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CONFERENCE SUMMARY

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CIO—MULTI-ASSET CLASS

MULTI-ASSET INVESTING: TURNING VIEWS INTO INVESTABLE POSITION

"Equity returns have the potential to be very positive in this mature-cycle environment, but they also tend to come with much higher volatility and correlation with bond market returns."

KEY POINTS

- Equities look attractive, but will come with high volatility
- Inflation-sensitive assets, especially TIPS, appear to be cheap
- In credit, short duration removes a lot of interest rate risk without sacrificing much yield
- Hedge funds and uncorrelated strategies can help mitigate late-cycle volatility

Erik took the economic and market themes identified in Joe Amato's opening presentation and extrapolated them into ideas for investment positioning. He began by setting out the headline views from the latest Asset Allocation Committee meeting.

Equities represent a reasonable opportunity on a 12 month horizon, following the correction during the fourth quarter of 2018, with the focus on the U.S., Asia and emerging markets. These markets may also be supported by a weaker dollar, as investors re-focus on the U.S. twin deficits that they ignored through 2018. Positioning for higher rates and inflation implies an overweight view on inflation-linked bonds and commodities, funded from an underweight in sovereign nominal bonds. Credit markets present some specific opportunities, despite spreads remaining quite tight overall. Both directional and low-volatility hedge funds, and especially uncorrelated strategies, could play a role in navigating an environment of higher volatility and rising stock-bond correlations. And finally, while private equity buyout looks very expensive and over-leveraged, niche and opportunistic strategies in private markets still hold out attractive options.

In equities, Erik noted that history shows that a 10%-plus correction in the S&P 500 has been followed by an average 12-month return of 11.8%—so long as those 12 months pass without a recession. When there has been a recession, the 12-month return has averaged just 0.5%. Much depends on our central scenario of a "soft landing" for the U.S. and global economy: if that is what we get, S&P 500 earnings growth might be expected to hit the 6 – 8% range in 2019. Valuation multiples appear even more attractive in emerging markets, Erik observed, especially when one takes into account the changing composition of those markets toward more Asia and technology exposure.

Equity returns have the potential to be very positive in this mature-cycle environment, Erik noted, but they also tend to come with much higher volatility and much higher correlation with bond market returns. This informs a positive view on hedge funds, alternative risk premia, index put-option writing strategies and sources of uncorrelated risk.

Our view on interest rates is that the U.S. Federal Reserve is likely to be on hold for the first half of the year, but where the market is starting to price in a rate cut in the second half of the year, we think that this will only be a pause, followed by a resumption of the upward path. That reflects our view that we will see a moderate uptick in inflation in 2019. Those views inform a positive view toward commodities and Treasury Inflation Protected Securities, which we think are trading very cheaply, as well as a bias toward short duration in credit markets, where a lot of interest-rate risk can be removed while sacrificing very little yield or spread.

Erik followed Joe in identifying China's economic slowdown as the biggest risk to our economic and multi-asset portfolio views. Our global soft-landing view depends upon China being able to engineer its own soft landing with its stimulus measures, he explained, and while we believe it can succeed in those efforts, the true impact of current stimulus efforts will not be clear for at least another three or four months, leaving us with quite a lot of uncertainty around the basis of our asset allocation views.

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