Amplia Monthly Investment Letter

A blend of strong earnings growth and geopolitical concerns

October month has so far been bleak for world's equity markets. The fall started from investor concerns on sustainability of growth as the Federal Reserve signalled to stay on course with their rate hike trajectory. Geopolitical tensions flamed on multiple fronts, as the killing of Saudi journalist in Turkey and ongoing worries about the prospect of a Sino-American trade war kept the mood lacklustre. A further uncertainty factor comes from the looming US mid-term elections on 6th November.

As of 24th October, European stock markets exhibited significant declines from the beginning of the year, with Euro Stoxx 50 being down 10.08% and DAX 12.71% year-to-date, respectively. On the other side of the Atlantic the earlier gains melted with the exception for NASDAQ that is still up 7.74% year-to-date. Whereas in Europe long-term interest rates have stayed at the same levels as where they were in the beginning of January, in the US the 10-year Treasury rate has climbed by 73 points to almost 3.14%, contributing to the shift in yields throughout the curve.

Despite the concerns, especially US companies have reported strong Q3 numbers. As 123 of S&P 500 firms have published their figures, net 4.44% surprised positively, compared to the analyst consensus estimates. The earnings are also growing by 24% compared to the same quarter a year ago, which is an impressive result at this stage of the business cycle and demonstrates the health of the US economy on a broad front.

A turn in sight?

Looking at macroeconomic data, markets get support from strong trends in industry and consumption. US Conference Board Consumer Confidence kept climbing to a new high of 138.4 in September, symbolising the strength of US consumers and their faith in future prospects. Similar signals are being received from industry where the primary challenge seems to be finding qualified workers at the hot labour market rather than potential disruptions to supply chains from tariffs. For instance, the non-manufacturing ISM report for business conditions also notched to a new high of 61.6 in September.

In contrast to the good spirits in industry and consumption, global asset prices and monetary environment remain challenging in the near-term. While the European Central Bank finishes its quantitative easing by the end of the year, markets assign a 74.4% total probability for at least ¼ percent rate hike in Fed Funds rate in December. Whereas we deem the interest rate normalisation in the developed world as crucially important for the long-term balance of the markets, the anxiety associated with the pace of the rate hikes in the US will remain a drag on stock markets' performance in the short-term.

Market psychology signals are still predominantly negative, although the recent sell-off gradually appears to come to a halt. Although the indicators relating to hedging demand have improved in the recent weeks, economic surprises and the generic market risk sentiment do not warrant a full equity exposure yet. The recent weeks' sell-off was broad-based and money has been flowing out from equities. Therefore, we do not want to try catching a falling axe but keep still ca. 50% of the equity exposure hedged, as it has been since June. It is however conceivable that should the markets fall further from here without having negative impact on the fundamentals, more attractive valuations may prompt us to increase the risk levels again.

On the rates front, we favour long-dated US investment grade corporate debt thanks to its good liquidity, improving credit metrics and anticyclical characteristics of long duration in a balanced portfolio. In other words, we take active interest rate risk in the USD space to lock in today´s yield levels. In Europe and Scandinavian currencies, the picture looks quite the opposite, as investment grade bonds and sovereign debt do not compensate for the inherent interest rate risk, and because anything with low durations barely exhibits positive yields and thus loses out to inflation. For these reasons, we see most value in small, Northern European non-rated issues of companies with adequate credit quality and business model we understand. The illiquidity premium the investor gets due to the missing credit rating from the agencies and the subsequent lack of interest from certain types of institutional buy-side investors is so remarkable that it makes this asset class most attractive within the Euro-denominated fixed income universe.

In terms of currencies, we see USD remaining strong as the Fed proceeds with its rate hikes, and our base case is therefore that irrespective of the outcome of US mid-term elections, EUR/USD will trade in the 1.13 – 1.17 range in the upcoming 3 – 6 months.

Asset allocation - October 2018	
Industry	↗
Consumption	↗
Monetary environment	↘
Market valuation	↘
Fundamentals total	↗
Hedging demand	↗
Economic surprises	↘
Market risk	↘
Market breadth	↘
Money flow	↘
Risk sentiment total	↘
Equity exposure (of maximum):	**50%**

Yours sincerely,

Juho Kivioja

Juho Kivioja, CFA | Chief Investment Officer | Amplia & Co. AG | Claridenstrasse 34 | CH – 8022 Zurich | Switzerland