MULTI-ASSET QUARTERLY

Insight broad opportunities strategy (USD)

Q1 2019

SUMMARY

The strategy performed solidly over the quarter, with all main components added to returns. We have seen an implicit loosening in policy following the Q4 market turmoil; but despite a recovery in asset markets, the emphasis on symmetry around inflation targets means a U-turn from here in central-bank messaging seems unlikely. The near-term outlook remains challenging, at least until some key event risks are in the rear-view mirror or a greater degree of economic clarity is forthcoming. Since the beginning of the year we have adopted a more tactical approach to managing our broad directional exposures against a background where asset price moves were likely to be driven more from position extremes and policy responses, rather than tracking the trends in economic data.

ECONOMIC AND MARKET REVIEW

At the start of the year, the question we posed was whether the economic data would follow where markets were guiding them or whether markets had overshot the likely economic reality. One quarter on, it seems reasonable to say the bounce in risk assets began from oversold conditions (as evidenced by positive market price reactions to even poor earnings releases back in January). But a shift in policymakers' thinking, both on interest rates and on the likelihood of some de-escalation in US-China trade tension, helped take away some of the economic tail risk. This has given risk appetite a more solid platform on which to build a constructive narrative even though we have yet to see any material rebound in macroeconomic data.

Ultimately, the sustainability of the rebound will require these hopes to be translated into stabilization in the underlying economic data and an improvement in global growth prospects.

The US economy continues to show relative resilience but, even here, there has been a notable deceleration. Positive economic surprises have fallen sharply while growth estimates have been revised down. Interpreting recent data is complicated by transitory factors such as the December-to-January government shutdown, but signs of domestic fragility, the consistent undershoot in inflation and heightened external growth risks are all factors that have caused a shift in policy thinking.

In Europe the economic data docket has been particularly poor. Data showing a contraction in German manufacturing – to levels last seen in the eurozone debt crisis of 2012 – was a catalyst for a big lurch lower in government bond yields, but it was just one of a number of weak data points in the region.

Amid the economic gloom there were a few green shoots. Importantly, there are signs that activity in China is improving. The latest Chinese PMIs both bounced above 50 in March with the sub-components also offering hope that activity is stabilizing. At the same time, the March US ISM manufacturing index picked up. To be sure, this evidence is tentative and needs to proliferate if market sentiment is to avoid another downturn.

With risk assets back at close to six-month highs and government bond yields close to their recent lows, our asset-allocation biases are guided by our macro framework. Regular readers will remember our process in stylized form:

