BEST PRIVATE BANK
FOR SUPER AFFLUENT CLIENTS
IN LUXEMBOURG

BILBOARD Lite

Financial market news

August 2017

When will the tide turn for yields?

With the global economy looking sunny, equity markets relentlessly reaching new heights, political risk diminishing (in particular in the euro zone) and companies posting stellar earnings results for the second quarter, we wonder when the tide will turn.

From a macroeconomic point of view, we believe that a few more months will pass before we see this positive momentum reach its peak. This outlook underpins our base case, namely that reflation will make a come-back after this temporary respite and that the US and European yield curves will gradually steepen over the medium-term.

In the US, Q2 GDP growth was 2.6% on an annualised basis – not too far off Trump's promised 3%. Business confidence, which surged owing to the post-election stock market rally, continues to hold strong in a number of sentiment indicators. For example, the Philly Fed Manufacturing Future Capital Expenditures Index hit 42 in July, the highest level since 1976, indicating that a strong uptick in capital spending is on the horizon. Consumer confidence also rose sharply to 121.1 in July. These developments are bolstering expectations about the economy and earnings, which in turn is boosting US equities. In point of fact, solid Q2 earnings growth (+9%) was complemented by exceptional sales growth (+6%).

In Europe, GDP grew by 2.1% (annualised) in the second quarter and economic sentiment is at its highest level in almost a decade (+111.1). This was also reflected in the Q2 earnings growth figures (+11% for those companies that have published their results). The strengthening euro – which has appreciated some 12% against the US dollar – is penalising euro investors. If this currency continues to rise, it could weigh on future prospects and potentially exacerbate vulnerabilities in the euro zone. The Italian elections in 2018 also pose a certain risk and could inject higher volatility into markets.

The synchronised nature of the ongoing economic expansion means that investors can now also look to emerging markets (EM), which are feeling the effects of the upswing. Commodity prices – which are linked to the health of EMs – are trending upwards, with Brent crude above USD 52 per barrel and the spot price for iron ore touching USD 73 per tonne. China, the world's production hub, is currently defying the naysayers. Annualised Q2 GDP growth was 6.9% and Producer Price Inflation has stabilised, coming in at 5.5% in June. This key reflation indicator was watched closely by investors at the end of 2016 when the reflation trade first picked up.

The central banks are expected to make further announcements regarding the withdrawal of accommodative monetary policies soon. It is key that 'dovish tapering' be enacted by the European Central Bank (ECB) to avoid any undesirable market reactions. It is thought that when Mario Draghi, President of the ECB, attends the US Federal Reserve's (Fed) symposium in Jackson Hole this August, the banks will coordinate their respective tightening agendas, despite inflation remaining stubbornly low. We believe that headwinds, such as a low oil prices and weak wage growth, are temporary and that inflation will firm up, although there is some uncertainty as to when exactly this will happen.

What does this mean for financial markets?

Equities have enjoyed a strong run for six months and counting, which makes it tempting to want to de-risk. However, though there may be some potential for tactical corrections, equities are our preferred asset class, given the improving macroeconomic outlook, as well as robust earnings growth. Our allocation is driven by the following themes: continued global growth, expectations of a steepening yield curve and a weaker dollar. We believe Europe and Japan are poised to benefit from spreading economic expansion, including a recovery in global manufacturing and EMs. In the second quarter, Japanese equities enjoyed earnings growth of +21%, surprising on the upside by +15%.

Yves Kuhn
Chief Investment Officer

“A weaker dollar should bolster Emerging Market (EM) equities”

We have noticed the first signs that US fixed income investors are beginning to believe in reflation – the spread between the yields on 2 and 10-year Treasuries has slowly started to widen. This shall lead to style rotations in the US equity space, allowing value stocks and financials to flourish. In European equities, the value style has already started to outperform.

A weaker dollar – which the US will continue to promote in order to boost exports – should bolster EM equities. At present, these trade at a 26% discount to developed market equities (on a price-to-earnings basis), whilst offering a similar return (which is set to improve with increasing margins and higher asset turnover). We are monitoring this asset class, keeping an eye out for any suitable opportunities to increase our positions.

