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ASSET MANAGEMENT

ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

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"Keep an eye on the cycle and central banks"

The global cyclical recovery continues apace while inflation has stabilised at abnormally lower levels (with the notable exception of the UK). With the economy accelerating in industrialised countries G7 central banks, apart from the Bank of Japan, are already cautiously tightening monetary policy slightly or about to do so.

THE RECOVERY IS STILL ON TRACK

Two developments are gaining ground and they are at odds with the market mood: investors had been banking on reflation following Donald Trump's election but now they are thinking again.

- The recovery is still on track while the likelihood of a looser fiscal stance in Germany, probably followed by Japan and the US in 2018, means the cycle has a little more visibility. Even if growth has so far failed to generate inflation, there is every reason to bank on a completely different trend in the future. Some experts like Janet Yellen think that the link between growth and inflation has simply been distorted by the global 2008 crisis and that it will gradually return to normal. Others are of the view that significant structural shifts, such as the price war triggered by the emergence of players like Amazon, has resulted in inflation going global, a development that has demoted domestic growth rates to a lesser role. We tend to think that inflation will return very gradually to normal and that, in the absence of tangible proof, markets are underestimating the chances of today's abnormally low and stable inflation coming to an end.

- Most central banks are moving towards higher interest rates although very cautiously because of soft inflation and also because they want to avoid market turmoil. Even so, markets are behaving as if investors do not really believe rate hikes are round the corner.

KEY POINTS

- Fresh interest in Japan
- Profit taking on subordinated financial debt
- Now underweight UK equities

JAPANESE EQUITIES HAVE THE MOST ATTRACTIVE VALUATIONS

Due to this risk that the pendulum might swing the other way, we have tactically reduced our exposure to US Treasuries and reinforced Japanese equity weightings at the expense of emerging country equities. Japanese stocks tend to outperform -and emerging countries underperform- in a more reflationary economy or when interest rates are rising. Moreover, Japan is clearly recovering and labour market tensions there are at record highs. To cap it all, the Bank of Japan is sticking with its highly expansionary monetary stance. As a result, Japan is an excellent reflation play, the main problem being that the government has to pull out all the stops to overcome consumer attitudes nurtured by 25 years of deflation. Additionally, Shinzo Abe's decision to call new elections has put pro-active policies back on the front page: whatever the election results, the main thrust will be to sustain the recovery. Japanese equities are also interesting because they have the most attractive valuations among major stock markets. In contrast, emerging country equities now have less upside, especially after a good run so far this year. And as investors are largely overweight the zone, it could be hit by profit taking, particularly as the tech and commodity stock cycle is already very mature. Finally, the cheap US dollar and low bond yields will obviously not be around forever to sustain emerging markets.

We have also taken some profits on subordinated financial bonds but are still overweight. We see no specific threats to the segment and it still boasts one of the best risk-return profiles in the bond universe. We have also cut our rating on UK stocks. The Bank of England's volte-face in favour of tightening and the risk of a hard Brexit are two good reasons to underweight the UK.

NEXT HEADLINE EVENTS

- ***October 26: next ECB meeting***
- ***October 31/November 1: next Fed meeting***
- ***October 30 & 31: next BoJ meeting***

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