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Insight INVESTMENT

MONTHLY UPDATE // MARCH 2016

ABSOLUTE **INSIGHT**

REFLATION REDUX

To call markets fickle so far in 2016 would be an understatement unmatched since the Black Knight in Monty Python's *Holy Grail* complained of a "flesh wound" after being dismembered. Equity indices are back in the black having entered bear market territory in February, credit spreads have returned to levels last seen at the end of 2015, commodities have rebounded with oil holding north of $40/bbl since mid-March and once spurned emerging markets are seeing robust investor inflows.

This dramatic reversal in sentiment can in part be explained by policy. The actions of central banks are dictating the mood of the markets and both the tone and substance of policy pronouncements has been unashamedly dovish. The European Central Bank (ECB) showed it could still surprise positively by delivering a potent cocktail of further monetary easing and support for the financial sector. The US Federal Reserve has also adjusted the course of further tightening to something far closer to market expectations.

The sustainability of market sentiment will require more than further sops from policymakers. They are increasingly running out of options. But there are some signs that this new mood of optimism may be soundly based. Among the many assets that have been repriced since March are US inflation-linked bonds. The 10-year inflation rate implied by TIPS has risen from 1.18% to 1.61%. When inflation runs ahead of policy rates it transfers wealth from savers, but erodes the cost of debt. It may seem odd, but avoiding a debt deflation death spiral may be enough to keep investors happy for now.

The long and the short view: Absolute Insight positions across asset classes

For illustrative purposes only, as at 29 February 2016. Positions shown are both long and short. Some positions are outright longs or shorts. Positions held in actual portfolios may be materially different. These positions are subject to change without notice and may not represent current or future portfolio composition and should not be construed as investment recommendations.

This sharp swing upward has doubtless been a pain trade for some. In the equity market we are also noting a rotation in market leadership away from stocks with strong price momentum and the growth darlings and towards value.

ANDY CAWKER
Head of Specialist Equities

With the global economy still close to stall speed, small changes in the growth outlook are causing big swings in sentiment.

The rapid rebound in commodity prices and risk assets since the mid-February lows is the latest manifestation of this binary risk-on/ risk-off pattern, something we believe is being exacerbated by fragile liquidity. This sharp swing upward has doubtless been a pain trade for some.

In the equity market we are also noting a rotation in market leadership away from stocks with strong price momentum and the growth darlings and towards value.

We have managed gross exposure down, which has allowed us to stick with conviction positions and keep capital available as opportunities arise. Patience will have a limited opportunity cost if this period of stabilisation proves durable.

ALEX VEROUDE
Head of Credit

The key question the performance of credit markets has posed in 2016 is whether the sell-off was an inevitable reaction to the long grind lower in credit spreads or if it foreshadowed a cyclical downturn?

To some extent the jury is still out, though additional monetary accommodation has certainly helped by attenuating the cycle.

For companies that have too much leverage and dim prospects of growing future earnings against a continuing backdrop of weak growth, the day of reckoning has been postponed. To reflect this we have reduced our outright short position, but remain defensively minded.

Monetary policy is close to reaching the limits of its effectiveness and periods of unstable equilibrium are likely be punctuated by further bouts of volatility.

Keeping some cash on the side lines ready to seize opportunities as they arise is likely to be rewarded.

PAUL LAMBERT
Head of Currency

The biggest surprise in markets has not been monetary easing from the ECB or the new low-ish for longer stance of the Fed, but rather the market reaction. In spite of the US escaping the zero-bound – and two more rate hikes in 2016 *still* being priced in by the Fed's dot plot – the dollar has been weak. This reflects a recovery in risk appetite and improving sentiment toward commodity producers and China.

Our inclination is to remain tactically defensive to see if this rebound in sentiment is matched by economic data.

If it is, there are still plenty of opportunities to play an improving macro picture via currencies. Being wrong-footed by short-lived trends that may have as much to do with the technical adjustment of positioning as fundamentals is not a risk that we are prepared to run.

COLM MCDONAGH
Head of Emerging Market Fixed Income

We are getting close to an inflexion point for emerging market assets. The recent stability in oil and other commodity prices and the weaker dollar has helped improve sentiment markedly. While it is arguable that developed markets have been overly reliant on monetary policy to stimulate growth, some emerging markets are determinedly pursuing the right policies in spite of economic pain. Good examples include oil exporters such as Colombia and Mexico, which have raised interest rates to quell imported inflation caused by currency weakness. These economies are now well positioned to prosper in a more stable macro environment. Yields are at levels last seen in 2009, so investors are being compensated for taking risk. We are adding modestly to long currency exposure and favour local currency-denominated sovereign debt and corporates.

FIND OUT MORE

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