ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

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« The economic and financial environment will remain relatively upbeat for risk assets »

Has Brexit turned into a non-event? It has, at any rate, constantly surprised us:
- **first, by actually happening as few people were expecting the UK to go for this option**
- **second, by the relatively sanguine market reaction to what was a major upset and**
- **third, by the rebound in risk assets. Equity markets in Europe have moved back to levels seen ahead of the vote while international markets are now higher.**

More importantly, the FTSE 250, comprising British mid caps which mostly sell to the domestic market and so do not benefit from sterling's slump, is flat year to date even though the UK could soon move into recession.

TODAY'S ULTRA-ACCOMMODATING MONETARY POLICY IS SKEWING FINANCIAL MARKET REACTIONS

Several surveys in recent months have shown that international investors cut overweight positions in European equities and moved into other zones ahead of the UK referendum and just after the result. That would indicate caution at the local level but not generalised wariness.

All in all, Brexit's negative consequences were partly overlooked perhaps because markets often struggle to assess political issues and saw no immediate impact, or perhaps because market reactions have been skewed by ultra-accommodating monetary policy.

THE MARKET REBOUND IS NOT AN ACCIDENT

The July rebound was impressive but not without some logic. Cyclicals outperformed when markets saw signs that the US recovery was still intact. At the same time, future easing from the Bank of England and the Bank of Japan – there is talk of radical action – appears to have convinced investors that the FED will now find it practically impossible to raise rates and that other central banks like the ECB will opt for additional easing.

KEY POINTS

- High yield bond overweight cut
- US Treasury underweight trimmed
- Slightly overweight equities, particularly in the eurozone

THE MID-TERM OUTLOOK SUGGESTS WE SHOULD BE MORE CAUTIOUS

Equity markets are now trading at valuations that are not uncomfortable but are still flirting with the boundaries of normal behaviour. Bond market yields are particularly low and no longer dependent on economic rationality but on coordinated central bank action. Economic growth should continue at a suitable, non-excessive pace so, in theory, the economic and financial environment should remain relatively upbeat for risk assets.

WE REMAIN CAUTIOUS ON THREE COUNTS:

- **Brexit** could have **negative effects** that investors have partly overlooked.

- **Markets are probably expecting too much loose monetary policy** in coming months and this is underpinning risk assets. True, the Bank of England is expected to ease and might go for more quantitative easing. However, some of the current euphoria is clearly based on speculation that the Bank of Japan will vote for “helicopter money”, a move aimed in this case at funding government spending more or less directly instead of hoping for indirect benefits from more negative rates and the wealth effect generated by quantitative easing. At a time when markets are increasingly sceptical about the benefits of quantitative easing and convinced that central banks have used up all their ammunition, the simple fact that a major institution is thinking about helicopter money undeniably makes central banks look all-powerful again. Former Fed chairman Ben Bernanke in a recent blog entry shared his views on the practical issues at stake if such a policy were to be introduced. His opinion reinforces its probability and a major taboo is arguably being lifted, at least in principle. Will the Bank of Japan open the way to fresh, more efficient action that will serve as an example for other central banks? In our view, it is far too early. The BoJ will reserve this option for genuinely difficult times. Elsewhere, it is remarkable that investors have factored in the Fed’s next rate hike for the beginning of 2018 even though almost all rate hike indicators are now flashing green. As for the ECB, its leeway has shrunk significantly. We can, as a result, expect it to take a less proactive and more reactive approach. And yet markets are expecting an increasingly accommodating bias, an option that is feasible but not a done deal. Global inflation, meanwhile, is very low if only because of base effects but it should recover a little. That is another reason why we should put today’s market sentiment in perspective. In short, beware monetary euphoria!

- **The post-holiday political agenda is heavy**. October and November will feature Italy’s referendum, which might result in the prime minister resigning if «no» wins, the rerun of Austria’s presidential election which could see the extreme right wing FPÖ candidate win, and the US presidential election with some opinion polls predicting a Donald Trump victory. All three events carry market risks. Brexit is a useful reminder that markets sometimes tackle these issues in the wrong way, with some surprising results.

CUTTING PORTFOLIO RISK

At the moment, we are trimming risk in portfolios but reducing our overweight in high yield bonds and tactically cutting our US Treasury underweight. The coming weeks will probably require a more tactical approach. For the time being, we continue to be slightly overweight equities as a whole and eurozone equities in particular.

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