Amplia Monthly Investment Letter

Observing storm clouds on horizon

Following the stark stock market rout of October, which wreaked havoc on investor confidence, markets have dragged lower by the time of writing this (23rd November), with most indices down slightly in November: Euro Stoxx 50 -2.22% and S&P 500 -3.05%, respectively. One index stands out from the pack: NASDAQ that has lost so far 5.32% month-to-date. The correction in NASDAQ has been a healthy and expected phenomenon, as the tech sector valuations got distracted from those of other sectors in the past 12 months. Investors seemed to extrapolate the one-off tax breaks introduced by Mr. Trump's administration as a boon ongoing into the future, leading to forward-looking price-to-earning ratios last seen during the tech bubble of the Millennium. The discussion on both sides of the Atlantic to tax the internet giants harder is a healthy reminder that no industry is isolated from shifts in consumer or corporate spending and that proper diversification is still warranted.

In the grip of old concerns

What did then change over the past months? Not much really. The Italian debt issues hardly came as a surprise to anyone; neither did Brexit whose chances of success were always precarious. The intentions to tax the internet giants also dated back to times well before Mr. Macron. Hence, any real disappointments were rather on the corporate side, with for instance Apple losing surprisingly much market share in China to its local rivals. Accordingly, plenty of the recent drop can be attributed to changes in investor sentiment and re-evaluation of market risks rather than new external shocks.

In the macro economy, consumption remains the driving force behind the growth at the moment. In the US, the latest reading of the broad University of Michigan Consumer Sentiment survey came in at 97.5, down slightly but still reasonably close to the highs of March 2018 and higher than the tops before the financial crisis in 2007. US employment stands strong: with unemployment at 3.7%, lowest since December 1969, the private sector remains healthy. Despite all the talk about "decoupling" of the global economy, US private consumption makes out 68% of the country's GDP, and US GDP in its turn 24% of the global one, giving us every reason to closely monitor the mood of American consumers. Reflecting the strong consumption patterns, industry and service sectors' purchasing manager indices (PMIs) still point towards improving business conditions in the US, Europe and China.

In contrast, Eurozone consumer confidence has been declining since its peak in January 2018, something that gives us cause for concern. Similarly, the monetary tightening progresses, with central banks raising rates or cutting down on quantitative easing almost in unison. The rise in the price of money and discount rates may not yet prevent companies from investing but do not bode well with historically high asset prices, most notably real estate.

Looking at the aggregate macro picture, the development is slightly negative albeit at levels where corporate earnings and dividends are still favourable for equities. Our biggest risk scenario remains the Keynesian "animal spirits", changes in the sentiment of consumers and business leaders that – if trembling – will have repercussions for the real economy. The investor psychology was barely influenced by the ongoing discussion around the prospects of the Sino-American trade war earlier this year but now the newly flared-up concerns of fiscal stability in Southern Europe and Brexit, amongst others, took their toll on risky assets in the recent months. Traditional late bull market signs have appeared, with investors navigating from cyclical to defensive sectors, equity and high-yield bond market correlation picking up and option prices with low strike prices rising in relation to options with high strike prices, implying that investors seek more protection against market decline.

So far this has been a concern for asset prices rather than the economy. The ultimate risk lies in these concerns spilling over to the real economy. If consumers' savings rates increase and businesses postpone investment decisions due to uncertainty, the real economy might start cooling down.

Our markets positioning

We have held 50% of our equity exposure hedged since June. On 30th October, we took a tactical trade to close the hedges, as we considered the stock market oversold. We reintroduced the hedges on 20th November, as the rally was not sustainable and as the investor concerns were intensifying rather than ebbing away. On top of this, we allocated a further 25% from the maximal equity allocation to money market and bonds, as we see better risk-adjusted returns outside the stock markets.

Asset allocation - October 2018	
Industry	↗
Consumption	↗
Monetary environment	↘
Market valuation	↘
Fundamentals total	↘
Hedging demand	↗
Economic surprises	↘
Market risk	↘
Market breadth	↗
Money flow into risky assets	↘
Risk sentiment total	↘
Equity exposure (of maximum):	**25%**

We favour healthcare, financials and consumer discretionary in terms of sectors, and underweight information technology and materials.

Our favoured spots in fixed income remain variable-coupon, Nordic issues in EUR and SEK terms as they exhibit a sizeable illiquidity premium despite being fully marketable securities. In US dollar terms, we go to the other end of the duration spectrum to benefit from the "portfolio insurance" nature of long-term debt: buying bonds with maturities between 2023 – 2028 should prove right if the next rounds of Federal Reserve rate hikes fail to raise the long-term rates. We would not expect the 10-year US Treasury rates to climb higher than 3.2 - 3.3% at its best, meaning that the rate curve would flatten further. On the other hand, should the markets take a turn worse, this would press down interest rate expectations and result in higher bond prices.

We shun away from Chinese high-yield and underweight emerging market debt. Euro-denominated fixed-coupon high yield and generally bonds with issue size greater than EUR 200m should feel the pain of dwindling ECB support, and we recommend to avoid these as well.

In Zurich on 23rd November 2018,
Yours sincerely,
Juho Kivioja

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