Investment Insight

Friday, 16 March 2018

ARIA | CAPITAL

Faraway hills: *Another voice added to the theme of reducing U.S. exposure, this week in the guise of Henry McVey of private equity firm KKR.*

KKR will be familiar to many for its increased presence in the Irish market in recent years. However, McVey's perspective (he is New York based) is that of a U.S.-based strategist. He sees much more attractive opportunities outside of the U.S. than he does domestically at present, particularly citing Emerging Markets opportunities. In the ***Inside Track*** *we look at his reasoning.*

Losing interest: *When meeting an Investment Director from Fidelity International recently, we discussed the prospect for interest rate increases in Europe. Clearly the US is already making progress on this front and, while nobody is too hawkish presently, continued improvements in the European economic climate and any associated inflation may bring the prospect of European rate rises into greater focus. However, there is a very good reason why global interest rates may not advance too far: debt. There is almost $140 trillion of debt currently outstanding in the global financial system and the increased cost of servicing it if interest rates rise too much would be crippling. In this week's* ***Pic of the Week*** *we take a closer look.*

Quoted...

"I have noticed even people who claim everything is predestined, and that we can do nothing to change it, look before they cross the road." – Stephen Hawking

The Inside Track

KKR's Global Macro & Asset Allocation Team led by Henry H. McVey sees more opportunity outside the U.S. currently than within. The following are some of their thoughts on asset allocation and positioning.

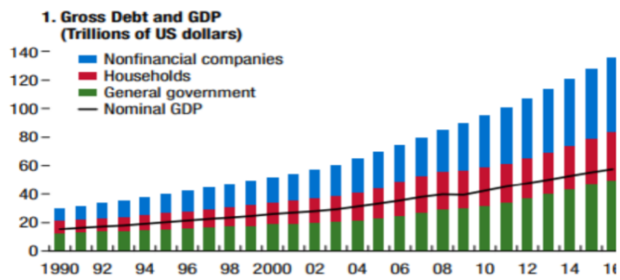
As we position our portfolio for the later stages of the economic recovery, we are further tilting our asset allocation targets to take advantage of the many compelling opportunities we see abroad. To be sure, we believe that the opportunity set in the U.S. remains substantial, particularly as the recent tax cuts and deregulation efforts are likely constructive for the positioning of U.S. corporations. However, much of this benefit now seems to be in the price from a tactical perspective. Maybe more important, though, is that strong pro-growth fiscal and regulatory policy amidst bigger deficits will likely inspire the central bank in the U.S. to become more aggressive than it might like to be, which represents a 'diverging path' relative to what we currently see in Europe and Asia. Moreover, our recent trips across these regions give us additional confidence that Europe and Asia appear to be increasingly elegant plays on many of our most important macro themes...In addition, many of our quantitative macro models are suggesting a heavier allocation to non-U.S. equities, Emerging Markets in particular. Finally, both implicit and explicit in what we are saying is that the U.S. currency has peaked in terms of structural outperformance, a trend we outlined in our 2018 outlook in January.

Overall, we believe that we are at an important inflection point in global asset allocation. On the fixed income side, we are aggressively advocating shortening duration (as measured by our 17% underweight to government bonds), while on the equity side, we are advocating more money flow into non-U.S. companies (and we are now at our widest allocation towards non-U.S. since we began providing target asset allocation models in 2012). Not surprisingly, both directives stem from our strong belief that investors should spend less time championing the benefits of a global synchronous recovery and more time understanding the difference in monetary policy that the current global growth dynamics are creating. If we are right, then the upside to these asset allocation changes could be as significant as we have seen since the introduction of quantitative easing (QE) following the onset of the great financial crisis (GFC). Therein lies the opportunity, we believe.

Pic of the Week

There are clear signals from the Fed and the Bank of England towards normalisation of monetary policy and European interest rate expectations have risen and too. As the chart shows, in both absolute and relative (to GDP) terms, the amount of debt is much greater now than it was at any time previously, including at the time of the debt-precipitated global financial crisis. Much of the current stock of debt has only ever cost sub-2% to service, meaning that even a 2% increase in rates would at least double debt servicing costs. That, allied with structural issues such as labour market flexibility and unfunded future commitments, may well help to constrain interest rates.

Debt relative to GDP



Source: IMF, Fidelity International

Week ahead: Key events

19/03 UK House Prices & Inflation Data
19/03 Eurozone Consumer Confidence & US Retail Sales
20/03 UK Unemployment & US Mortgage Applications
21/03 US Existing Home Sales & Federal Reserve Economic Projections
22/03 Eurozone PMI & UK Retail Sales
22/03 BOE Rate Decision & US Manufacturing PMI
22/03 Japan CPI
23/03 US Residential Sales & Unemployment Data

Market View

	Last 7 days (€)	Last 12 mths (€)	YTD (€)	5Y Ann. (€)
Global equities	+2.1%	+2.4%	-1.2%	+11.3%
US equities	+2.3%	+2.6%	-0.0%	+14.8%
European equities	+1.1%	+3.5%	-3.3%	+7.5%
EM equities	+2.7%	+13.8%	+2.3%	+5.9%
Irish equities	-0.9%	+0.9%	-5.1%	+11.3%
Commodities	-0.2%	-6.3%	-3.2%	-8.3%
Hedge funds	+0.2%	+0.4%	-1.2%	-1.2%

Currencies	*Current*	*YTD Δ*
EUR:USD	1.2304	+2.6%
EUR:GBP	0.8828	-0.7%
EUR:CNY	7.7780	-0.4%
GBP:USD	1.3936	+3.2%
Bitcoin	8,303	-42.7%

Commodities	*Current*	*YTD Δ*
Gold	1,316.41	+1.1%
Copper	7,015.00	-2.0%
Oil	65.00	-2.4%
Wheat	478.50	+12.1%

Central Bank rates	*Current*
Eurozone	0.00%
USA	1.25%
UK	0.25%

Economic indicators	*Bond yields*	*Inflation*	*GDP YoY*
Ireland	+1.0%	+0.5%	+7.2%
Germany	+0.6%	+1.4%	+2.9%
USA	+2.8%	+2.2%	+2.2%
China	+1.9%	+2.9%	+6.8%

66 Fitzwilliam Square
Dublin 2
D02 AT27
Ireland

T: (+353 1) 685 4100
E: research@aria-capital.ie
W: www.aria-capital.ie

UNDIVIDED ATTENTION