

cautiously optimistic investment strategy

20 September 2016

It is not all plain sailing for the global economy, but we remain cautiously optimistic. Stocks continue to be preferred over bonds; and within stocks, those of emerging-markets Asia are preferred over US and European equities.

The global economy continues to “muddle through,” with mixed economic data. Most recently, various economic “surprise” indexes have fallen, indicating that the pace of global economic growth is not meeting expectations. ABN AMRO Group Economics, however, continues to be cautiously optimistic that the business cycle will improve in coming quarters. Central banks are also expected to remain supportive.

There has recently been a mini-burst of risk aversion, resulting in inflows toward safe-haven assets. It is the result of changes in regulations for US money market funds. Flows out of money market funds have created demand for short-term Treasury-linked paper. These inflows are expected to be temporary.

The Global Investment Committee made no changes to the overall asset allocation at its meeting on 15 September. The allocation continues to consist of a neutral allocation to stocks and an underweight allocation to bonds. Real estate and commodities are overweight. There is a neutral stance to hedge funds. Within the fixed income portfolio, there has been a reallocation from high-yield to investment-grade bonds. With this move, the high-yield position has been reduced by half.

Interest rates not expected to go lower

The Committee discussed at length the current low and negative interest rate environment. There is broad consensus that the current rates represent the lower boundary for central banks. Further incursion into negative interest rates is not expected.

Group Economics expects the European Central Bank (ECB) to expand the duration of its quantitative easing programme until September 2017 (past the current end date of March 2017) and to increase the range of eligible assets. It is not expected that interest rates will be further reduced. While the ECB could increase the amount of assets it is buying every month, this is also not expected, given the market distortions that are created. The US Federal Reserve is expected to hike rates in December if the economy does not unexpectedly weaken. Two more hikes are expected to follow in 2017.

Neutral stance to equities

After improving, equity markets have more recently been affected by uncertainty over the course of US interest rates. In general, it seems that there is doubt over the ability of central banks to fuel economic growth and inflation. As only modest global growth is expected, earnings momentum is underwhelming and valuations are no longer cheap, a neutral stance toward equities was maintained.

In terms of regions, there is a preference for emerging-markets equities, and, in particular, Asian emerging markets. Emerging markets are preferred because of an improved outlook for the region. Commodity prices are stabilising, emerging-markets currencies have strengthened and the outlook for commodity-exporting countries has improved. Emerging markets also offer diversification from the political risk present in developed markets.

In terms of sectors, those with long-term profitability, global scope and strategic drivers, such as health care and information technology, are preferred. Defensive stocks, such as those found in the consumer staples sector are also favoured. Sectors with problematic business models (financials, utilities) or that have already anticipated a recovery in manufacturing (industrials) are not preferred.

Quiet period in bond markets is over: high-yield position reduced

After a calm summer, the volatility in bond markets has recently increased. It is a reaction to fears regarding the next steps to be taken by central banks.

With the goal of reducing risk and taking profits in the bond portfolio, the position in high yield was reduced by one-half. The proceeds were invested in investment-grade corporate bonds. These bonds continue to benefit from the ECB's asset purchase programme, which is overwhelming fundamental considerations. In general, investment-grade corporate issuers are benefitting from healthy balance sheets and the absence of leverage. High-yield bonds, however, are under threat by a low-growth, low-inflation environment, which means that debt-laden companies may find it hard to grow out of debt. The new bond portfolio allocation appears as Figure 1.

Commodities & real estate remain overweight

Commodity prices have recently stabilised after a strong recovery. A more positive demand dynamic is making commodities less vulnerable to the oversupply situation that existed last year in the energy sector. After having been closely linked to equity markets, the correlation between equities and commodities is lessening, which has increased the diversification benefits of investing in commodities.

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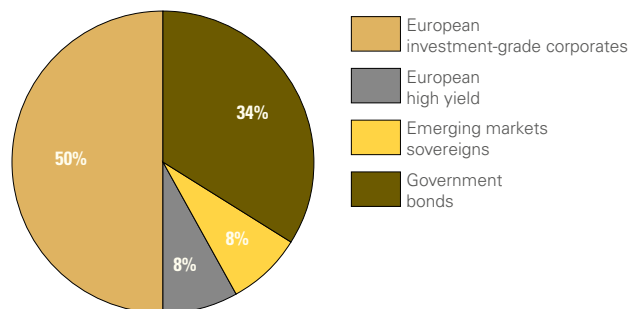
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The investment case for real estate remains intact, despite recent underperformance versus bonds and equities, owing to the threat of interest rate hikes. Nonetheless, real estate fundamentals remain attractive, with good momentum and attractive dividend yields.

Figure 1: Bond allocation (profile 3)



The bond portfolio for profile 3 (balanced portfolio) is represented here.

Source: ABN AMRO Private Banking

Global Investment Committee

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US Person

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