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HOTTINGER

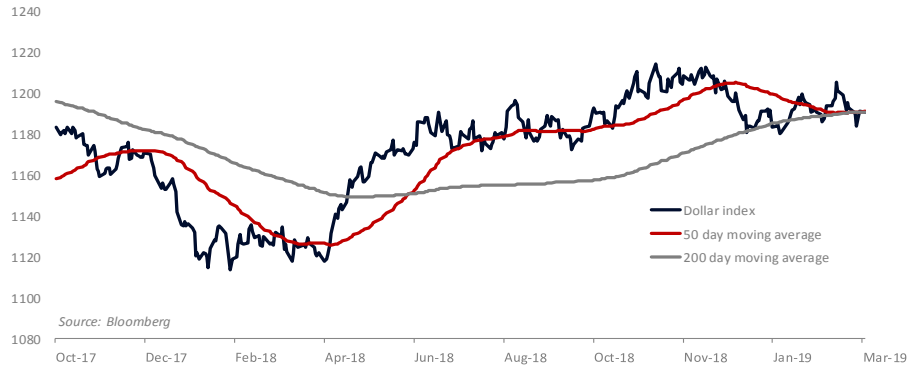
GROUP

GLOBAL INSIGHT

Overview

- Allocating to genuinely uncorrelated, liquid, sources of return has arguably never been harder than it is now. Using similar inputs to everyone else is hindering this.
- In our **feature article,** Jonathan Dagg and Vinesh Jha argue that adopting sources of alternative data, based on innovative and specialist R&D, can give fund managers an edge over their competition.
- In our **Macro View**, we account for a synchronized global slowdown that has spread from China to the United States via Europe. China's role appears to be pivotal, with the country exporting weak activity to Europe and low inflation to the United States.
- There are signs that looser monetary policies may have arrested the slowdown, but with much of what has been announced merely intentions rather than actions, we think downside risk remains. Political headwinds limit the use of effective fiscal policy in Europe and the United States.
- In our **Investment Outlook**, we assess activity in the first quarter as markets recover from allayed fears over the US-China trade standoff and a hawkish Federal Reserve.
- The resolution of trade tensions and the Fed's change of heart on interest rates may be enough to stop the rollover in global growth and anchor global interest rates at low levels.
- Relative to bonds, equities remain attractively valued and it is only in the US that bond yields are above the dividend yield and offer a credible alternative to equities.

Dollar trading during Q1 2019 suggests period of dollar strength may be ending



Inside this issue

Economic Highlights

- Global shipping volumes declined by 50% in January.
- Car sales in China slumped by over 15% during Q1.
- Weak producer inflation in China weighs on US prices.
- UK inflation falls below the Bank of England's 2% target.

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Based upon information available up to and including 16th April 2019