We're maintaining a negative outlook towards most pockets of the fixed income market, which is the key asset class in bubble territory. Prices have been inflated by years of central bank intervention, which is in the process of being withdrawn. Now, the Fed will start to unwind its USD 4.5 trillion balance sheet and the ECB is expected to taper its asset purchase programme (APP) from the current pace of EUR 60 billion per month. The recent tightening in monetary conditions due to the stronger euro might have bought some time for the APP. US Treasuries will also take a hit if the market starts buying into 'Trumponomics'. Given the political turmoil in the US, expectations are so low that any incremental progress will put upwards pressure on yields – the 10-year rate of around 2.2% seems too low in light of US growth and we expect to see this increase to as much as 2.6% by the first quarter of 2018. We view emerging market bonds more favourably, given their yield of around 5.5% on a 10-year basis. This provides an adequate cushion in a rising yield environment.

Over the long-term, we are bullish on the euro (as a result of the long process of normalisation of European monetary policies), while we are bearish on the US dollar. We remain invested in gold, using it as a hedge for the purpose of portfolio construction. With regard to oil, the global growth rally and OPEC's desire to keep prices elevated (see the planned Saudi Aramco listing) will allow prices to rise.

Always wear sunscreen

We conclude that there is still potential in the equity markets and we should continue to enjoy the long, hot summer, albeit with adequate protection, implemented through a nuanced asset allocation. As for the fixed income markets, the dawn of quantitative tapering is upon us and it is hard to find a silver lining for this asset class. As Warren Buffet once said, only when the tide goes out do you discover who's been swimming naked.

0 to 3 months

	- -	-		+	+ +
Equities				current	
Fixed Income		current			
EUR Sov Non-Core		current			
EUR Sov Core (D)	current				
EUR Credit			current		
US Treasuries		current			
US Credit			current		
EM Bonds (US)				current	
HY Credit US			current		
HY Credit EUR	current				
Duration EUR		prior	current		
Duration USD		prior	current		
EUR Equity				current	
US Equity			current		
EM Equity				current	
Devel. Asia Equity			prior	current	
EUR			current		
USD			current		
EUR Real Estate			current		
US Real Estate			current		
Oil			prior	current	
Gold			current	prior	

3 to 9 months

	- -	-		+	+ +
Equities				current	
Fixed Income		current			
EUR Sov Non-Core		current			
EUR Sov Core (D)	current				
EUR Credit			current		
US Treasuries		current			
US Credit			current		
EM Bonds (US)				current	
HY Credit US			current		
HY Credit EUR	current				
Duration EUR		current			
Duration USD		current			
EUR Equity				current	
US Equity			current		
EM Equity				prior	current
Devel. Asia Equity			current		
EUR				current	
USD		current	prior		
EUR Real Estate			current		
US Real Estate			current		
Oil			prior	current	
Gold			current		

current prior

EN-08/17

As economic conditions are subject to change, the information and opinions presented in this outlook are current only as of **August 4, 2017**. This publication is based on data available to the public and upon information that is considered as reliable. Even if particular attention has been paid to its content, no guarantee, warranty or representation is given to the accuracy or completeness thereof. Banque Internationale à Luxembourg cannot be held liable or responsible with respect to the information expressed herein. This document has been prepared only for information purposes and does not constitute an offer or invitation to make investments. It is up to investors themselves to consider whether the information contained herein is appropriate to their needs and objectives or to seek advice before making an investment decision based upon this information. Banque Internationale à Luxembourg accepts no liability whatsoever for any investment decisions of whatever nature by the user of this publication, which are in any way based on this publication, nor for any loss or damage arising from any use of this publication or its content. This publication, prepared by Banque Internationale à Luxembourg (BIL), may not be copied or duplicated in any form whatsoever or redistributed without the prior written consent of BIL 69, route d'Esch ı L-2953 Luxembourg ı RCS Luxembourg B-6307 ı Tel. +352 4590 6699 ı www.bil.com.