A time for selectivity

Global growth is slowing and sentiment softening, while manufacturing continues to suffer as the trade war shows no sign of ending. And then there is the US yield curve, stubbornly clinging to a flat or inverted shape. There is a lot of encouraging news too though. The US economy remains healthy and the US consumer strong. There is also hope that governments will start to loosen fiscal policy. For investors with a half-empty or half-full view, now is clearly a time to be selective across all assets.
We continue to receive mixed messages from macroeconomic data and markets, with the latter pricing in a recession across several gauges. At the same time, the late-cycle position we are in makes markets vulnerable to accidents that could come from any number of sources, including Trump’s unpredictable tweets, Brexit and the ongoing trade war.

Financial markets today are showing clear signs of anxiety around an imminent economic recession. The dollar index and gold, defensive investments, recently reached two-year highs. At the same time, US Treasury yields have plummeted this year. The decline has been most pronounced in long-term bonds, leading to curve flattening. Some parts of the curve have even inverted—historically a reliable harbinger of recession.

However, the yield-curve inversion this time around differs from those that preceded recessions in the past. The latest inversion has been driven by a fall in long-dated yields, as opposed to a spike in short-dated ones. This means investors expect interest rates to remain suppressed several years from now, which is more a reflection of the easy monetary policy that has been widely adopted over the last decade. Another difference this time around revolves around oil prices. In past instances of a recession following yield-curve inversion, oil prices were also at their peak growth rate, whereas today oil price growth is at near a three-year low.

At the same time macroeconomic data, while mixed, indicate that the current cycle has more room to run. The manufacturing sector has clearly suffered, both in terms of data and negative company earnings revisions. However, the services sector, which is a closer proxy to the real state of the economy, remains broadly stable. Meanwhile, the clearest short-term recession indicators – jobless claims and unemployment – are not flashing any warning signals. Indeed, unemployment in many major economies remains at historically low levels.

For these reasons, we do not believe a recession is around the corner. The manufacturing sector’s share of equity indices is significantly higher than its share of economic growth, so we could live in a low earnings growth world for a while. Instead, we are in a late-cycle economy, which makes us particularly vulnerable to any “accidents” that could come in the form any number of (geo)political surprises. We are therefore staying selective in equities, favouring companies with pricing power and dividend growers, and treating volatility as an asset class in itself.

In order for the current cycle to continue, economies need fiscal easing from governments. This need is punctuated by the broadly depleted state of central bankers’ toolkits, given that most major central banks have run out of ammunition and their ability to support the economy is diminishing. On this front, the UK government has planned extensive fiscal spending. We might also hope for Germany to loosen its purse strings, especially as pressure to address the climate crisis builds among German voters. For now, we are moving from underweight UK equities to neutral, because we now do not expect a recession, regardless of the Brexit outcome.
In a nutshell

Polarisation is widespread in today’s markets.

The mega caps that dominate the S&P 500 have outperformed the equal-weighted S&P index since end-2016, signalling strong market polarisation. However, the narrowing of market returns shows the S&P 500 is running out of breath. For markets to go sustainably higher will require a rally in a wider range of stocks. Interestingly, the S&P equal-weighted index is significantly less expensive than its market-weighted counterpart.

While the majority of economies’ manufacturing sectors are in contraction territory, with PMIs below 50, services show a different picture. The services sector, which is more closely linked to the health of the economy, remains in healthy, expansion territory in most major economies.
Waiting for long-term economic policies

Central bank dovishness, plus fiscal and budgetary stimulus could help prolong the current cycle. But more coordination is needed to put long-term growth on a firm footing.

Central banks around the world are busy easing monetary policy again, injecting new liquidity into markets in a bid to stimulate flagging growth and inflation rates. This is why, as in previous years, an imminent global recession is not our central scenario. Yes, global manufacturing is in the doldrums, but there are signs that the slowdown in global activity might be reaching a trough. The economic cycle, already the longest since World War Two in the US, could be prolonged.

Mario Draghi used the press conference following the latest European Central Bank (ECB) stimulus announcement in mid-September to call on governments with fiscal space “to act in an effective and timely manner”. Indeed, there are stirrings on that front, with governments from London to Beijing starting to open the budgetary purse strings. The government of Emmanuel Macron is estimated to have injected EUR 25bn into the French economy since he took office in 2016, for example, with EUR 5bn in tax cuts in the offing. Faced with declining growth, voices are even being raised within Germany about the country’s rigid adherence to a balanced or surplus budget.

In general, we believe a greater concertation between monetary and fiscal experts to come up with fresh economic policies could produce more enduring results. There is still a chance for authorities in the West to pre-empt the risk of ‘Japanisation’—of decades-long low growth and inflation. But salvation will not come from stop-gap monetary measures or from a scatter-gun approach to spending public money. Instead, policy makers need to concentrate on encouraging investment and innovation, still the two main pillars of high-quality, self-sustaining growth.