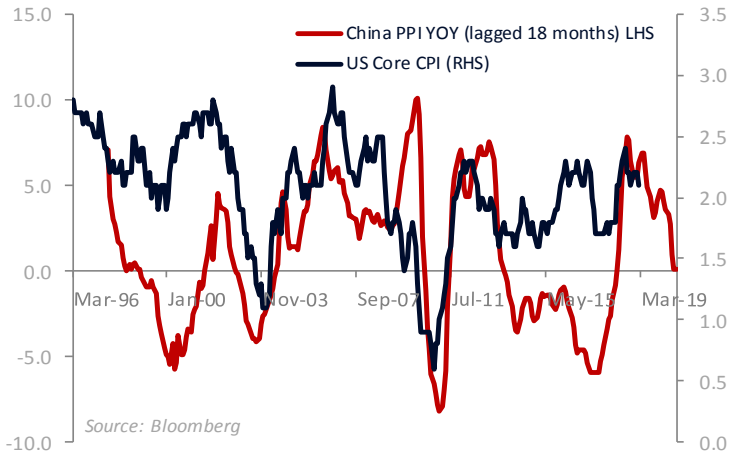
Key Issues in Charts

China exports its economic weakness to Europe

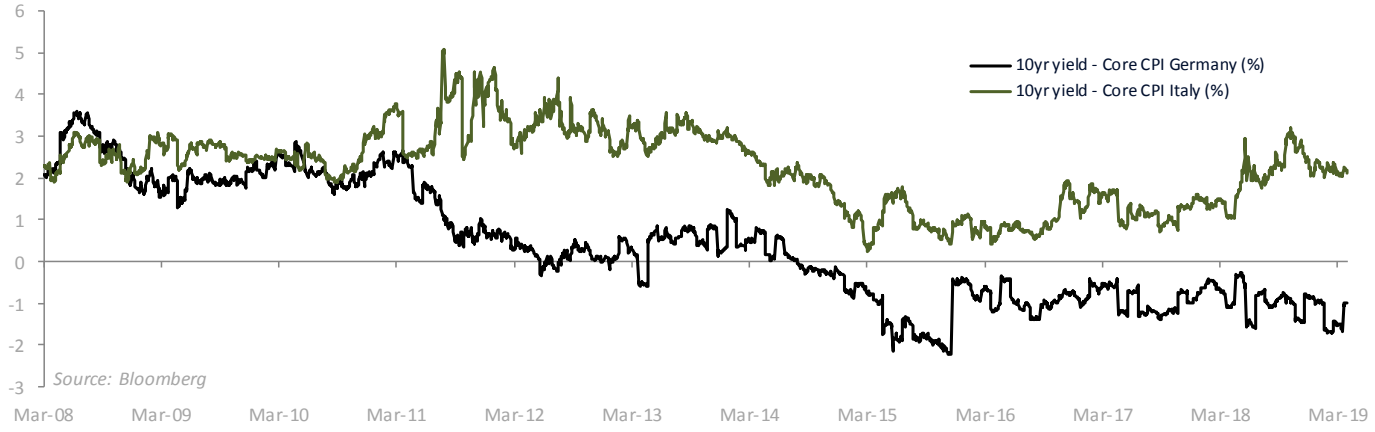
- The chart shows the relationship between the purchasing managers' index for Eurozone manufacturers with the index for China's export orders lagged by three months.
- Slowdown in demand for Chinese exports can have a knock-on effect for Chinese producers' demand for European imports of capital goods.
- One manifestation of this new China-Europe link is the collapse in car sales in China. Annual growth in sales of automobiles has been consistently above 5% since at least 2014. Since summer last year, however, sales growth turned strongly negative.

China exports its low inflation to the United States

- China's producer price inflation index – lagged by 18 months – is a leading indicator for US consumer prices.
- Lower price pressures out of China create disinflationary forces that ripple out globally.
- It is commonly thought that the emergence of China to economic pre-eminence is a key reason why inflation remains low particularly in places that trade extensively with the country.



Divergence in real interest rates between Germany and France creates headaches for the European Central Bank



- The chart shows that real interest rates in Italy have diverged from those in Germany since the Eurozone recession of 2011. A combination of higher nominal yields and lower core inflation in Italy, compared to Germany, is to blame.
- The ECB is in a difficult position because if it eases policy too much to suit Italy, it generates too much inflation for places like Germany, and if it tightens too much for Germany, it can push countries like Italy into deeper recession.

Alternative Data: The new frontier for absolute returns

By Jonathan Dagg, *Director at* ***Alpha Beta Capital*** *and* ***Vinesh Jha,*** *CEO at* ***Extract Alpha***

Most fund managers use similar information in similar ways: company news, financial statements, research reports, price and volume. In recent years this has inhibited much of the absolute return fund sector; with so much capital chasing absolute and uncorrelated returns, using similar inputs is leading to correlated returns.

"Recent underperformance of the absolute return sector may have been due to crowding in common strategies, being a victim of its own success, and the rise of 'smart beta' products."

Today we are awash with alternative data that can give insight into an investment opportunity: from sentiment, online consumer demand, transactional data or alternative measures of Environmental, Social, and Governance (ESG) investing.

In this article, we look at how the erosion of traditional sources of investment edge is motivating the search for alternative data sets and explanations for why adoption has been gradual. We then examine some important issues with alternative data, including dispelling some myths around the hype; most importantly we examine how alternative data can help improve portfolio risk and returns.

Absolute returns: Motivating the search for alternative data

Recent underperformance of the absolute return sector may have been due to crowding in common strategies – being a victim of its own success – and the rise of 'smart beta' products. It turns out, for example, that a momentum strategy in Fund A is not hugely dissimilar to a momentum strategy in Fund B: who'd have thought it, eh?

One clear prescription seems to be for investment managers to diversify their sources of investment return.

Alternative data adoption has been gradual

With so much data available today – most of which was unavailable even just a few years ago – the need for alternative data adoption is clear. Nothing worthwhile is ever easy. As such, many fund's portfolios are still dominated by classic, likely crowded strategies.

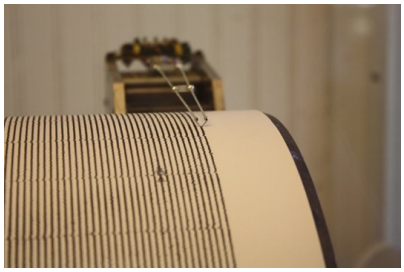
"Many fund managers seem to prefer their bets proven wrong at the same time as their competitors."

Chief among the reasons for this is that figuring out which data sets are useful is difficult, and turning them into an investment edge is more difficult still.