Monetary/ financial conditions lead…

↓

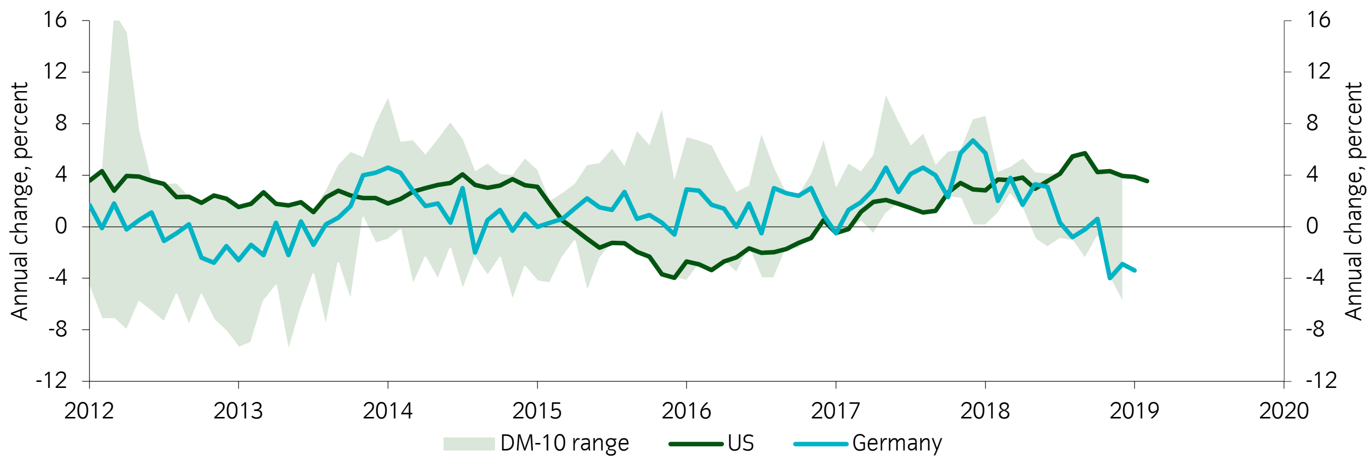
…economic growth, which in turn leads…

↓

…inflationary pressures

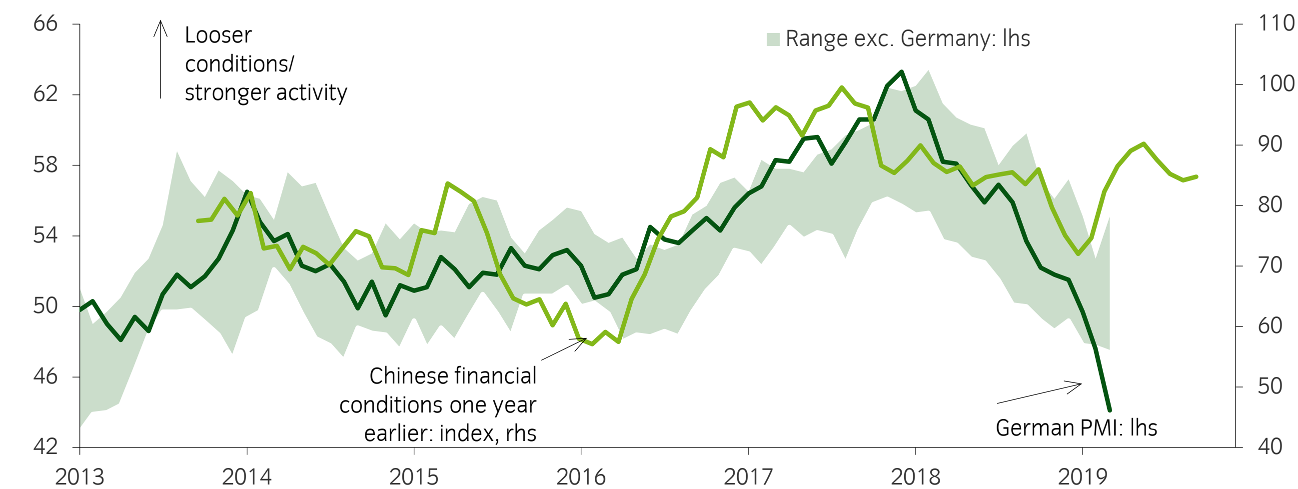
When viewed through this lens recent asset-class moves make sense. While the jury is out, our hypothesis (that easier policy leads growth) looks set to be tested sooner rather than later.

Chart 1: European activity slowing – industrial production – annual change, percent



