned to withstand a drop in oil prices than previously (although it still poses a threat).

Investment grade also has positive fundamentals: Solid economic growth, strong demand and reduced reliance on short-term financing offsets concerns about high leverage and tight spreads. It provides a good source of income in a modest growth world.

➤ Exhibit 2: Credit valuations are now extremely tight

High yield and investment grade spreads have been tightening since their peak in February 2016, and investment grade spreads are now at their tightest since late 2014.



Source: Bloomberg

In Europe, high yield spreads are already fully discounting the positive outlook, so I expect European high yield to underperform the rest of the credit market.

Within investment grade, financials over non-financials: The ECB is expected to begin tapering of asset purchases in early 2018. That move likely means a steepening of the yield curve, which should support European financials. The swift resolution of Banco Popular and the decline in European political risk have also strengthened confidence in financials.

U.S. preferred securities look attractive: In the United States, solid growth and potential regulatory roll-back still paint a positive picture for financials. But in the current low-rate environment, yield-focused investors can gain exposure to financials through preferred securities.

U.S. credit over European credit: Strong macro momentum and diminishing political risk paint a positive picture of European credit, but the sharp rally in European spreads has rendered it marginally less attractive than U.S. credit. The likely ECB tapering in early 2018 will also challenge European credit considering it has benefitted greatly from the ECB's corporate quantitative easing program.

Emerging market credit over developed market credit: Emerging market credit is under some pressure from the political turmoil in Brazil and the coming reduction in the Fed's balance sheet, while valuations are not as attractive as in the previous quarter. Yet emerging market macro fundamentals are improving and will be further supported by the weaker U.S. dollar, while emerging market credit is also more attractive from an income perspective.

Inflation-linked bonds over nominal bonds: Given the tightness in the labor market, I believe inflationary pressures are building and bond markets are providing inadequate compensation for the inflationary backdrop. Similarly, in Japan, wage pressures should eventually push up inflation, so I believe inflation-linked government bonds can do well.

Relative value in...

Real Estate

Low volatility and benign financial conditions support U.S. commercial real estate valuations, although I am wary of slowing economic momentum and rising interest rates.

Debt modestly over equity: The economic recovery is now in late-cycle stages and core real estate investment performance has slowed meaningfully. Softening rent growth and a slowing pace of capital appreciation signal a broad tilt to debt over equity.

By sector, industrial over offices: Slow, sustained economic growth has led to an increase in homebuilding, a steady and expanding manufacturing sector, and growing retail sales. As a result, industrial availability rates continue to fall. By contrast, given the potential for moderating employment gains, office is expected to underperform and retail continues to face headwinds from e-commerce competition.

A primary risk to the industrial sector is its susceptibility to the global economy amid geopolitical instability and a wave of nationalist and protectionist populism in developed nations. Recent moves to more protectionist agenda from the Trump administration would negatively affect trade and possibly be very disruptive to U.S. supply chains, and ultimately, demand for industrial space.

Buy private mortgages on setbacks: The flat yield curve and tight spreads are likely to weigh on return potential in the near term. However, if inflationary pressures pick up, resulting in a steepening of the yield curve, this may present a buying opportunity.

Public debt may provide a cushion if volatility increases: The potential for further spread compression in commercial mortgage-backed securities (CMBS) is limited given current levels; however, a widening in spreads would represent an opportunity to add higher-quality assets. An allocation to higher-quality CMBS and mortgages with shorter duration may be helpful in managing near-term volatility.

Positive on private commercial real estate: In the current reflationary environment, private commercial real estate would be a good hedge against unexpected inflation. Private commercial real estate moves closely in line with core inflation, since increasing material costs to reproduce existing assets help support property values.

Prefer global REITs to U.S. REITs: U.S. REITs are particularly vulnerable to Fed policy tightening. Rising interest rates may mean that investors may require additional yield pickup to compensate for the additional risk, putting upward pressure on cap rates in some markets and property types. Global REITs are more attractive because of rising growth momentum in international markets and easy monetary policy from global central banks, relative to the Fed.

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