Putting it another way, alternative data hasn't yet "crossed the chasm." Geoffrey Moore's text Crossing the Chasm [1991] explains the life cycle of a product from the perspective of innovative technology companies – noting that the hardest part of the adoption cycle is increasing take-up from visionary "early

adopters" to the more pragmatic "early mainstream" adopters, who are more averse in their adoption of new technologies.

This concept is well known among tech startups but hasn't been widely considered by the fund management industry – but it applies just as well. Alternative data is at the early stage of adoption, but perhaps at the tail end of the early stage – i.e. at the edge of the chasm. Early adopters in the fund management industry tend to be fund management companies who are already data-savvy, and who command the resources to ingest new data sets.



"Finding datasets that move the needle requires a specialist R&D function and hard work."

Most funds available to European investment managers have little exposure to non-traditional data

Perhaps the holdouts who have not embraced alternative data are hoping that value, momentum, and mean reversion aren't very crowded, or that their take on these strategies is sufficiently differentiated.

It is possible that a behavioural explanation is at work: herding. In a similar way that sell side research analysts often move their forecasts with the crowd to avoid a bold, but potentially wrong, call, perhaps fund managers prefer to have their bets proven wrong at the same time as their competitors' bets. This may seem to some fund managers to be a better outcome than adopting alternative data which is innovative but requires specialist R&D.

How can Alternative Data help to improve overall portfolio risk and returns?

Most alternative data sets simply do not add much utility to fund management, or the scope of their deployment is inherently limited. The data sets often seem intuitively appealing, but may lack much practical use; for example, there are lots of research firms that that have started to count the number of cars in the parking lots of big box retailers using satellite imagery, especially in the United States, or to gauge the contents of oil containers. However, the total number of financial assets for which this information may be relevant is naturally limited.

"It is likely that as more data about the physical and online world is collected, researchers will find ever more value in processing these emerging data sets to unlock value."

As another example, data sets which capture sentiment from online activity, perhaps the earliest form of what we now consider alternative data, have exploded, with many dozens of providers, the majority of which mine Twitter for sentiment. Beyond the obvious observation that Twitter contains significant noise, some empirical studies of microblog sentiment have shown that the predictive power of these signals is just too fleeting to be part of a viable investment strategy.

One needs to aim to formulate at least a general hypothesis, based on capital markets experience, as to why value could be found in a data set, whether that value comes from predicting stock prices, volatility, fundamentals, or something else.

Our track-record shows that alternative data sets can help with all of these things if they are carefully vetted and rigorously tested.

Away from the hype, Alternative Data is being used successfully

We use some alternative data sets to look directly at proxies for a company's fundamentals.

Consumers spend an increasing share of time online, not just to buy products; they also engage in researching those products prior to making purchasing decisions. This is true of retail consumers and business-to-business buyers alike. Therefore, it is possible to proxy the demand for a company's products by the amount of attention which is paid to the company's web presence. Although attention can be a negative sign (in the case of a scandal), literature has shown that on average more attention is a good thing for a company's prospects.

This type of attention data is well-established in the digital marketing industry, but is relatively new to stock selection models.

Conclusion

Allocating to genuinely uncorrelated, liquid, sources of return has arguably never been harder than it is now. Using similar inputs to everyone else is hindering this.

Forward-thinking funds have begun to use alternative data sets in their decision-making processes, though there is significant room for additional adoption by the mainstream. It is likely that as more data about the physical and online world is collected, researchers will find ever more value in processing these emerging data sets to unlock value.

Alternative data is the new frontier for absolute return investing.

Jonathan Dagg is Director at Alpha Beta Capital, a systematic investment management company that specializes in the application of new and interesting datasets to asset management.

Vinesh Jha is CEO at ExtractAlpha, an independent research firm dedicated to providing unique, curated, actionable data sets to institutional investors.