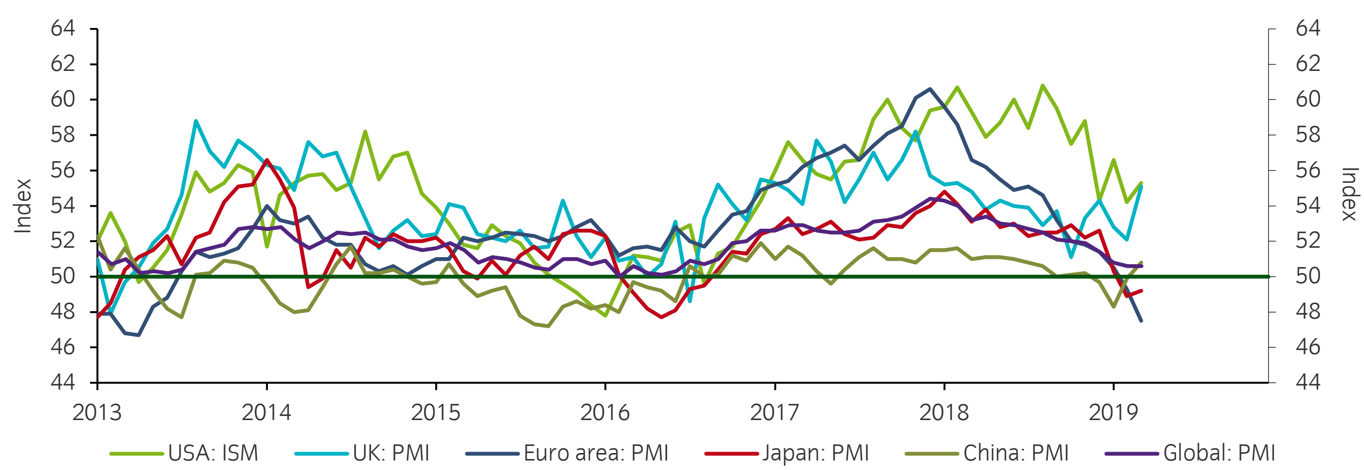
Source: Bloomberg and Insight Investment as of March 29, 2019.

Chart 2: European manufacturing PMIs versus Chinese financial conditions



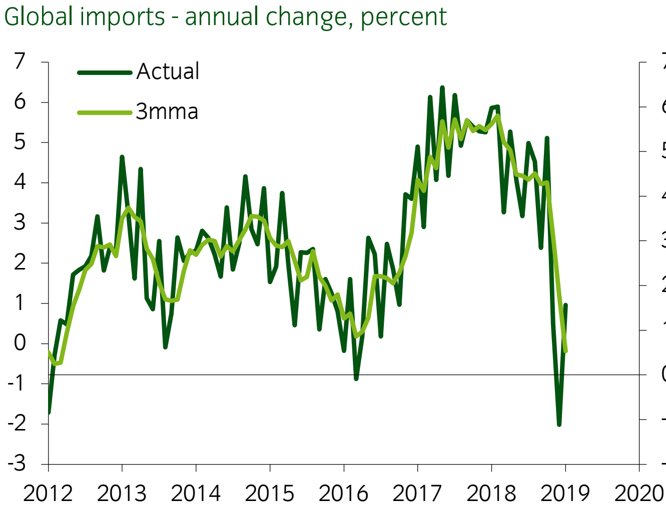
Source: Bloomberg and Insight Investment as of March 29, 2019.

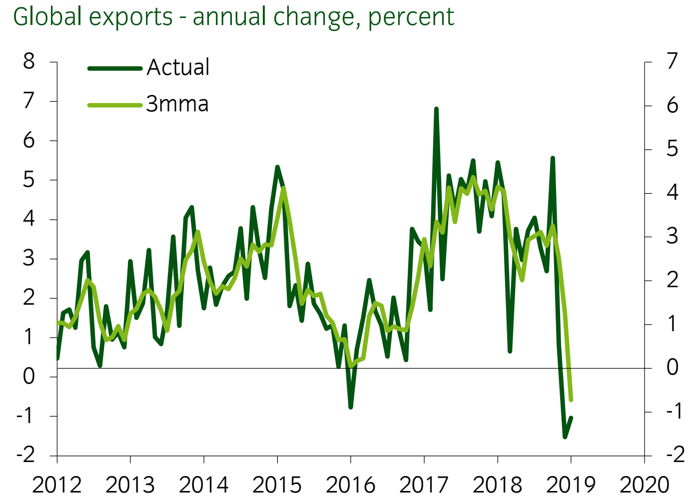
Chart 3: Global growth indicators – manufacturing PMIs in moderation zone



Source: Bloomberg and Insight Investment as of March 29, 2019.

