A tale of two markets

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Performance over the quarter to March has felt like two worlds, with equity performance acting like there is a bright future approaching, while bond performance paints a darker picture. There are many ways the future can play out, so we remain cautious.

Market Review:

Equity markets continued to rise in March, with many indices posting their strongest quarterly return since 2009. In the US, the yield curve between 3-month T-bills and 10-year Treasuries inverted for the first time since 2007, a potential flag for recession – although it should be noted that the lead time from curve inversion to recession has varied significantly over different cycles, ranging from less than 12 months to over three years. Nevertheless, the Fed stated that it is no longer expecting any further rate hikes in 2019, while money markets are pricing in almost two rates cuts over the next year. Money markets in Australia are pricing a similar degree of easing in light of weak growth figures and the property market continuing to decline, particularly in Sydney and Melbourne. Meanwhile, the ECB also announced its expectation that rates in Europe will remain on hold through 2019, along with a further round of Targeted Longer-Term Refinancing Operations (TLTRO) loans aimed at providing cheap financing for European banks. In the UK, Brexit continued to dominate headlines with Theresa May's Brexit proposal defeated for a third time in Parliament, despite May offering up her resignation to lend support to the deal. A number of other Brexit proposals were also voted down.

Global equities returned 1.6% in local currency, while the Australian market posted a more modest rise of 0.7% over the month. China A shares continued to be the global standout, with the market rallying 5.5% in March and almost 30% over the first quarter. Within Australia, yield sensitive sectors like REITs were the standout performers, while Banks and Energy stocks lagged the broader market. Global government bonds also rallied, with 10-year yields in the US falling by 0.31% to end March at 2.41%. In Australia, 10-year yields followed a similar pattern, dropping by 0.33% to end the month at 1.78%. 10-year yields also contracted in other markets, falling by 0.25% in Germany and 0.06% in Japan. There was little movement in credit spreads, with investment grade moving slightly tighter over the month, while high yield spreads widened by about 10 bps.
Schroder Real Return CPI +5% Fund

Largest contributors:

From a total return perspective, the key driver in March was the large falls in bond yields. This was captured via the strategy's exposure to Australian and global government and corporate bond markets. Australian equity positions added to performance, primarily through the strategy's exposure to Australian large cap equities. Positive contributions were also achieved through the strategy's holdings of Australian higher yielding corporate bonds and global high yield bonds.

Largest detractors:

The largest detractor in the month mirrored the largest contributor, in that the strategy's duration overlays (bond futures), which are used to reduce the overall portfolio's total duration, saw a negative contribution. Although, this only partially offset the contribution for the bond holdings. The strategy's absolute return positions also detracted from performance, primarily through the short Australian REIT versus long Australian equities, with the REIT sector performing strongly, responding to the falling bond market.

Portfolio activity and key themes:

When I look at markets during the March month and quarter I can't help but think about a play on a Charles Dickens' book title: it was "A tale of two markets". Having watched the performance of both the global bond and equity markets it is hard not to be confused, as both point to very different economic outlooks, with bond markets pricing in a relatively dire outlook, while the equity market is much more optimistic.

A dovish turn by the US Federal Reserve, pausing their policy tightening, led to a sharp fall in bond yields. Not only did markets move to price in the pause they went one step further and moved to price in two 0.25% cuts in the official cash rate. The market also saw an inversion of the US 3-month bill rate/10-year bond yield curve, which has historically been a very accurate leading indicator of recession. A recession model created by the Federal Bank of New York, which uses this relationship, places the risk of the recession this time next year at 27%.

On the other hand, the equity market has gone from strength to strength, rising by 13% in price terms over the quarter to be up 8% over the past year. As equity markets generally lead earnings by around nine months this suggests a strong rise in earnings over 2019, one that is generally in line with the positive outlook based on consensus analysts' expectations, and in line with healthy GDP growth.
While we do not expect recession this year, our allegiances lie more to the bond market's view. We have argued that the trade dispute between the US and China would have a more negative economic impact than generally expected, and believe the weakness in the US economy, and particularly the manufacturing sector, supports that view. While we expect a positive outcome from the current talks between the US and China, there will remain lingering uncertainty around whether the deal will stick in the medium term and that President Trump's more aggressive approach to foreign affairs will see geopolitical risks remain elevated.

Also, global growth has been weighed down by China's crackdown on its shadow banking sector, which has slowed its economy and had a negative flow-through impact on Europe, seeing European exports weaken. Although policy has recently been eased in China, the easing remains measured, and we would only expect it to stabilise growth, not be a source of significant stimulus to global economy.

We firmly believe that equity markets have become too optimistic and therefore expect more volatility in the short run. We have thus maintained our relatively defensive positioning. However, we are acutely aware of the risk of a continued improvement in business confidence and equity market performance, and worry that a trade deal will lift corporate confidence more than we expect. To help manage this risk we added to our S&P call options in March, taking the total notional exposure to 5%. We are thus positioned to minimise the damage to the portfolio from another bout of equity market weakness, while still having enough risk to participate in a continued equity market rally.

**Market Outlook:**

**Equity**

After a difficult end to 2018, equity markets have bounced strongly so far this year. The standout performers during the month was the Chinese equity market followed by European equities. The Chinese market was supported by the positive momentum in the trade talks and policy easing, while European markets were up despite weakness in business surveys. Most other markets had flat to small positive returns with the Australian market in the middle of the pack.

During March we added to our US equity market call options, taking the total notional exposure of call options to 5%, in addition to the 2.5% of equities we added at the end of December. We are using call options given the uncertainty in the outlook, which will allow us to participate in any market upside, by minimising any losses if equity market pare their gains. Overall, we still remain relatively defensive with our base case of another bout of volatility.
We still struggle with US equity valuations and our return forecasts are suggesting a loss over our three-year horizon. We have a more constructive view on Japanese equities where valuations remain the most attractive in our framework, and Australia where valuations are close to fair value, if not slightly cheap. Emerging markets are starting to look a little more interesting, but we would prefer to see more evidence of capitulation (and more attractive valuations) and/or confidence in a peak in the USD before buying.

**Fixed Income**

Sovereign yields rallied strongly in March. In Australia, the increased prospect of RBA easing monetary policy after a weaker than expected GDP print and further declines in house prices, saw a significant rally in the local bond market. Global bonds also performed strongly with both the Fed and ECB setting a more dovish tone.

There was not a great deal of movement in credit spreads during the month, with a small tightening in investment grade spreads, and a small widening in high yield.

**Currency**

During March, the safe haven currencies such as the Yen, Swiss Franc and US Dollar were the strongest performers, along with the Australian Dollar which performed strongly on the back of higher commodity prices. The GBP fell as the British Parliament was still unable to vote on any sort of Brexit agreement, and the prospect of a hard Brexit becomes more likely. While we have a small physical position in GBP on longer-term valuation grounds, we have covered shorter-term uncertainty with an equivalently sized put option.

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