Macro View

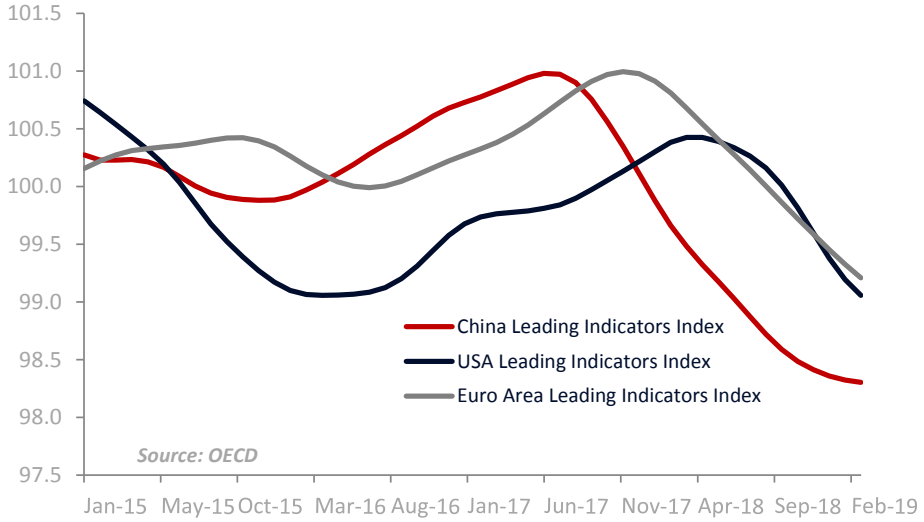
-1.8%

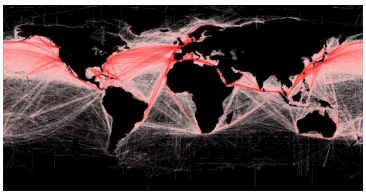
"World trade volumes slumped 1.8pc in the three months to January, according to the CPB Netherlands Bureau for Economic Policy Analysis."

During the first three months of 2019, we saw further movement in the direction of a global slowdown. Economic activity in the three major world regions – the United States, China and Europe – has markedly decelerated, causing central banks to turn to supportive monetary policies and national treasuries to consider increasing public spending. World trade volumes slumped 1.8pc in the three months to January, according to the CPB Netherlands Bureau for Economic Policy Analysis.

At the point of writing, there are signs that looser policies may have arrested the slowdown, but with much of what has been announced merely intentions rather than actions, we think downside risk remains.

Slowdown in China has infected the rest of the world





"In January, the Baltic Dry Exchange Index dropped by a further 50% before recovering only weakly over the quarter."

China

In January, the National Bureau of Statistics announced that the growth rate for the Chinese economy has fallen towards the government's target of 6.5%. The real slowdown may have been worse as indicated by measures of electricity consumption and freight volumes.

In December, according to China's Customs General Administration, exports fell by 4.4% annualised but imports fell even faster, by 7.6%. Being at the heart of the world's manufacturing and inventory system, China is likely to be accountable for the significant drop in the Baltic Dry Exchange Index, which measures volumes of goods shipped along global trading routes, many of which flow through the South China Sea. The index had fallen by a third between August and December last year. Ominously, in January, the index dropped by a further 50% before recovering only weakly over the quarter. While the index is volatile

and has a strong seasonal component, the size of the move in its value in recent months suggests the upward trend in global shipping since the start of 2016 could be coming to an end.

China's Shanghai Stock Exchange was one of the worst performers in 2018 but recovered almost all of its lost ground in the first quarter of 2019, suggesting stimulus measures may have boosted liquidity and undergirded financial markets. The effect of the 250bp cut in the reserve ratio requirement during 2018 has passed through into lower interest rates for banks, which broadly increased lending during Q1 2019. Tax cuts to small businesses, amounting to $29bn in January alone, and on personal incomes could boost consumer spending as house price growth in major cities slows.

"Tax cuts to small businesses, amounting to $29bn in January alone, and on personal incomes could boost consumer spending as house price growth in major cities.

Since January, exports have recovered but imports have not, which means that any stimulus that has worked its way through China has yet to bring dividends for the rest of the world, particularly Europe.

Europe

Developments in the last 18 months have given us the impression that we live in a China-centric manufacturing world but a US-dollar centric financial world. Europe is uniquely exposed to Chinese economic activity to the extent that investing in European industrials has now in part become a bet on the macroeconomic performance of China. Meanwhile, Europe's banks are uniquely sensitive to global liquidity and dollar funding conditions.

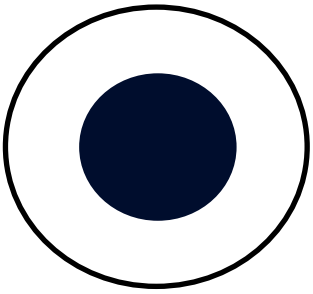
Since mid-2016, Eurozone manufacturing PMIs have tracked China's export orders index – an indicator of internationally focused industrial activity – with a three month lag.

One expression of this new China-Europe link is the collapse in car sales in China. Annual growth in sales of automobiles has been consistently above 5% since at least 2014, and there is strong demand from Chinese consumers for German and European cars. Since summer last year, however, sales growth turned strongly negative. We saw some of the consequences of this in the UK, with the decision of Jaguar Land Rover (JLR) to cut the number of people it employs in Britain. JLR posted a £3.4bn quarterly loss in Q4 2018 partly on the back of a collapse in sales to Chinese buyers.

"Since the mid-2000s, the German economy has hitched its wagon to China, growing its exports to the country by over $70bn per year."

