2019 mid-year check-in

How we're managing our clients' portfolios

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As the first half of 2019 draws to a close, mounting uncertainty over the China-U.S. trade war continues to fuel investor fears and engender broad-based risk-off sentiment. Business confidence is low, capital spending is negative, and global manufacturing is weak. All of these indicators, coupled with decelerating profit growth and the inversion of the U.S. Treasury yield curve—which means that long-term Treasury yields are falling below short-term Treasury yields—point to the need for caution at this stage. The inverted yield curve, which is a hallmark of the late cycle, has predicted nearly every global recession over the past 50 years. However, the prospect of Fed easing, Chinese stimulus measures, and trade compromise could mean this inversion is a false signal.

For now, we recommend heightened caution. Rather than getting caught up in alarmist news headlines, it is vital that investors stay grounded, set aside the noise, and focus on market fundamentals: business **cycles**, security **valuations**, and investor **sentiment** (CVS). And, as always, we recommend that investors prudently diversify their portfolios.

In this communication, we discuss how we are managing our clients' portfolios using our CVS framework.

Nuanced regional preferences

We hold fast to our underweight preference for U.S. equities in our multi-asset portfolios, in order to fund overweights to EMEA ex-U.K. and U.K. equities. Our view on U.S. equities is driven by expensive valuations and late cycle concerns over the trade-war escalation, fading fiscal stimulus, and yield-curve inversion. We like the value offered by emerging-market equities, as emerging-market economies in the Asia-Pacific region should benefit from supportive central banks and Chinese stimulus. These emerging markets are, however, at near-term risk from potential trade-war escalation and disruptions in global supply chains. For this reason, we remain cautious and continue to maintain neutral allocations to emerging-market equities. We shifted to an overweight position for the Japanese yen, as it is an undervalued currency and can potentially serve as a safe-haven asset if the trade war were to escalate. We were rewarded for our positioning during the escalation in May, when our underweight to U.S. equities and overweight to the yen were both tailwinds; and the yen strengthened considerably against other major developed-market currencies. This countercyclical characteristic makes the yen particularly valuable as a diversifier in our portfolios.

Interest-rate uncertainty

The yield-curve inversion is a signal to the Fed that its current policy stance may be restrictive. As such, the Fed is adopting a dovish approach to rate changes, awaiting more economic data before it considers slashing borrowing costs. This makes government bonds an uncertain bet. We see government bonds as universally expensive, although we believe U.S. Treasuries are closer to fair value than German bunds, Japanese government bonds, and U.K. gilts—therefore, we are long the former, and short the latter. Beyond the fixed income allocation, we maintain underweights to interest-sensitive assets such as infrastructure and utilities.

Rising recession probabilities

Our Business Cycle Index (BCI) model, which uses a range of economic and financial variables to assess the strength of the U.S. economy and to forecast the probability of recession, has entered "risk-off" territory for the first time during this long economic expansion—at 10 years old, it is now the longest expansion in U.S. history. Although short-term risks remain low, the BCI model at mid-year estimates that the probability of a U.S. recession in 12 months is roughly 30%, hovering perilously close to the warning threshold for leaning out of risky assets. As a result, we have staged some initial cyclical downgrades on equities and risk-seeking fixed income. We are underweight corporate credit such as high yield and EMD hard currency, as high yield credit is expensive and losing cycle support—this is typical late in the cycle, when profit growth slows and concerns about defaults grow. Moreover, high yield bonds tend to be more sensitive to the impact of a recession than are other types of fixed-income securities.

Our team of investment strategists and portfolio managers will continue to monitor market developments and will adjust portfolios to help ensure we're capitalizing on opportunities and managing risk below long-term strategic levels for our clients. At the end of the day, our focus is empowering our clients to achieve their outcomes, and making sure we're putting your money in the right place.

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