

Macro matters

Weekly Digest

20 August 2018

– Jernej Bukovec, CFA

When I raise the issue of the importance of macro, I sometimes get the response: ‘no one has a good record predicting macroeconomic variables like GDP growth’; ‘where do you start when it comes to the many interrelated factors that influence inflation?’; or more bluntly ‘why bother?’.

I would agree; predicting these key variables – growth, interest rates and inflation – or, more importantly, the changes in those variables is extremely difficult. This is the reason why our asset allocation process also relies on bottom-up asset class valuations. We believe that over the long-term prices will follow business fundamentals and the prices you are paying today will ultimately determine your future returns.

Nevertheless, we know that businesses are not immune to changes in the macro environment and that, in the short term at least, macro does matter. If GDP growth surprises to the downside, company sales are likely to be lower thereby pushing the market price lower. Equally, if inflation is higher than expected, the squeeze on real incomes is likely to have a similar effect by reducing consumer discretionary spending.

We approach macroeconomic research by identifying three likely scenarios: a base case, bull case and a bear case, with a view on the likely probabilities of each outcome. For each scenario, we take a view on what will happen to the key macroeconomic variables and their impact on investment returns in each main asset class.

Currently, we believe the most likely outcome for the global economy is a modest growth scenario, where contractionary forces are partly counteracted by

stimulatory policies, resulting in economic variables recovering but staying below their pre-crisis norms for the foreseeable future. Our second most likely scenario is reflation, where policy measures are effective in overcoming contractionary forces, productivity levels rebound, higher nominal growth improves fiscal ratios and improving consumer and business confidence makes global growth accelerate towards its pre-Global Financial Crisis trend. The third and least likely scenario is the return of deflationary forces, where policy tools are ineffective and consumer and business confidence are destroyed causing a downward recessionary spiral.

Ideally, we would be right all of the time, know exactly what will happen to interest rates and inflation, and invest accordingly. Unfortunately, this is close to impossible and the best we can do is to: 1. Simplify the range of potential outcomes into a manageable number of scenarios; 2. Evaluate what we think will happen to the businesses and governments we invest within each of these scenarios; 3. Armed with this information, consider what we’re being asked to pay today for different investments.

There is a key distinction between a purely top-down approach to investing, akin to an investment clock – ‘we are predicting a great GDP number next quarter hence equities can only go up’ – and an approach that incorporates macroeconomics in combination with bottom-up analysis, determining what key variables like company earnings are likely to be, in a range of scenarios, while all the time paying close attention to current prices and valuations. We adhere to the latter; hence, while we don’t believe in investing on the basis of macro, we do not ignore it entirely.



The Marketplace

- Brent crude fell 1.3% to \$71.9 a barrel
- Gold fell 2.8% to its lowest level since January 2017
- Investors flee commodities
- Emerging markets approached bear market territory after a tumultuous week

Market Focus

US

- The Dow Jones index rose 1.4% to 25669
- The Nasdaq 100 fell 0.4% to 7377.5
- China to send a delegation from its commerce ministry to Washington for talks over tariffs. US-China trade tensions still one of the the main drivers of the macro scene
- July retail sales came in at 0.5% mom, beating expectations of 0.1%

UK

- Brexit talks resume ahead of the EU leaders summit next month. Merkel has indicated she hopes for a 'reasonable negotiated agreement' though this would include re-accepting EU rules

- The FTSE 100 fell 1.4% to 7558.6
- June unemployment was at a 43 year low at 4% . Average weekly earnings growth fell 10% to 2.7 yoy

Europe

- The Eurostoxx 50 fell 1.6% to 3372.9
- Euro-area expansion was revised up to 0.4% from 0.3% for Q2 with Germany and the Netherlands leading the gain
- Italy's populist coalition has begun making steps to revoke the licence of Atlantia SpA to manage tolls and bridges in the country. Global infrastructure funds fell on news of the disaster in Genoa
- Turkey sees its credit rating S&P and Moody's cut deeper into higher yield territory

Asia/EM

- After a rocky week the Nikkei ended the week flat down just 0.1% at 22270
- MSCI's China tech gauge lost 9% last week with big names like Tencent leading the falls
- Concern that growth in China will be hit has led to a fall in commodities. Rising interest rates in US pulls money out of EM
- The MSCI Emerging Markets index falls over 5% in a seven day period
- The Hang Seng fell 4% to 27213

