ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

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"The risk of protectionism is driving volatility"

Our concerns that volatility was about to return led us to start 2018 with more neutral exposure to risk assets. There were two clearly identified sources of tension, fears of inflationary pressure in the US and the risk of a revival in protectionism.

IT IS TOO SOON TO WORRY ABOUT GALLOPING INFLATION

US inflation is undoubtedly trending higher, but we have to keep things in perspective. The market reaction to January's weekly wage data in the US was so violent that we decided it afforded a good opportunity to rebuild equity market exposure. We took the view that monthly data can often be erratic so it would be rash to read too much into the very latest batch to appear. What's more, the Fed itself is expecting inflation to rise which is why it is mulling three, and now perhaps four, rate hikes this year. But inflation has so far always fallen short of expectations, so it would first have to rise at a quicker pace to meet the Fed's scenario before we should start worrying about it overshooting. Markets had also become technically fragile due to massive puts on volatility indices.

Washington's introduction of import duties on steel and aluminium has, for the moment, only been symbolic as it will have no visible impact on the global economy. But a race to protectionism most probably would, even if it is objectively tricky to gauge to what extent. At any rate, investors are in doubt and are currently factoring in a risk premium to reflect the possibility of a trade war and all the consequences that might have. For the moment, we believe it is too early to overplay this risk even if we are likely to see other twists and turns.

KEY POINTS

- Preference for equities
- Focus on Europe and Japan maintained
- US Treasury exposure raised

SEDUCTION RATHER THAN ACTION?

The resignation of a free-marketer like Gary Cohn clearly raises a number of questions over the Trump administration's protectionist intentions. But we should remember that the mid-term elections later this year look like being difficult for the Republican party and it is quite possible that the President wants to send a message to those rust belt workers who in 2016 voted for a Republican candidate for the first time. In other words, the focus might be on seducing certain electoral fringes rather than actually implementing measures.

At the same time, there is a strong desire to force China to open up its markets and show more respect for intellectual property rights. Due to Beijing's explicit or implicit protectionism, there has been a lot of negative feedback from US companies trying to develop within China and CEOs have been complaining to Washington. China has lots to lose from a trade war and the country is now more developed and strong enough to ward off the risk by granting some concessions. The protectionist theme could well persist and fuel volatility for another few months but we think the risk is still too low to warrant a change in our preferred scenario.

We raised equity exposure to our preferred zones, Europe and Japan, when the February sell-off was bottoming out, but also reduced weighting differentials with the US and emerging countries. And after the rise in bond yields in recent months, we also think we no longer need to steer clear of US Treasuries and so have upped exposure.

NEXT HEADLINE EVENTS

- ***March 20 & 21: next Fed meeting***
- ***April 26: next ECB meeting***
- ***April 26 & 27: next BoJ meeting***

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