However, there are two problems to concertation: on the one hand, monetary policy, including quantitative easing, is becoming increasingly ineffective, with interest rates already so low and negative bond yields showing liquidity is abundantly available, it is not clear that the latest ECB’s policy moves will have an enduring impact. And as for fiscal/budgetary policy, in many leading economies, public debt is well over the 60% of GDP level, beyond which it becomes difficult to ease fiscal policy in any sustainable way. Setting the right priorities for the most productive allocation of capital is complex and takes time to implement, and is not aided by short-term political calculations.

Yet, by at least stabilising economic prospects at their current (low) level and dispelling the risk of an imminent recession, the latest stimulus moves should provide greater visibility for risk assets, helping valuations remain at their current high levels, or even push them higher. Earnings expectations for this year, which in the case of US equities have fallen dramatically, could stabilise. Finally, combined monetary and fiscal stimulus should help offset the negative effect of trade tensions.

As for fixed income, the downward pressure on yields exerted by central bank dovishness could be more than offset by rising fiscal stimulus. By helping dispel the fears of imminent recession, this could reverse the fall in long-term bond yields that for some time have been well below nominal growth (a powerful indicator of bonds’ fair value). While core government bonds will always have a protective role in portfolios, the prospect that they will play only a minor or negative role in generating performance needs to be taken into account in multi-asset portfolio allocation.

“We believe a greater concertation between monetary and fiscal experts to come up with fresh economic policies could produce more enduring results.”
INVESTMENT INSIGHTS

The endowment model and investment strategies for large wealth

The Yale Model, sometimes known as the Endowment Model, sets out investment strategies and basic principles that are also part of the investment philosophy Pictet applies to large clients with a long-term perspective.

What lessons can long-term family investors draw from US endowment funds?

The annual NACUBO report looks at the governance, performance and asset allocation of US endowment funds. It shows that the top-tier endowments achieve very strong results by taking advantage of their long-term time horizon and ability to tolerate short-term drawdowns to invest across assets globally with an important allocation to private investments.

The Yale endowment fund has delivered an average annual return of 11.1% over the past 10 years ending June 20, 2019, for example. Over longer periods, including important market downturns, the results look even more impressive, with an average annual performance of 11.4% over the past 20 years. This validates an approach to investing that balances the needs of current beneficiaries with those of future ones—with asset allocations to match. Yale University’s endowment fund had a 17% allocation to public equities in 2018, 37% to private equity, 23% to absolute return/hedge funds, 16% to real estate and natural resources, and 7% to bonds and cash.

What’s the link between endowment funds and multi-generational wealth management?

The link is the similarity in investment objectives and governance. Endowments and families intent on maintaining and growing capital in real terms for the benefit of current and future generations have a lot in common: they both seek to maximise risk-adjusted returns from a portfolio of global assets, they have a long-term investment horizon (meaning they generally have limited liquidity needs) and they both can have high tolerance for short-term drawdowns. They are also less regulated than other large institutional investors and typically managed by compact investment teams able to leverage third-party expertise in areas such as alternative asset management.

But the overall objectives for a family are more complex than an endowment’s. Families’ overall wealth can be broadly allocated according to three main goals (see chart): first, to provide financial security in the face of unknowable risks; second, to maintain and grow wealth net of inflation; and finally, to make an impact through more ‘aspirational’,

“Replicating endowment funds

In the 2019 edition of Horizon*, in which contains Pictet Wealth Management’s (PWM) 10-year return expectations across asset classes, PWM analysts replicate US endowment funds (with their focus on alternative assets) to come up with a model that produces higher expected returns than for classic 60/40 portfolios.

*The appeal of endowment-style investment’ in Horizon — Return expectations for the next 10 years, Pictet WM AA&MR, 2019.

KRISTOFFER JONSSON
Senior Investment Manager
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more emotionally-driven investments. A portfolio aligned to the second goal, maintaining and growing wealth net of inflation, should be managed using an asset allocation similar to that for endowments. An initial wealth allocation of assets that takes into account all three goals is an important step towards clearly defining the perimeters of the 'endowment'-like portfolio, which often accounts for the majority of a family’s wealth.

What are the risks that need to be considered?
The main risk that concerns us is the permanent loss of capital, not volatility in the asset or portfolio value. We like to point to the success of Warren Buffet and Berkshire Hathaway, whose long-term investors have been rewarded for accepting short-term drawdowns. Berkshire Hathaway has delivered an average annual rate of return of more than 20% since 1963 even though it has gone through five market corrections with price declines in excess of 35%.

Given an endowment portfolio aims to exist in perpetuity, there are three key risks we focus on (with risk defined as the probability of permanent capital impairment).

• First, inflation can significantly impact long-term purchasing power. Therefore, most of a portfolio needs to be invested in equities and real assets, whose cash flows can be expected to provide protection in real terms.