Asset Class/Region	Currency	Currency returns			
		Week ending 17 Aug. 2018	Month to date	YTD 2018	12 months
Developed Market Equities					
United States	USD	0.6%	1.8%	7.5%	18.9%
United Kingdom	GBP	-1.2%	-1.1%	1.2%	6.0%
Continental Europe	EUR	-1.1%	-2.5%	0.0%	2.3%
Japan	JPY	-1.3%	-4.0%	-5.5%	7.4%
Asia Pacific (ex Japan)	USD	-2.7%	-3.7%	-6.7%	1.8%
Australia	AUD	1.3%	1.3%	7.1%	14.5%
Global	USD	0.0%	-0.3%	3.0%	12.5%
Emerging markets equities					
Emerging Europe	USD	-1.7%	-10.6%	-15.5%	-7.3%
Emerging Asia	USD	-3.7%	-4.7%	-8.7%	0.9%
Emerging Latin America	USD	-2.5%	-8.4%	-9.9%	-7.9%
BRICs	USD	-4.3%	-6.8%	-9.6%	0.4%
MENA countries	USD	-2.9%	-3.3%	7.1%	6.7%
South Africa	USD	-7.9%	-14.1%	-24.1%	-11.3%
India	USD	-1.6%	-1.4%	-0.3%	6.7%
Global emerging markets	USD	-3.7%	-6.1%	-10.2%	-1.6%
Bonds					
US Treasuries	USD	0.0%	0.7%	-1.0%	-1.3%
US Treasuries (inflation protected)	USD	-0.2%	0.5%	-0.2%	1.1%
US Corporate (investment grade)	USD	0.1%	0.6%	-2.0%	-0.6%
US High Yield	USD	0.0%	0.4%	1.6%	3.5%
UK Gilts	GBP	0.0%	1.1%	0.8%	0.9%
UK Corporate (investment grade)	GBP	0.1%	1.2%	-0.8%	-0.1%
Euro Government Bonds	EUR	-0.2%	-0.1%	-0.1%	0.2%
Euro Corporate (investment grade)	EUR	-0.1%	0.5%	0.0%	0.6%
Euro High Yield	EUR	-0.1%	0.0%	-0.4%	1.0%
Japanese Government	JPY	0.0%	0.0%	-0.2%	0.2%
Australian Government	AUD	0.3%	0.8%	2.7%	3.6%
Global Government Bonds	USD	-0.1%	-0.6%	-2.1%	-1.5%
Global Bonds	USD	-0.1%	-0.6%	-2.2%	-1.3%
Global Convertible Bonds	USD	-1.0%	-1.2%	-1.7%	0.0%
Emerging Market Bonds	USD	0.3%	-2.2%	-6.4%	-5.6%

Asset Class/Region	Currency	Currency returns			
		Week ending 17 Aug. 2018	Month to date	YTD 2018	12 months
Property					
US Property Securities	USD	3.1%	4.7%	4.2%	6.3%
Australian Property Securities	AUD	1.5%	3.3%	4.5%	9.6%
Asia Property Securities	USD	-2.0%	-5.0%	-6.4%	-0.3%
Global Property Securities	USD	0.7%	0.1%	-0.6%	5.0%
Currencies					
Euro	USD	0.1%	-2.6%	-5.1%	-2.8%
UK Pound Sterling	USD	-0.2%	-3.1%	-5.9%	-1.1%
Japanese Yen	USD	0.3%	0.5%	2.0%	-0.6%
Australian Dollar	USD	-0.2%	-1.7%	-6.8%	-7.9%
South African Rand	USD	-5.0%	-11.1%	-16.3%	-10.9%
Swiss Franc	USD	0.1%	-0.6%	-2.1%	-3.3%
Chinese Yuan	USD	-0.3%	-0.9%	-5.3%	-3.0%
Commodities & Alternatives					
Commodities	USD	-1.5%	-3.0%	0.8%	11.6%
Agricultural Commodities	USD	0.7%	-1.0%	-0.1%	0.4%
Oil	USD	-1.3%	-4.2%	7.4%	40.8%
Gold	USD	-2.8%	-3.8%	-9.9%	-8.5%
Hedge funds	USD	-0.4%	-0.5%	-1.4%	1.6%

For more information, please contact your adviser or alternatively contact:

Financial Partners Ltd.
泛柏資產管理有限公司
Unit 01 - 03
24/F, Kinwick Centre
32 Hollywood Road
Central, Hong Kong

Tel +852 2827 1199
Fax +852 2827 0270
client.services@f-p.hk
www.f-p.hk

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