Since the mid-2000s, the German economy has hitched its wagon to China, growing its exports to the country by over $70bn per year. In contrast, the combined increase in exports to China from Italy, France and Spain is just $29bn. It is no surprise therefore that Germany and its manufacturing sector have been the worst hit by China's slowdown. But we should not forget other essential states in the euro area.

With a $2 trillion economy, a public debt-to-GDP ratio of 130% and an unemployment rate at 10%, Italy plays a pivotal role in the fortunes of the euro area. Italy fell into technical recession in Q1 2019 as GDP fell by 0.1% for the second consecutive quarter. Italy's macroeconomic problem is that its core inflation rate is too low. Except for very brief periods, the rate has sat below 1% since 2014. This creates problems because it keeps borrowing costs in real terms too high. The third chart on page two of this publication shows the divergence in real interest rates between Germany and Italy, illustrating the perversity of the ECB's single interest-rate policy, which when adjusted for inflation can yield counter-productive results. In Italy, real interest rates are too high; in Germany they are too low.



The ECB has often responded to the more volatile headline inflation rate, rather than the core rate that has stayed persistently low.

Further, persistently low core inflation suppresses consumer demand. Low inflation begets expectations of lower inflation in the future, so consumers delay their purchases, keeping demand weak. Similar to the Bank of Japan's inadequate efforts to reflate Japan in the 1990s, the ECB may have lost its credibility to deliver higher prices by being too slow and reluctant to respond to economic slowdowns in the past. Inflation expectations in Europe are much lower than they are in the U.S.

Italy needs stimulus, but it is unlikely to get it from an ECB that – due to the influence of anti-inflationary Northern European states – is reluctant to implement a more suitably aggressive stimulus. Indeed, the ECB has a bias to targeting headline inflation, which is influenced by volatile energy and food prices, over core inflation, which remains stubbornly low across the euro area. Commercial banks, on which European businesses rely for funding, are also struggling with weak profit margins from the low interest rate environment. Easier Fed policy may probably help European banks get dollar financing on easier terms, but that alone is unlikely to arrest the sharp decline in euro area manufacturing activity that has persisted throughout Q1 2019.

A new fiscal settlement in Europe requires more real solidarity between member states, especially between Northern and Southern Europe.

We think that Europe could recover modestly if the stimulus in China and the United States is large enough to raise demand for European exports and liquidity in global financial markets. But for more sustainable results, there needs to be greater public spending, not just in Italy but Germany too. Europe suffers from deficient demand and has relied on export growth to plug it. That strategy appears to be unsustainable. There needs to be a rethink of the euro area's governing ideology of low inflation, fiscal restraint and limits on the pooling of euro area public debts. That is easier said than done.

United States

There are signs that the global slowdown, which started in China in the middle of 2017 and spread to Europe during 2018, has now found expression in the United States too. For half of last year, the US was expanding at an annualized rate of approximately 4%. Since last autumn, however, growth has sharply decelerated. In March, NowCast forecasts produced by the Federal Reserve Bank

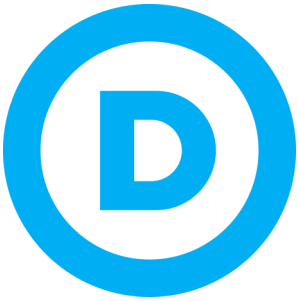
of Atlantic predicted seasonally adjusted growth of just over 1% in Q1 2019 before recovering. Poor retail sales and softer manufacturing activity came despite sustained increases in US wages. The effects of the Trump administration's cuts to corporate and personal taxes appear to be fading.

The slowdown in U.S. economic activity has justified the continued softening of the language from the Federal Reserve regarding its future interest rate policy. The minutes from the most recent meeting of the Federal Open Markets Committee – its rate setting body – stated that the Fed reserves the right to raise interest rates this year but also importantly mentioned that current economic conditions suggest that rates are unlikely to change until the end of the year. The Bank also indicated that it is looking to end Quantitative Tightening, in which it allows up to $50bn of Treasuries and mortgage backed securities to roll of its balance sheet each month, by September this year, a significant sign that central banks will hold government debt on their accounts permanently.

"Lower price pressures out of China create disinflationary forces that ripple out globally."

What happens in China is also impinging on US monetary policy. The Federal Reserve's more dovish policy stance has been influenced not just by the tantrums in equity markets but also due to falling inflation expectations. China's producer price inflation index – lagged by 18 months – is a leading indicator for US consumer prices. The second chart of page two of this publication goes some way to explaining the disconnect between US wage inflation and price inflation. Lower price pressures out of China create disinflationary forces that ripple out globally. Indeed, it is commonly thought that the emergence of China to economic pre-eminence as a low-cost producer is a key reason why global inflation has remained relatively subdued over the last decade.

