Madala

INPUT FOR STRATEGIC ASSET ALLOCATION

OCTOBER 2018

PERSPECTIVES (3-6 MONTHS)

Observations Markets & News: Inflation Pressure

The US has a positive real interest rate for the first time in a decade with the Fed at 2% and PCE inflation[i] at 1.5% in August. US interest rates rose on the back of a strong employment market, rising wage data, and bullish sentiment data. This trend is likely to continue for several months.

We expect the global outlook to remain extremely challenging for the EMs and a deterioration in the corporate debt market could follow soon with the prospect of interest-rate normalization and the end of an unprecedented ten-year monetary stimulus cycle in the developed economies, which continue to perform robustly. Higher USD rates are inherently bad for EM where significant debt is issued in USD.

Implied volatility is set to rise as key events approach.

Politics

US-China trade war: The two largest economies are on contrasting economic trajectories. The US embarks on monetary tightening to prevent its economy from overheating in the context of the lowest unemployment rate since 2000 and GDP growth set to be the fastest since 2005. The Chinese government has moved toward more flexible fiscal and credit policies to avert an economic slowdown, which could be transformed into a hard landing by the impact of Trump's tariffs.

Risk premia rises because of Fed policy and due to a White House that is imposing trade tariffs on even the closest allies. 'America First' stands for nationalism, which has historically lead to isolation in the short-term and to wars in the longer-term. Each passing month highlights how the market regime has changed, with rising interest rates, the culmination of Central Bank asset purchase programs, increasing geopolitical tensions, and trade wars increasing uncertainty and driving volatility higher.

Economies & Monetary Policies

Economies face narrowing output gaps and rising inflation yet markets continue to expect accommodative central bank policies. Wages are rising in the US, UK, Europe and in Japan. Investors may be underestimating the probability of tighter monetary policy. The risk is that markets respond asymmetrically.

The US economy is accelerating and the US labor market is tight. The US growth outlook for 2019 has strengthened. There are unequivocal signs of cost pressures in terms of both inputs and wages. Inflation will pick up as a result.

The risk is higher for the Fed to hike more, not less than the market has currently priced in. The risks to inflation have become asymmetric.

The current situation for sovereigns was compared to Prince Rupert's Drop[ii] ("larme de verre"), in that what is perceived as a strong, balanced system one day could blow up the next.[iii]

Equities

Despite tightening policy and slowing growth equities have not yet meaningfully responded and remain near all-time highs.

Mining and mining services stocks generally outperform when bond yields are rising. Tech companies with growing revenue and earnings at high levels are independent of economic growth.

We favor healthcare and biotech stocks where price/sales ratios remain close to historic lows and a near record number of companies trade below 2x cash while drug innovation is accelerating.

Fixed Income

The cost of fixed income is being repriced globally, one market after the next. The balance of risks to bond yields relative to market pricing is heavily skewed to the upside.

USD yields could move substantially higher in order to entice international investors to finance the rising US deficit[iv]: US corporates need to refinance $4 trillion of bonds over the next five years (Wells Fargo Securities, May 9, 2018; $ca. $700 bn in 2018, $750bn in 2019 and $880 bn in 2020). About $3 trillion is investment grade, mostly in the lowest rungs BBB / Baa, with the rest in high-yield. Higher borrowing costs look to coincide with tighter credit conditions. If companies will be forced to refinance at higher rates, credit conditions could erode leading to a vicious circle of more downgrades and pushing bond buyers to seek out better-rated issuers.

Emerging Markets Currencies & Debt

EM show symptoms of a broader weakness in the structure of global financial markets. Negative turn in EM debt since mid-April.

EM currencies with large current account deficits and a large portion of their debt in foreign hands (Turkey & Argentina) have sold off steeply. Countries on borderline of economic weakness could get sucked into the vortex (e.g. Indonesia, South Africa, India, Brazil).

EM debt at a record USD11trn with liquidity at US$4.9trn in 2017.[v] A rise in USD rates speeded by the turn of QE to being a net negative, could destabilize bond markets globally creating a serious headwind for all fixed-income asset prices.

Commodities

Oil: US shale production growth could peak later this year.[vi] The extension of the OPEC cut through the balance of 2018 cemented a bullish underlying supply/demand balance. Almost all oil capex has been directed toward US shale production.[vii]

Demand in rare earths such as lithium, cobalt and graphite is exploding because of increasing popularity of electric vehicles.[viii]

Asset Allocation

With so many key events in the coming months regarding US-China trade relations, the Italian budget negotiation, Brexit, Iran sanctions, and the US midterm elections the benign pricing of risk premia strikes us as a bit complacent.

Wise to look for diversifying assets and / or strategies. Implied vol is likely to move higher before long. Merger Arb or event driven strategies profiting from M&A offer attractive risk/rewards. Examples for hedges are long Japanese yen as a general risk aversion trade, short Australian dollar as a hedge against a China slowdown, short US high yield and CMBS due to deteriorating credit quality and an increase in borrowing rates, and short Italian government bonds as a hedge to escalating European political risk. Short sovereign debt or CDS on corporates could profit if either rates rise and/or spreads widen.

Roland Eberhard

October 4, 2018

[i] PCE Inflation stands for personal consumption expenditure price index (PCEPI) and is a good measure of US inflation as it tracks the change in prices of goods and services purchased by consumers.

[ii] Equinox Partners

[iii] Wikipedia: “Prince Rupert's Drops (also known as Dutch tears) are toughened glass beads created by dripping molten glass into cold water, which causes it to solidify into a tadpole-shaped droplet with a long, thin tail. These droplets are characterized internally by very high residual stresses, which give rise to counter-intuitive properties, such as the ability to withstand a blow from a hammer or a bullet on the bulbous end without breaking, while exhibiting explosive disintegration if the tail end is even slightly damaged. In nature, similar structures are produced under certain conditions in volcanic lava.

The drops are named after Prince Rupert of the Rhine, who brought them to England in 1660, although they were reportedly being produced in the Netherlands earlier in the 17th century and had probably been known to glassmakers for much longer. They were studied as scientific curiosities by the Royal Society and the unravelling of the principles of their unusual properties probably led to the development of the process for the production of toughened glass, patented in 1874.”

[iv] Karya

[v] Bank for International Settlements: between 2010 and 2017 the total value of emerging market debt securities outstanding more than doubled from US$5trn to around US$11trn. Yet over the same period, according to the Emerging Market Traders Association, trading volumes in emerging market debt fell, sliding from more than US$6.5trn in 2010 to US$4.9trn in 2017.

[vi] Rig count in the Permain basin has flatlined around 460 with new production at 620 brl/day to a new production of 285'000 brl/day. Legacy decline is over 300’000 brl/day implying that Permian output could fall in the next few months. Source: Horseman, 25.07.2018

[vii] Horseman Global, BBL Commodities

[viii] Regal Funds Management