A cautious state of exuberance

Despite rallying markets - from equities to fixed income, and with standard safe haven assets such as gold rallying, suggests that investors are concurrently cautious in the current macro environment.

This has been driven primarily by the following:

- Political uncertainties: Prolonged trade tussles between the US and China
- Economy: Global factory output continues to weaken
- Monetary policy: Optimism over the extent of policy easing by the US Federal Reserve (Fed), as well as how easier monetary policy boosts assets prices and economic growth
- Equities: Fears that the long bull run which has hit record highs is building into an asset bubble

Political uncertainties

While representatives of the US and China will be meeting in Shanghai this week, uncertainties remain. The expectations for a material de-escalation of the tariffs and an improvement in outlook are seemingly slow going into the talks. Trade tensions and political uncertainties are likely to keep lifting the Swiss Franc and Japanese Yen, both popular haven currencies.

Economy

The ongoing trade spats have already slowed global trade and thwarted economic growth. During the first quarter of 2019, global trade expanded by 0.5 per cent, the lowest level since 2012. The International Monetary Fund (IMF) warns that tariffs could eclipse the global trade outlook further and slashed 2019 global growth expectations by 0.9 points to 2.5 per cent.

Monetary policy

With the Fed iterating a commitment to sustaining the near-record expansion, markets are increasingly expecting interest rate cuts. Outside of the US, other developed market central banks have expressed intentions to commence easing and Asian central banks (South Korea, Indonesia) have joined the easing bandwagon.

Accommodative monetary policy would have the immediate effect of supporting asset prices. It is hoped that they would also provide a longer term boost to growth. However, adopting overly accommodative monetary policy comes with risks. The fist is an increased risk of asset bubbles, and capital misallocation, but persistently low interest rates undermine the smooth functioning of the financial sector. The impact of interest rate cuts in the event of an actual downturn would hence be blunted as the policy tools had already been utilised.

Equities

As markets increasingly price in the Fed delivering a quarter-point cut when it meets this week, many have pointed to parallels scenarios in 1995 and 1998 that inflated asset prices. In 1995, the S&P 500 gained 13 per cent in six months after the first cut and gains shot up to 29 per cent for 1998. During those periods, growth levels were moderately low and macro events (Asian financial crisis and Russian financial crisis) threatened to drag US domestic growth lower which is similar to the situation today.

House view

UOBAM favours an overweight on fixed income and staying underweight on equities as growth risks continue to loom.

In the fixed income segment, we continue to like the investment grade segment as looser monetary policy would have the effect of tightening credit spreads. In an environment of low and positive economic growth, investment grade bonds tend to deliver returns that are above average and the high yield segment will deliver average returns at best.

The outlook for global equities remains less clear as the cycle is already mature and equities would be vulnerable if global growth slows further from current levels. Although pre-emptive “insurance cuts” have bolstered market optimism by helping to sustain the ongoing US economic expansion, these policy cuts could potentially inflate asset prices to elevated levels. In the Asia ex-Japan equities segment, the positioning is largely dependent on a US-China trade resolution, which still far from reaching a full resolution. We remain cautious on China in the near term as it is at the epicentre of geopolitical and economic tensions with the US. We are aware of the downside risks and have switched to a defensive portfolio positioning in an absence of any clear catalysts. Hence, we now favour countries with lower exposure to global trade namely India and South-East Asia. We are also underweight on cyclical sectors and overweight more defensive sectors such as utilities, telecommunication, consumer staples and REITs.

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