Amplia Monthly Investment Letter

Bucking the trend of positive years

The slide in markets that started with losses in September and October are about to turn 2018 into the first year of losses in major global equity markets since 2011. By the time of writing this, with S&P500 down by 7.71% and EuroStoxx 50 by 14.38% since the start of the year, it is probable that the total returns – index performance plus dividends – may remain in the negative territory for the full year. Especially in the US this would mark the end of the long streak of positive total returns: the broad S&P 500 had a negative total return for a calendar year last time a decade ago, when the index lost 37% in 2008 (including distributions).

Recalibration of growth expectations

Ironically, most of the concerns that investors have fretted over in the past months either stayed unchanged or even partially faded. Italy was able to reach a compromise budget for 2019 that pleased its electorate and Brussels and presidents Trump and Xi agreed on a "cease fire" of three months to their trade disputes. Recently, investors began to cite the central bankers' hawkish tone as the main culprit behind the market correction.

In our view, the outcome of world's central bankers' December meetings was as expected. The Federal Reserve had systematically hinted at a 0.25% hike in December to come for a long while, as had the Riksbank of Sweden. Both banks even lowered their projected policy rate path (the "dot plot") for 2019 and 2020 slightly, so the message should not have come across as overly aggressive. Similarly, many central banks, such as Bank of Canada and Bank of England, abstained from rate increases in December.

With the monetary policy continuing to tighten gradually across the globe, we re-iterate our opinion that this ought not to bring markets to fall per se. The rise in short-term interest rates should not materially change the way investors discount future cashflows (such as dividends and coupons) to the present because the mid- to long-term rates have stayed unchanged or even fallen. In fact, whilst the 2-year Treasury yield quotes at 2.67%, the 5-year one has fallen to 2.66% and the 10-year to 2.80%. In other words, the yield curve has flattened further and partially even inverted. Accordingly, bond markets seem to price in a slowing macroeconomic environment and barely any further rate hikes. This contradicts company-level growth expectations, with markets expecting 8.32% earnings growth for S&P 500 companies in 2019. Over time, either the bond or equity markets will have to recalibrate their expectations.

In the macro economy however, the rising interest rates, especially in US dollar terms, are starting to have an adverse impact on global growth. This is becoming clear in many ways. First, consumers have many of their loans linked to variable interest rates. The rising cautiousness is visible at best in the falling number of US mortgage applications. Second, small- to mid-sized companies have their bank loans usually linked to LIBOR rates as well. Third, the continuous rate hikes have kept the USD strong vs. emerging market currencies, which has resulted in many emerging markets having severe difficulties in balancing their budgets among rising external debt service costs. Thus, the monetary policy *trends* over the globe are currently not supporting economic expansion.

Up until now, consumption and industry have been the elements holding up global growth. Recently both of these two have started to falter as well. Many indicators that reflect corporate spending or consumers' confidence in their future prospects still are in positive territory, however the latest signals are pointing downwards, as is evident in indicators such as the US Composite PMI or S&P Case-Shiller US National Home Price Index (seasonally adjusted). Looking at valuations, the recent slump in equity prices has corrected the picture somewhat but many asset classes, such as equities and real estate, remain at elevated price levels in terms of long-term equilibria.

Our markets positioning

Nothing in the recent economic or asset price development gives us reason to change anything in our market positioning. In equities, we keep only 25% of the maximal (investor-specific) equity weight, with rest either hedged via index futures, allocated in fixed income or other return sources such as option strategies to profit from the risen volatility.

Asset allocation - January 2019	
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 financials, health care, energy and utilities and underweight consumer discretionary, consumer staples and materials. We have raised information technology to a neutral weighting after the recent market correction especially in NASDAQ.

In fixed income, in USD terms we keep our preference for long-term investment-grade corporate bonds. In EUR terms, our favoured issues remain small Nordic issues that exhibit a "stranger" premium due to their comparably small issue size and that have variable-rate coupons.

We still shun away from Chinese high-yield and are cautious towards emerging market debt. In euro terms, 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 21st December 2018
Wishing you an enjoyable Christmas Season,
Juho Kivioja

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