• Second, the forced disposal of investments at distressed prices in adverse financial markets to provide liquidity can significantly impact long-term value. As such, forecasts of future cash flows need to be prudent.

• Finally, changing the investment policy to reduce risk at times of market stress can lead to disposal of assets at depressed valuations, and therefore permanent losses.

Multi-generational wealth portfolios and endowment funds show a broadly similar allocation to equities and real assets, helping mitigate inflation risk.

However, liquidity and cash needs differ between family wealth and endowments. Cash flow needs are unique to each situation, something that must be taken into consideration when developing the asset allocation strategy for families.

The consequences of behavioural risk also differ. When volatility increases, private investors tend to become more risk averse. They seek liquidity and extrapolate short-term trends to the extreme, meaning also they become less willing to be contrarian. This can be mitigated by making sure the principals (families or their family offices) fully understand and adhere to an endowment investment philosophy.

As early as 1979, Nobel laureates Daniel Kahneman and Amos Tversky described how losses have a stronger emotional impact than gains and showed that the probability of occurrence of extreme events is not realistically assessed, but rather positively or negatively distorted at the edges. This often leads to irrational decisions. Such behaviour is so deeply rooted in us and all market participants that is difficult to control unless a disciplined investment philosophy is deeply anchored in the investment strategy and among principals.

But there are important issues of scale and governance involved before you can transpose endowment investing to managing money for families.

Certainly, scale is an issue. Top-performing US endowment funds’ resilience and success owe much to their size and long experience in investing in alternative assets.

Leaving aside our 214-year history and our particular partnership management structure, which means we have a certain legitimacy to talk about long-term investment, we have the experience of managing wealth over generations. We invest across asset classes globally on behalf of our clients. We have significant experience in a broad network of private equity partnerships, having invested in this asset class for 30 years, ensuring we have access and capacity with top-tier alternative asset managers today.

Over the years, Pictet has developed sizable discretionary multi-asset relationships in public equities as well as in private equity and co-investments, fixed income and hedge funds. We view a multi-asset portfolio holistically rather than as a series of independent asset class mandates and can properly size investments both through direct investments and through funds. This allows us to avoid over-diversification, while driving long-term performance and providing comprehensive consolidated reporting. In many ways, we manage bespoke discretionary multi-asset portfolios for our large clients very much like successful endowments. ■

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1 Yale Endowment Management, September 2018
With most of the US Treasury yield curve now inverted, including the first inversion of the 10 year-to-three month part of the curve in 12 years, fears of a US recession next year have risen. Different models based on measuring the slope of the US Treasury yield curve show that risks have indeed increased.

The slope of the US Treasury yield curve has proved to be one of the most reliable predictors of future economic activity. An inverted yield curve (when short-term yields are higher than long-term ones) has correctly signalled all nine recessions since 1955 and only sent one false signal, in 1966. Strikingly, while each recession has been different, patterns in yield curve inversion have been remarkably similar each time. This is because the US Federal Reserve (Fed) and market participants tend to behave in similar ways at the end of each business cycle. The Fed raises its policy interest rate to respond to inflationary pressures and this pushes market participants to buy safe, long-term Treasury bonds as they anticipate that tighter monetary policy will eventually cause the economy to slow or even enter into a recession.

Nonetheless, there remain important uncertainties. First of all, what causes what? Does the fear of a recession encourage market participants to buy long-term bonds for protection, thus sparking yield curve inversion, or does the buying of long-term bonds trigger recession by tightening financial conditions—a so-called self-fulfilling prophecy? In other words, is this time different? This is an open debate.

A second uncertainty, and an important headache for investors, relates to the lead time between yield curve inversion and the onset of a recession. In the past, the delay has ranged between six and 24 months. The current unprecedented environment is a third source of uncertainty. Unusually low Treasury yields could have been caused by an important decline in the natural rate of interest due to low productivity growth and ageing populations, with the compressed term premium due to massive long-term asset purchases by the Fed in the aftermath of the global financial crisis. So, low long-term yields may not necessarily reflect recession expectations after all, but rather a ‘new normal’ for interest rates.

Recession modelling

The most common model used to measure the probability of US recession based on the yield curve slope is the one developed by the Federal Reserve Bank of New York (FRBNY), which looks at the spread between the 10-year Treasury and three-month yield. A stir was created when the model showed the probability of a recession over the next 12 months rising from below 15% in late 2018 to 38% this August. Moreover, it crossed its significant threshold in the first half of the year, when it started to signal that a recession could start in the US as soon as 2020.

Other measures of the yield curve slope have also been used to forecast recessions, in particular the 10-year to two-year Treasury spread, which is seen as the best indicator of the effectiveness of monetary policy by market participants. After briefly dipping into negative territory at the end of August, the 10-year-to-two-year spread steepened again in September. Another popular measure is the percentage of the US yield curve that is negative. After a rapid increase in this percentage in the last nine months,
our own model suggests that there is now a 43% chance of seeing the US economy entering a recession in the next 15 months.