While wage growth reached 3.5% during Q1 2019, there has been a lack of follow through in consumer prices. Weaker pricing power and limited productivity growth put pressure on company margins, but it also gives cover to the FOMC, which has a mandate to maintain stable prices and inflation at around 2%. Indeed, Fed Chair Jay Powell has indicated that he could tolerate running inflation above the 2% target for some time to balance out the long periods since 2008 during which it has sat below the target. While it remains to be seen whether the Fed can actually engineer higher inflation on its own, the more supportive language from the Fed should boost the global economy.



Low inflation arguably makes it harder for policymakers to bring down debt burdens through inflationary policies and generate sustainable economic growth. It is why we think the era of central bank independence is coming to an end as increasingly populist electorates call for greater public spending. In the coming years, we expect to see fiscal policies to take a stronger role in maintaining GDP growth and inflation. In the U.S., we are seeing this already, with Trump favouring large deficits to fund defence spending and tax cuts and the Democrats considering a Green New Deal of radical public support for new forms of energy production, universal healthcare and free university education.

"We think the era of central bank independence is coming to an end as increasingly populist electorates call for greater public spending."

"The Federal Reserve's recent dovish stance has also staunched the trend for a strengthening dollar."

Emerging markets

What the Federal Reserve does matters not just for the United States. Academics have found that changes in interest rates in the US can affect financial conditions across the world due to the pre-eminence of the dollar for international trade. Further, many emerging market countries – particularly those with high borrowings in dollars – rely on maintaining their exchange rates with the dollar on a formal or informal basis. This often means that their central banks sometimes need to move in line with the Federal Reserve. China's dirty float with the dollar means its central bank often follows the Federal Reserve, and other large emerging countries such as India, Nigeria and Indonesia use US interest rates to guide their own rate decisions due to their soft pegs with the dollar.

The Federal Reserve's recent dovish stance has also staunched the trend for a strengthening dollar. On a trade-weighted based, the 50-day moving average for the trading value of the dollar index trended towards the 200-day moving average (see chart on p.1), indicating that momentum for a stronger dollar has weakened. For emerging markets, this is typically positive as a weaker dollar eases financial conditions for their internationally-focused firms.

United Kingdom

"A surprise hard Brexit is now a less immediate concern."

In the UK, house price growth was recorded at a six-month low and consumer prices inflation fell during Q1 2019, indicating that any labour market pressures revealed by recent real growth in wages did not pass through to general prices. In that sense, the story is similar to the US and there may well be a Chinese element to the story too. In any case, the picture suggests that the pressure on the Bank of England to raise rates to curb inflation has reduced.

We now understand that the new Brexit date is October 31st 2019. A surprise hard Brexit is now a less immediate concern but should it happen later this year, it could lead to a sterling shock similar to 2016, which could push inflation up above 3% in the next 18 months. That would be bad for gilts, especially if the BoE follow through with their action plan to raise interest rates in response. However, we think that the BoE is more likely on an easing path in any situation. With the Fed and ECB delaying monetary tightening, and the Bank of Japan keeping policy loose, it is unlikely that the Bank of England will stand alone in committing to its past statements on raising interest rates.

An unresolved Brexit with the prospect of a General Election and a Corbyn government may provide a propitious outlook for gilt investments through the safe haven channel, supposing both events are non-inflationary. Alternatively, a favourable Brexit outcome with receding election risk removes much of the uncertainty and could create a positive environment for British risk assets. We have also discussed in previous publications how a smooth Brexit could create a positive outlook for British risk assets as investors take advantage of relatively cheap valuations and high dividend yields.

Investment Outlook

It has been a frenetic six months with one of the worst quarters on record followed by one of the best starts to a new year. The two major concerns that sent investors heading for the exit in Q4 2018, namely US-China trade tensions and a hawkish US Federal Reserve (Fed), abated in early 2019. The resolution of trade tensions should be enough to stop the rollover in global growth. Meanwhile, the Fed's change of heart and new found 'patient' approach combined with more dovish positioning from the People's Bank of China and European Central Bank (ECB) may anchor global interest rates at low levels. There was even talk of the 'Goldilocks' scenario, whereby growth is neither too hot nor too cold and asset classes are able to flourish. However, at the end of the quarter the bond market sent a warning shot across the bows as the US yield curve inverted with 3-month rates trading below the 10-year Treasury bond, which in the past has flagged a recession is looming, albeit with a time lag.

"The two major concerns that sent investors heading for the exit in Q4 2018, namely US-China trade tensions and a hawkish US Federal Reserve (Fed), abated in early 2019."

