



# investment strategy

Investment

Strategy

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The Global Investment Committee, at its meeting on 10 September, confirmed its conviction in the existing asset allocation. It consists of an overweight in equities, a strong underweight in bonds and overweights in commodities and hedge funds. A main discussion point was the growing divergence between developed and emerging economies, which has been thrust centre stage by events in China. The committee believes, however, that while other emerging-markets countries may be negatively affected, China's slowdown will not affect global growth prospects.

## **Developed markets strengthening but increasing concern for emerging markets**

Recent data has been positive for developed markets. Europe, the US and Japan are doing well. Improvements in the eurozone economy are broad and credit growth is now positive. Moreover, consumer demand is strengthening, unemployment is falling and business confidence is improving. In the US, there is a broad swath of improving data, ranging from labour and housing markets, to consumer and business confidence. Industrial output is also expected to strengthen in the months ahead.

Emerging markets, however, are a different story. As the Chinese economy slows, countries that export to China are being hurt. This affects emerging economies more than Europe or the US. And, unfortunately, this is just one of several negative factors to have hit emerging economies. Falling commodity prices, for example, have hurt Indonesia, Malaysia and Thailand. And the depreciation of the yen over the past two years has hurt the competitiveness of Asian emerging markets in general.

There is also a worrying lack of transparency related to the future actions of Chinese policymakers. Nonetheless, Group Economics maintains that a "hard landing," where the Chinese economy would tip into recession, is unlikely.

Instead, emerging markets are expected to turn the corner. Growth for emerging markets overall is expected to fall from 4.4% in 2014 to 3.8% in 2015 before accelerating to 4.6% next year. Risks have clearly increased.

## **Developed markets are resilient to weakening in emerging markets**

Group Economics believes that the effect on the eurozone of slowing growth in emerging markets will be limited. This is because a slowdown in emerging markets imports is being offset by growing domestic demand within Europe and the US. Demand has also been helped by the euro's 5% depreciation over the course of 2015. As a result, developed markets have so far been resilient to the problems in emerging markets.

Another positive factor is the active role played by central banks. They remain vigilant in providing financial liquidity and supporting economic growth. The Federal Reserve is now considered unlikely to hike rates in September and the ECB is expected to increase its asset purchases in the next few months. The Peoples Bank of China is also applying a variety of monetary and fiscal policy measures and has significant room left for manoeuvring. It should be noted, however, that monetary policy actions typically face a lag between implementation and visible results. Nonetheless, the GIC is convinced that the effect of monetary policy actions will prove positive.

## **Equities overweight maintained**

The overweight allocation to equities was maintained. The position is based on ample liquidity, trend-like growth and the very low return available from cash. The recent volatility in global equity markets is seen as a correction in a bull market, albeit, an aging bull market. Equities are also benefiting from monetary stimulus in the eurozone and low interest rates. An increase in the ECB's asset purchasing programme and the delay in rate hikes by the Federal Reserve are both positive for stocks.

The second-quarter earnings season was better than expected in both the US and Europe. Earnings surprises among European companies were found mainly in cyclical sectors, such as information technology (IT) and industrials, which were supported by falling oil prices and a weak euro. In the US, companies tied to domestic demand did better than analysts had expected, while exporters were hurt by a stronger dollar.

European stocks are preferred over US stocks, based on earnings potential and the fact that Europe is in an earlier stage of the economic cycle. Earnings yields are also higher in Europe than in the US, where margins will be under pressure as employment rises and wages increase. While we retain an overweight allocation to emerging-markets Asia stocks, it is suggested to continue to hold these positions, but it is not the time to add to them.

### **Strong underweight in bonds is maintained**

There is no case to increase bond positions and the strong underweight in the asset class is maintained. Forecasts for bond yields were recently revised. German Bunds are now expected to perform better than cash through the end of the year, but the small positive returns (before costs) that are expected will likely turn into losses by mid-2016. The government bonds of eurozone periphery countries offer more reward. These markets continue to benefit from the European Central Bank's large-scale purchases of bonds, which is expected to increase. High-yield bonds also offer some additional yield, but there are also significant risks. It is also advised to continue to avoid emerging markets bonds. The impact of slow and gradual hikes on the bond market is expected to be moderate. We now expect the Federal Reserve to start a slow and gradual rate-hike cycle in December.

### **Overweights maintained for commodities and hedge funds**

In August, commodity prices fell off a cliff, but later had a remarkable recovery. The CRB Index, which tracks futures prices for 19 commodities, lost 8%, as it moved in line with Chinese equity markets and emerging-markets currencies. The CRB Index, however, is dominated by energy and agricultural commodities, so when the oil price started to recover recently, so did the index. We expect commodities will continue to improve, and, in particular, for base metal and oil prices to appreciate. The overweight in commodities provides a hedge for active portfolios. During the Greek financial crisis, for example, commodities rose when other asset types corrected. Hedge funds offer similar protection, with long/short equity strategies recently proving effective in turbulent markets.

### **Outlook for emerging markets currencies is poor; euro and dollar to reach parity**

The environment for emerging market currencies remains very negative. There has been a negative feedback loop between lower commodity prices, concerns about global growth, deterioration in investor sentiment, weak domestic growth and expectations that the Fed will start hiking rates in 2015. Group Economics believes that the currencies of Brazil, South Africa, Turkey, Colombia, Malaysia and Indonesia are the most vulnerable.

In developed markets, the euro and the US dollar are expected to reach parity, based on monetary policy divergence and an expectation of constructive financial markets. The bearish view on the yen is maintained, based on additional monetary policy stimulus by the Bank of Japan, a widening difference in interest rates with the US and less interest in the yen as a safe-haven currency.

### **Conclusion**

Markets have had a difficult time recently. The GIC believes it is important to look beyond short-term nervousness and to focus on longer-term drivers, such as company earnings and the recovery seen in Europe, the US and Japan. While the slowdown in China is a threat, it is not expected to hurt global growth. Central bankers will continue to be vigilant in fostering economic growth. The slight economic acceleration that is expected through the end of the year, together with the actions of central banks, should result in financial markets stabilising, although short-term bouts of increased volatility are likely to continue.

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