To ascertain whether ‘this time is different’, we have also looked at other indicators outside the yield curve to determine the chances of a recession. The divergence between two consumer confidence surveys, the Conference Board and the Michigan surveys, which have traditionally widened before every recession in the past 51 years, is now indicating a 52% chance of a US recession in the next 16 months.

The fact that the short end of the US Treasury yield curve is stuck near the fed funds rate level may mean that the recent inversion is due to the Fed not being aggressive enough in cutting rates (the first quarter-point cut was at the end of July, the next one in September) relative to the fall in the 10-year Treasury yield. Interestingly, most of the fall in the 10-year yield (about 90 basis points (bps) between 1 January and 19 September) has been due to the decline in the 10-year Treasury Inflation-Protected Securities (TIPS) yield, the so-called real yield. The latter is particularly sensitive to the Fed’s monetary policy and US growth momentum. Set alongside market expectations (as of 19 September) of almost 60bps of additional cuts in policy rates by the end of 2020 and the recent faltering of the US growth outlook, the fall in Treasury yields comes as no surprise.

Another sign of market participants’ increased fears of a US recession is the subdued inflation expectations imbedded in the 10-year yield (the so-called inflation breakeven yield). While already low at the start of the year, expectations have fallen further since then. Yet, at 1.62% (on 19 September, the level is too low when compared to its main drivers. The oil price has fallen since last year but is now stiffening, and the US core consumer price index rebounded to 2.4% year-on-year in August.

Looking ahead, we expect US growth to decline over the coming quarters towards a cruising speed of 1.5%-2%. As late-cycle pressure on wages continues to build up and US tariffs on imports start to impact prices, we see US headline inflation moving back above 2% in the coming months. But as the rise in prices (specifically core inflation) will be limited, we expect the Fed to continue to cut rates this year and to maintain a dovish bias going into 2020. Along with the ongoing trade war uncertainty, this should push the 10-year Treasury yield down towards 1.4% by year’s end. We would expect it to move back to 2% only if the Trump administration were to remove most of the announced and existing US tariffs on Chinese imports or, more improbably, if the Fed eased rates more aggressively to boost US growth again.

Encompassing all the information available, and applying our own inhouse models, there is a distinct possibility that a recession could strike in 2020. The more investors are convinced of this risk the more likely it will happen. Beware the self-fulfilling prophecy!
Analysts have slashed 2019 and 2020 earnings forecasts across the board this year. And yet, the earnings picture is not as bleak as revisions would suggest.

The magnitude of downgrades for the US and Europe has been between 7% and 8%, while Asia has suffered even more. Japanese earnings have been cut by around 15%, while for Chinese earnings the figure is closer to 20%. However, these figures do not give the full picture, which has touches of light.

Helped by earnings downgrades ahead of the reporting season, Q1 and Q2 turned out to be much better than expected. At the same time, the US has avoided an earnings recession so far. Q1 earnings for the S&P 500 advanced by a meagre 0.2% and by 0.8% for Q2 on a year-over-year (y-o-y) basis. In other words, we have been in a no-growth environment, which is in stark contrast to 2018, when equities growth reached 25% on the back of the US tax cuts rolled out in H1 2018.

Full-year 2019 growth expectations are now a meagre 1.9% in the US and 4.4% in Europe. The US reporting season provided reassuring signals on margins, with better surprises on the bottom line than on the top line. This was especially true for defensive sectors, which beat consensus estimates in both the US and Europe. Globally, defensive sectors are the only group with resilient earnings at a time when downgrades have been dispersed across all sectors.

Within defensives, ongoing macro issues have been a strong support to consumer staples, whose earnings proved much better than expected. After several years of disappointment, these companies reported excellent sales growth, which reached an average of 4% in the quarter, with top-performers posting 7% or more. This reflects not only the late-cyclicality of their business models, but also how a solid labour market has influenced consumer behaviour.

Profit growth was also well supported within healthcare, which generates over 10% earnings growth annually, driven by managed care and medical technology. Tech stocks continued to grow earnings ahead of the market, but at a slower rate than previously.

Among cyclical sectors, industrials posted decelerating sales growth, in line with disappointing hard data and ongoing trade uncertainty. In Europe, capital goods recorded a paltry 2% revenue growth, down by over two-thirds from a year ago. However, most companies managed to deliver solid profit growth and beat expectations as operating margins remained solid. On the one hand, they showed stronger cost discipline, which allowed operating leverage to remain positive, while on the other hand, price increases offset some of the raw material cost impact. In this environment, pricing power has a huge impact.