For bond markets, the benign interest rate environment resulted in healthy returns across all sectors. At the turn of the year, the Fed was the only major central bank in tightening mode but its 'pivot' during January was interpreted by interest rate markets that its next move would be to cut. As such, the US yield curve has flattened with the benchmark 10-year yield having fallen from over 3.2% in November to 2.4% at the end of the quarter. It is fair to say that financial conditions have eased markedly over a period when, on balance, the economic data has showed signs of bottoming out. It is hard to see the attraction of longer-dated Treasuries at present as a small rise in yields could wipe out the coupon on offer. That said, in a balanced portfolio Treasuries provide a hedge against a recession striking sooner rather than later.

European government bonds have also rallied strongly as the ECB communicated that rate hikes are off the table for this year while resurrecting its TLTRO (Targeted Longer-Term Credit Refinancing Operations) to help stimulate the economy. On aggregate, northern European sovereign 10-year bonds yields have fallen below 0.5% while the Italian 10-year benchmark yields no more than the US 10-year. As such, it is difficult to find value. No more so than in Germany where the 10-year Bund yield has fallen below zero for the first time since 2016.

"The US yield curve has flattened with the benchmark 10-year yield having fallen from over 3.2% in November to 2.4% at the end of the quarter."

In the UK, the benchmark 10-year yield fell to just 1%, yet the market has remained relatively tranquil given the deep implications of the impending Brexit decision. The calmness could just be investors sitting-pat given the heightened level of uncertainty and potential outcomes. For example, a no-deal divorce could see yields fall sharply as investors flock to safe-haven assets, while the Bank of England could respond with substantial stimulus. At the same time, however, sterling could take a hit which would be inflationary and negative for Gilts. The chancellor could also step-in with fiscal stimulus which would further depress the bond market. Conversely, the outcome from a favourable Brexit deal would likely see yields rise as the economy would be

better placed to withstand higher interest rates. We continue to hold gilts in sterling-based portfolios for their defensive qualities but acknowledge the risk to yields is to the upside.

"We continue to maintain exposure to hard currency emerging market bonds in portfolios as we believe there is room for spreads to contract further."

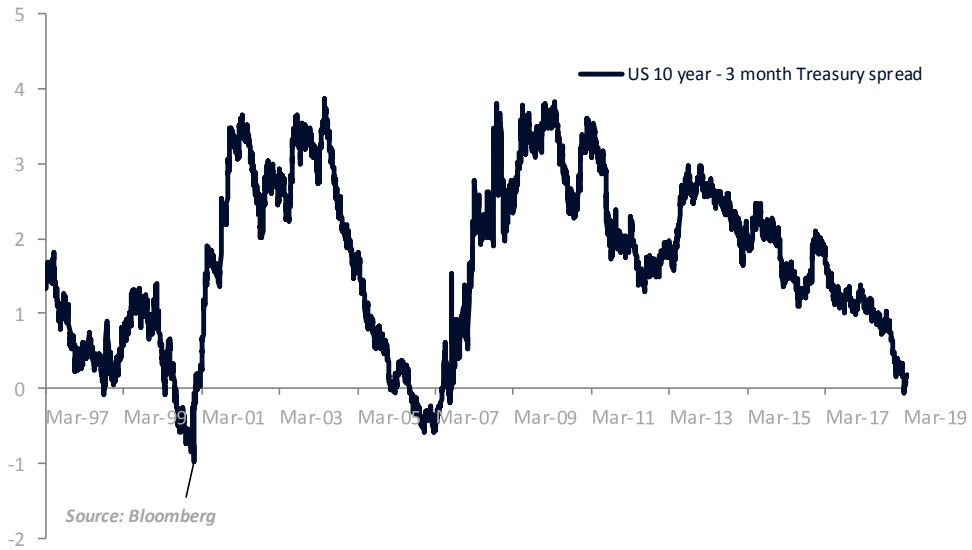
Emerging market bonds turned the corner before developed markets as a number of large and influential countries including Argentina, Turkey and Brazil overcame their financial difficulties in 2018. They have been further assisted in 2019 by a recovery in commodity prices, a more dovish Fed and a more subdued dollar. We continue to maintain exposure to hard currency emerging market bonds in portfolios as we believe there is room for spreads to contract further but are cognisant that it could be becoming a crowded trade.

Some value can be found in the corporate bond markets where investors continue to be paid for taking extra credit and maturity risk. However, spreads have already tightened this year and the fundamentals are becoming more challenging as corporate balance sheet leverage has increased at a time when earnings are weakening. According to Morgan Stanley analysis, on leverage ratios alone half of investment grade bonds should in fact be high yield. And in the US high yield sector, the ratings agencies have downgraded more companies than they have upgraded. On balance, the headwinds look manageable for now as the cost of debt remains low assisted by pragmatic central banks and stubbornly low inflation.

