ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

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"Tactical profit taking"

Fundamentals are still so good that we cannot help wondering if the only worry today is that investors do not seem to be worried. The global recovery is still on track and even seems to be marginally intensifying. What is most striking about it is not its strength, even if the global growth trend is now running above its potential, but the fact that all zones are now synchronised. The third quarter results season has so far tended to confirm macroeconomic trends by generally yielding pleasant surprises, especially in cyclical sectors.

CENTRAL BANK SYNCHRONISATION

Inflation in developed countries, except for the UK, has stayed abnormally low in this robust environment but that has not stopped major central banks, apart from the Bank of Japan, from introducing monetary tightening. In December, the Fed is expected to raise rates for a third time by 25bp while the Bank of England has just made its first rate rise in more than a decade. Thanks to the Fed's adoption of quantitative tightening, its balance sheet has already started to shrink. The ECB will reduce its QE efforts by halving bond buying over the first 9 months of 2018 but has not set a QE end date. And the timing of its first move to raise rates is even vaguer as this is expected to occur well after it stops its asset purchasing altogether. Meanwhile, China's central bank will press on with efforts to restrict the flourishing shadow banking sector while maintaining monetary policies which are broadly designed to stimulate the real economy.

Overall, central banks are starting to synchronise action little by little in their moves to normalise monetary policies. The end to easy money is approaching but has so far had no impact on markets (a marked contrast with the lax monetary policies which for years drove valuations higher). This is perhaps because the shift has been gradual and extremely cautious, or it may simply be due to a combination of robust fundamentals and weak inflation mitigating the impact of this central bank change-of-heart on both bond and equity markets. At any rate, markets are only expecting two more Fed hikes before the end of 2018 while FOMC members are on average going for four. But with the rapid yield curve flattening that has come with today's monetary policies, we should keep an eye on volatility. It is difficult to say exactly when this sort of risk might have an impact but after months of low volatility on rising markets, trading could become more erratic, particularly as so many investors, and risk parity funds in particular, have calibrated risk in line with recent market volatility. As a result, the impact of forced sellers in any turbulent market phase would necessarily be higher.

KEY POINTS

- Focus on eurozone equities
- Profit taking on Japanese equities
- Money market exposure raised

KEEPING SOME RESERVES BEHIND

Japanese equities enjoyed a strong rally in October with the Nikkei jumping 8.1%. This was due to improving macro and microeconomic factors but also to the victory of Shinzo Abe's LPD party in the parliamentary elections. The outgoing prime minister's success has restored his administration's authority and visibility and reinforced his persistently pro-active economic approach. After extending our Japanese equity overweight in October, we have taken some profits, taking exposure temporarily down to neutral. We continue to favour eurozone and Japanese equities rather than US and emerging country equities. We have also returned to neutral on convertible bonds and reduced exposure to eurozone and US government debt. This has led to a temporary increase in money market exposure. This is still a good time to be exposed to risk assets, but we prefer to keep some reserves behind so as to be able to benefit from any resurgence in volatility.

NEXT HEADLINE EVENTS

- ***December 12 & 13: next Fed meeting***
- ***December 14: next ECB meeting***
- ***December 20 & 21: next BoJ meeting***

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