Since mid-July, earnings per share (EPS) estimates for the US consumer discretionary sector have been cut by 1% to 9.8% expected growth for 2019. This group faces several overhangs that may yet put earnings at risk. Sales and EPS are threatened by rising tariffs, with a potential 25% levy on USD 300bn of US imports from China that include consumer goods like apparel, footwear and toys. This elevates the risk of margin contraction and supply chain disruption for retailers. Sales could drop as consumer confidence stalls and foreign tourism (particularly from China) to the US slows over key H2 shopping periods.
This is likely to imply higher prices for the consumer going forward that could also hurt demand. Furthermore, margins could be impacted by higher labor costs and growing tech budgets. Global retail IT spending is growing at 3.6% per year through 2021 to USD 219bn, namely on analytics and mobile and digital advertising. While the auto supplier sub-sector appears to be pricing in a recession already, the China and Europe macro risks keep us from upgrading our recommendations on the segment at this time.

At the same time, equity market valuations look rich, particularly in the US, with the S&P 500 trading at 17.2x 12-month forward earnings. This has raised concerns among investors, given that these were similar to the valuation levels hit ahead of the sharp sell-off in Q4 2018. However, one key difference is that the 10-year T-bond yield halved from above 3% to around 1.5% at the end of August, before slightly bouncing back. This makes equities more attractive relative to bonds, even if it does not translate into higher multiples. Indeed, the equity risk premium (difference between equity earnings yield and bond yield) tends to increase when interest rates get too low.

Even without further rerating in equities, valuations have already become polarised across sectors. Value stocks’ multiples have been hammered in the unsupportive yield environment, particularly in Europe, and while growth stocks typically trade at a valuation premium relative to value, this premium has become extremely stretched, with higher levels seen only in the TMT bubble in 2000. This led to September’s sector rotation into cyclical and value (mainly banks, autos, certain oil & gas and utility companies) over growth (Technology and Healthcare) stocks.

We find similar valuation dynamics in the defensive versus cyclical sectors, with the defensive sector premium nearing its peak, especially in Europe. In the context of resilient earnings, European defensives outperformed cycicals by more than 15% from the end of April to early September, when they gave up some of their gains. In the US, we have not observed such performance polarisation, resulting in a less pronounced valuation differential. In addition, European defensive sectors narrowed the US-Euro market margin gap, with the remaining difference explained by tech-oriented companies, which are concentrated in the US.

The recent move by the ECB and the current Fed stance reinforce the current low-interest rate environment with increasing debt. In this context, value and cyclical stocks can outperform in the short term, on the back of a tactical style rotation. Long term and structurally, we continue to favour growth and defensive sectors.

In a scarce growth environment, favour pricing power and dividend growers

As global growth decelerates, the environment has grown increasingly challenging for companies to drive top-line growth. This makes margins key to driving earnings growth. Corporate taxes and the cost of financing are now near trough levels, particularly for large caps. As such, wages and operating expenses are having a bigger impact on margins than before.

Companies with pricing power are ideal investment candidates in this environment, as their unique positioning makes it possible for them to pass on potential cost increases to customers and maintain earnings momentum. The competitive advantage that enables companies to yield such pricing power can come from various sources: a strong brand, as often found in the luxury space, a technological advantage, a unique presence in growth markets, and so on. Pricing power companies are mainly found in technology and defensive sectors, but some unique jewels can be found in more cyclical sectors as well.

As earnings growth curtails, expected returns on equities is graduallygearing more towards dividends. Companies able to increase dividends continue to send positive signals to investors. S&P 500 Dividend Aristocrats focuses on companies within the S&P 500 that have been able to continue raising their dividends over the past 25 years. This theme has performed nicely in 2019, and is expected to continue to do so going forward.

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1. MSCI China in CNY, September 2019
Despite elevated global uncertainty, notably linked to trade tensions, currency volatility has remained below its long-term average. It was even close to its lowest point in the past 17 years in mid-year. However, volatility has climbed since July.

Notwithstanding the new EUR/USD rate lows following the July Fed meeting, the main driver of the recent volatility spike was the renminbi’s break above the critical CNY 7.00 per USD threshold, highlighting China’s reduced willingness to keep its currency stable in periods of high stress. The subsequent official labeling of China as a currency manipulator by the US Treasury Department further increases the probability that the trade dispute spills over into the currency market.

The volatility decline at the start of September came at the same time as renewed renminbi strengthening versus the USD (and receding concerns of a significant depreciation in the renminbi). While some temporary trade truce cannot be ruled out, our view remains that fundamental issues (such as intellectual property) make a comprehensive deal between the US and China unlikely. Consequently, trade tensions are likely to continue to rumble on in the background, which may support volatility in the FX market should the renminbi prove less stable again.

Besides trade tensions, there may be other reasons for higher volatility in the (not so near) future. With fresh asset-purchase programmes and negative interest rates, central banks have been having a significant impact on the FX market. However, the market is now more accustomed to such measures, while forward guidance is tending to reduce the element of surprise. At the same time, central banks are now near the limit of what they can do, and with the risk of further moderation in global economic growth, new answers may have to be found to support the economic outlook. The headway made by ideas such as Modern Monetary Theory would likely support higher FX market volatility.