The about turn by US rate setters that has buoyed bond markets this year has also been positive for stock markets. Equities have rallied more on the back of lower real interest rates than fundamental earnings expectations where, according to Morgan Stanley, numbers have been revised downwards

An important part of the US yield curve inverted in Q1 2019, flagging recession risk

"Relative to bonds, equities remain attractively valued and it is only in the US that bond yields are above dividend yields and offer a credible alternative to equities."



in virtually every sector and region of the world. Yet, relative to bonds, equities remain attractively valued and it is only in the US that bond yields are above the dividend yield and offer a credible alternative to equities.

In the US, after a strong fourth quarter reporting season, earnings growth is forecast to turn negative in early 2019, according to Factset. President Trump's tax cuts from last year that gave a one-off boost to earnings will dissipate this year. At the same time, future capital expenditure (capex) intensions are falling rapidly, according to JP Morgan, which could result in a tighter labour market, higher wage inflation, and ultimately lower profit margins. US companies have used easy monetary conditions to increase their debt levels and buy back shares. Therefore, if margins have peaked, then debt servicing and the level of share repurchases may come under threat. On a positive note, the increased leverage of corporate balance sheets is particular to the US. Gearing in the eurozone has remained flat while Japanese companies have reduced their levels of debt.

"After a strong fourth quarter reporting season, earnings growth is forecast to turn negative in early 2019."

On the face of it, the backdrop for European equities looks unappealing due to a cocktail of low economic growth, chaotic politics, a weak banking sector, lack of tech exposure and a high weighting in 'old economy' stocks. Whilst these headwinds are likely to persist, much has ready been priced in to valuations while some potential positives are starting to emerge. The dividend yield gap is favourable courtesy of depressed, negative bond yields. In addition, the weaker euro should provide a tailwind for the region's exporters, which should also benefit from improving conditions in emerging markets.

The FTSE All-share index returned 8% during the Q1 but underperformed other major equities markets, not least because UK stocks have remained out of favour with international investors since the 2016 referendum. Yet during the intervening period UK-listed companies have delivered strong earnings growth. As a result, the All-Share index has undergone a significant de-rating. Further, the difference between the earnings yield (inverse of the P/E multiple) and gilt yield has widened to a level that has previously signalled a good opportunity to buy.

"On the face of it, the backdrop for European equities looks unappealing due to a cocktail of low economic growth, chaotic politics, a weak banking sector, lack of tech exposure and a high weighting in 'old economy' stocks."

It goes without saying that Brexit will be a large determinant in the direction of travel. As the UK is a high-dividend, defensive market, it tends to act as a bond proxy while the multinational companies that dominate the FTSE100 index are heavily influenced by movements in sterling. Therefore, a soft Brexit could result in a rotation from the heavyweight exporting stocks in FTSE100 to more domestically exposed stocks that are more prevalent in the FTSE250. In terms of Brexit-sensitive sectors, Banks would benefit from a rise in Gilt yields and Retailers could gain from a stronger currency improving gross margins. On the flip side, Utilities could suffer from higher Gilt yields and Healthcare could underperform given its defensive nature and high overseas earnings.

"The A-share market of onshore Chinese equities was bolstered by Premier Li Keqiang's comments that foreign investment laws would be relaxed."

In emerging markets, Chinese stocks posted their best quarter in more than four years to top the world rankings for equity returns in Q1. The A-share market of onshore Chinese equities was bolstered by Premier Li Keqiang's comments that foreign investment laws would be relaxed. Further, the country will enter the FTSE Russell index from June and will likely have its weighting raised in the MSCI Emerging Market indices from May. Overseas investors currently own just 2.6% of Chinese equities, a figure which Morgan Stanley forecast will rise to 10% over the next 10 years. Given the likely rise in demand for the region, we are considering raising our exposure through a local manager in the region.

Commodity markets played their part in the broad-based recovery. Oil rebounded 25% from its December lows and currently has a tailwind from the supply side. Saudi Arabia has passed its largest budget ever and therefore should push for supply constraints to keep the oil price elevated. Base metals also performed strongly but the outlook is opaque as supply disruptions that have driven prices higher may dissipate in the second quarter. Gold consolidated its strong fourth quarter performance. Historically, real interest rates have been a major influence on the precious metal and provide a favourable backdrop at present.

In summary, risk assets should continue to be supported by a stabilisation in global growth, albeit at lower levels, alongside dovish central banks and sufficient inflation. Bond markets are pricing in a considerably more negative outlook for the global economy than equities, which do not seem to be reflecting any material probability of a recession or crisis.

Equities are fair value, but a stronger fiscal response in China, progress in a US-China trade deal and, in Europe, a resolution to political headwinds could provide further upside. For portfolios, equities can provide a real yield whereas bonds offer the opportunity for capital appreciation due to their hedging characteristics.

"In summary, risk assets should continue to be supported by a stabilisation in global growth, albeit at lower levels."

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