Another source of potential volatility may stem from the US presidential elections. Trump may well end up running against a Democratic candidate at the very left of the party’s spectrum. If this is the case, whether the result is a Democratic president with a progressive policy agenda or a Trump unconstrained by re-election concerns, markets will potentially face a significant shift from current US policy.

Some exchange rates more volatile than others
Overall, volatility in the FX market largely means volatility of the EUR/USD rate, which is the most traded exchange rate (24.0% of all daily average turnover, according to the Bank of International Settlements’ triennial survey). With the European Central Bank’s September easing package now behind us and an extension to the Brexit 31 October deadline looking possible at time of writing, there appears to be reduced scope for an increase in volatility in the short term.

Although EUR/USD volatility may stay below its long-term average in the near term, volatility could be higher elsewhere. Obviously, volatility in sterling (GBP/USD represents 9.6% of all daily average turnover) is likely to remain elevated around Brexit-related uncertainty. To a lesser extent, we see scope for higher volatility in the Japanese yen (USD/JPY represents 17.8% of all daily average turnover), which is highly sensitive to the health of the global economy. Furthermore, long-term equilibrium values suggest that the yen is extremely undervalued and the Bank of Japan seems to have limited room for additional monetary easing.

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Although EUR/USD volatility may stay below its long-term average in the near term, volatility could be higher elsewhere. Obviously, volatility in sterling (GBP/USD represents 9.6% of all daily average turnover) is likely to remain elevated around Brexit-related uncertainty. To a lesser extent, we see scope for higher volatility in the Japanese yen (USD/JPY represents 17.8% of all daily average turnover), which is highly sensitive to the health of the global economy. Furthermore, long-term equilibrium values suggest that the yen is extremely undervalued and the Bank of Japan seems to have limited room for additional monetary easing.
The official Chinese manufacturing purchasing manager index remained in contraction territory for the fourth consecutive month in August. Domestic demand was also sluggish, while fixed-asset investment continues to trend lower. Infrastructure investment has failed to pick up despite policy easing, and property investment has begun to moderate. After a short-lived rebound in June, growth in retail sales has resumed its decline. And Chinese exports fell again in August, especially to the US.

The ongoing US-China trade tensions are clearly a major factor behind China’s growth weakness. Exports are being hurt through higher tariffs at the same time as prolonged tensions weigh on the broader economy via weaker business confidence and declining aggregate demand. We note some signs of reduced tensions between the US and China recently, after both countries agreed to resume trade talks. They could possibly work toward an ‘interim’ deal. In our view, however, the latest developments are unlikely to represent a turning point in the trade dispute, but may just be a pause.

On the domestic front, the Chinese government’s efforts to reduce financial risks have led to a sharp decline in shadow-banking activity over the last two years and forced much more stringent fiscal discipline on local governments. While these measures could help make the Chinese economy more sustainable in the long term, they have contributed to the near-term drop in growth.

Against the backdrop of continued growth weakness, the Chinese government has stepped up its policy support. On 6 September, the People’s Bank of China (PBoC) cut the required reserve ratios for all commercial banks by 50 basis points (bps), and by an additional 100bps for smaller city commercial banks. The PBoC estimated that the move could release Rmb900 bn into the financial system. Prior to this, the central bank had streamlined the transmission mechanism of its monetary policy by reforming the benchmark lending rate, paving the road for possible rate cuts. On the fiscal front, the government plans to raise the 2019 quotas on the issuance of local government special bonds that target infrastructure investment specifically. These enhanced measures could lead to a recovery in growth momentum in the last quarter of the year.

However, the strength of the expected recovery will likely be quite modest, in our view. The pickup in credit creation so far has been much weaker than in previous episodes of monetary easing, due to official caution about elevated debt levels. In particular, the government has made it clear that it would not try to stimulate the property market. Yet, given that they account for roughly a quarter of Chinese GDP, it is difficult to foresee a significant improvement in growth without a meaningful pickup in property-related activities.

The tax cuts that have been rolled out since late 2018 were an encouraging move on the fiscal front. But compared to outright fiscal spending, tax cuts tend to have a much less direct effect, and a less pronounced impact as a result. While the central government has tried to strengthen fiscal spending recently (e.g., on infrastructure), restrictions on local governments’ ability to obtain further financing may continue to be a constraint. The persistent economic headwinds and the government’s relatively measured stimulus policies mean our current Chinese GDP growth forecast of 6.3% for 2019 faces downside risk.
Modern Monetary Theory is influencing mindsets in Washington DC

US policymakers have grown enamoured of MMT, an experimental economic policy approach that combines both (very) loose budget and monetary policy (zero rates). From an equity standpoint, low rates, which do not necessarily lead to an equity valuation bubble, should be the focus of analysis.

Modern Monetary Theory (MMT), a macroeconomic theory advocated by heterodox economists, is gaining traction in the US. The theory adopts an experimental approach to economics, underscored by the fundamental belief that money is created by the government via budget spending—and not by central and private banks, as per traditional theory. Proponents of MMT in the US interpret current low inflation levels as an indication that there is not enough money in the system, with the result that there is insufficient budget spending. Central to MMT is the belief that the Federal Reserve should be merged with the US Treasury department and interest rates brought to zero in conjunction with increased fiscal spending.

The theory is also gaining traction because traditional economic theory struggles to explain the current situation. The Phillips Curve, which links a strong labour market to rising inflation, is not really functioning, nor is the traditional monetarist view that quantitative easing should lead to higher inflation. Indeed, the US consumer price index (CPI) has averaged just 1.8% since 2010, and 2.0% over the past 12 months, despite an unemployment rate of below 4%.

The Federal Reserve (Fed) is struggling to identify an appropriate new monetary framework to replace a focus on inflation targeting that is showing signs of fatigue. Within an inherently conservative Fed, there is broad disagreement as to what should succeed it. The Fed chairman himself, Jerome Powell, has equivocated vastly in his monetary policy views in recent months, much to the market’s disarray. Powell, a pragmatist and lawyer by training, seems to draw more from economic history and the playbook of economic history and the playbook of economic history and the playbook of economic history and the playbook of economic history and the playbook of

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CHART 1: BANK RESERVES AT THE FED AND % OF GDP VS INFLATION

[Graph showing bank reserves at the Fed (left-hand scale) and US CPI inflation (right-hand scale) over time]
former Fed chairman Alan Greenspan (especially with regard to the 1998 rate cuts) than from any particular monetary dogma. This lack of framework at the Fed enhances the potent appeal of the MMT ideology.

And while mainstream economists continue to resist MMT, it continues to gain traction all the same. Olivier Blanchard, former chief economist at the International Monetary Fund, argued in a crucial speech in January 2019 that more budget spending was indeed not only possible but also desirable. Fed Governor Lael Brainard has argued that yield curve control, which is now practiced in Japan, could be adopted in the US, should it be merited by conditions, such as a recession. Republican economist Arthur Laffer recently made a bang when he said he saw no point in the Fed’s political independence.

With the November 2020 US presidential elections looming, MMT has certainly captured the attention of politicians, who have in turn made fresh promises of additional spending. The Democratic party in particular has shifted widely to the left, moving the needle on new fiscal promises in so doing. Many identify MMT as a way to square the budgetary circle (or exit from the circle altogether). An indicative example is the ‘Green New Deal’ put forward by Democratic presidential candidate Bernie Sanders. With an estimated cost at USD 16.3 trn, the scale of proposed spending is staggering when compared with US GDP of USD 21.3 trn.

However, we are witnessing a true budget spending ‘regime shift’ that transcends both parties and dates back to Trump’s 2016 election. Voices in favour of a return to zero deficits have all but faded in the US. A new two-year budget spending bill passed in 2019 put more federal spending on the table. Meanwhile, the deficit approached 4.5% of GDP in Q2 2019, the highest in six years, despite a much stronger economy and, in theory, higher tax revenues.

From an equity allocation perspective, the main consequence of MMT is that it promotes the maintaining of interest rates at very low levels. This leads to two considerations. First, low yields tend to support valuation levels, but they do not necessarily lead to ‘valuation bubbles’, as the equity risk premium (the difference between the earnings yield and the sovereign yield) is not linear and tends to be in a high regime when yields are low (and low regime when yields are high). Importantly, low yields tend to make equity markets more polarised, with growth and defensive stocks performing better than value and cyclicals.

Second, the correlation between equity returns and bond returns tends to be more negative (i.e., bonds tend to perform well when equities are down). In such an environment, the diversification between equities and bonds becomes more optimal: balanced 60/40 portfolios and risk-parity strategies (focused on the allocation of risk/volatility) tend to behave well.

“We are witnessing a true budget spending ‘regime shift’ that transcends both parties and dates back to Trump’s 2016 election.”

CHART 2: ONE-YEAR ROLLING US EQUITY/BOND RETURN CORRELATION VS. TWO-YEAR US SOVEREIGN YIELD

[Diagram showing correlation between US benchmark bond and one-year stock-bond correlation]
Robo advising can no longer be ignored

Robo advisors are quickly becoming mainstream, which is good news for consumers who are looking for low-cost financial advice. We identify premium wealth management advisory services, which embrace human and digital advisors (Robo4Advisors alike), as the only way to maintain ‘timeless’ brand awareness.

Alessandro Nilo
Head of Quantitative Strategy
Pictet Wealth Management

As the world rapidly shifts towards digital and the digitalisation of services, the wealth management industry is being disrupted. Yet wealth managers have been hesitant to consider digitalisation as part of their service offering. Much of this reluctance is probably due to organisational complexity and cultural inertia, as well as the nature of wealth management and financial advice, which are highly dependent on personal relationships. At the same time, digital technology like self-service banking tools, endless financial information and 24/7 connectivity, are all putting decision-making power into the hands of investors, explaining why many advisors have come to perceive digitalisation as a threat.

Indeed, digital banks continue to draw significant venture-capital interest globally, especially in Europe, where many have recently announced plans to expand their services globally. Robo advisors in particular are part of a larger trend in financial technology (fintech), which is disrupting the role of large, established companies in the financial sector. These are essentially advanced computer algorithms that, by taking into consideration client preferences and risk appetite, can automatically suggest, build and manage a robust, bespoke tactical asset allocation. This includes the ability to know – within seconds – which clients might be affected by a specific news or macro-economic event.

Robo-4-Advisor is not just hype

Today, much of the growth in robo advisors is due to large financial institutions, two of which accounted for 80% of robo assets under management (AUM) at end-September 2019. But while the larger independent groups will probably thrive, the future seems increasingly challenging for smaller companies that have been unable to ramp up their AUM, especially as the move to low-fee and even no-fee models has become a common theme among retail-focused apps. The free model is, in our view, one of the truly disruptive changes in the investment technology landscape. A watershed moment for the wealth management industry will come when a majority of investors with experience of robo and human advisors, from retail to ultra-high net worth individuals, decides to gravitate toward institutions that offer both.

Up to now, the rocky start of many robo advice platforms has been good news for banks. The reason for this is that the current crop of robo advice platforms is not very sophisticated. It is not clear how well they perform...
(because they are rooted in old, inefficient econometric models) and they have often proved to be economically unviable on a stand-alone basis. The platforms’ problems have stemmed from their excessive focus on lowering pricing and on removing the human wealth advisor from the equation. The principle, according to which the less you spend, the more you save, could rapidly turn out to be an unsustainable model for fintech start-ups due to client frustration, especially with investment performance. This provides a chance for private banks to show that they remain at the cutting edge of the wealth management business. They can do this by renovating their businesses, providing new digital products with an impeccable level of quality that, as with luxury brands, remains constant over time.

In fact, we believe current robo advice solutions will evolve into a more sophisticated ‘Robo-4-Advisors’ service that is integrated into existing private banks’ offering, with cyber and robots proving increasingly decisive in helping advisors to find quick, easy-to-access and intelligent solutions for clients. In essence, we do not think that the digital disruption currently underway will replace the traditional investor-advisor relationship, but rather, it will emerge as a critical complement to institutions’ overall portfolio of services.

With this in mind, it would be unwise to consider robo advice as simply hype that will not impact the wealth management industry. A solid, evidence-based selection of a clear, easily explainable suite of multi-asset systematic ‘intelligent’ strategies may soon start to appear as satellite investments in clients’ portfolios. Most asset-class exposure that these rules-based strategies propose will be via passive investment vehicles (ETFs) due to their low cost and transparency, with the investment allocation continually optimised by robo-brokers every month or quarter. These digital traders, after the ideal portfolio has been determined under human rules and supervision, will manage investments’ progress automatically, by finding the best entry/exit points for clients through machine-learning models. These Robo-4-Advisors algorithms will then be able to analyse and review clients’ portfolios individually and make scientifically grounded suggestions to them and their human advisors in areas such as tax optimisation, changes in market risk and day-to-day variations in a family’s account balance (covering items such as credit card spending and life events).

**Conclusion**

Robo advising, like digital developments in general, could well be key to the future success of wealth management—not just by enabling the sector to grow but also by reducing costs, improving performance and better managing risks. Facing competition on many fronts, financial institutions will benefit greatly from effective partnerships with fintech companies and from seeing them less as competitors and more as sources of new ideas and technological expertise—in short, as allies toward the common goal of providing a better customer experience. Banks must understand quickly that embracing digital technologies will not adversely affect the overall quality of the bank-client relationship, but will actually improve it dramatically by improving the value proposition to their clients. Progressively, investors will grow to feel that traditional wealth management and digital relationships can co-exist. In conclusion, it is clear that fintech is here to stay and that banks that fail to invest strategically in this area may be left behind.

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**CHART 1: US FINTECH INVESTMENT BY SEGMENT IN Q1/19**

USD mn

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<th>Segment</th>
<th>Aggregate value (left-hand scale)</th>
<th>Number of transactions (right-hand scale)</th>
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<td>Insurance Tech</td>
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<tr>
<td>Investment and Capital Market Tech</td>
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<td>15</td>
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<tr>
<td>Banking Tech</td>
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<td>10</td>
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<tr>
<td>Financial Media and Data Solutions</td>
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<td>5</td>
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<td>Source: Pictet WM, S&amp;P Global Market Intelligence, June 2019</td>
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**CHART 2: ASSETS UNDER MANAGEMENT AT US-BASED DIGITAL INVESTMENT MANAGERS THAT TARGET RETAIL INVESTORS**

USD bn

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<thead>
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*Based on actual and projected figures for 54 asset managers. P = projection.

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