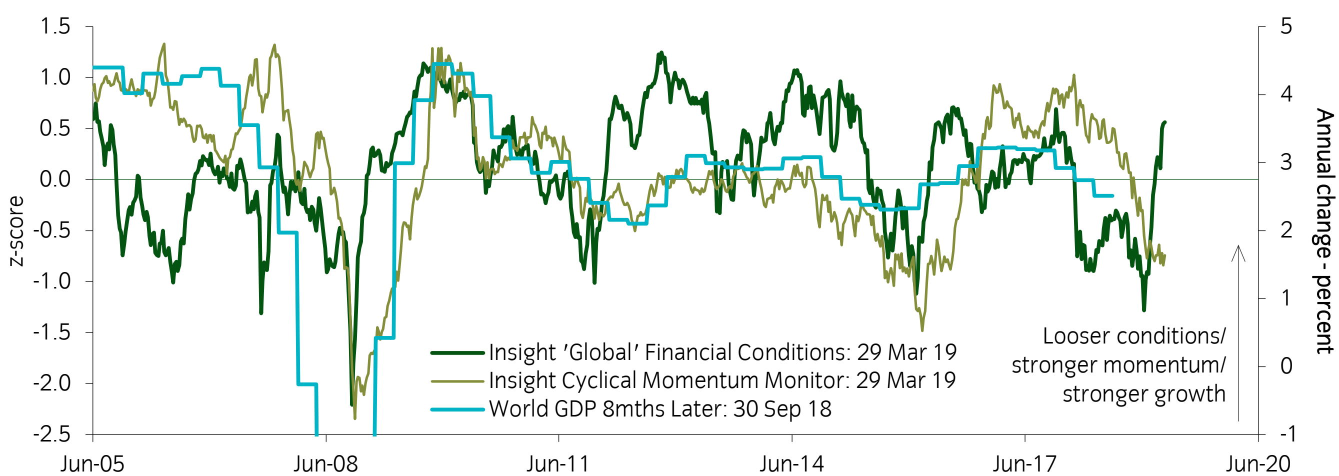
Chart 4: Global trade levels





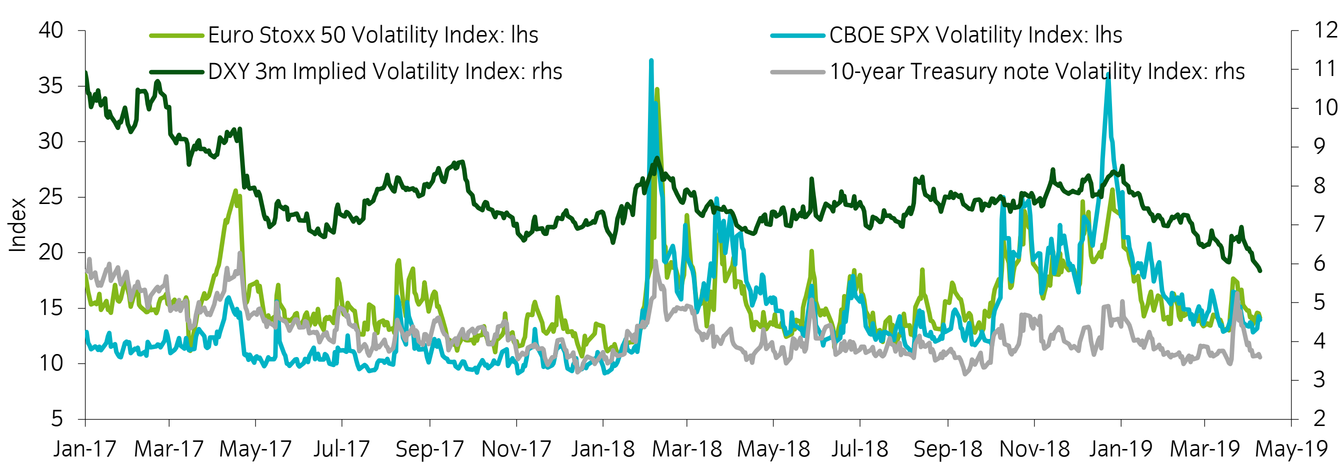
Source: Bloomberg, Thomson Reuters and Insight Investment as of March 29, 2019.

Chart 5: Global GDP versus Insight financial conditions and cyclical momentum measures



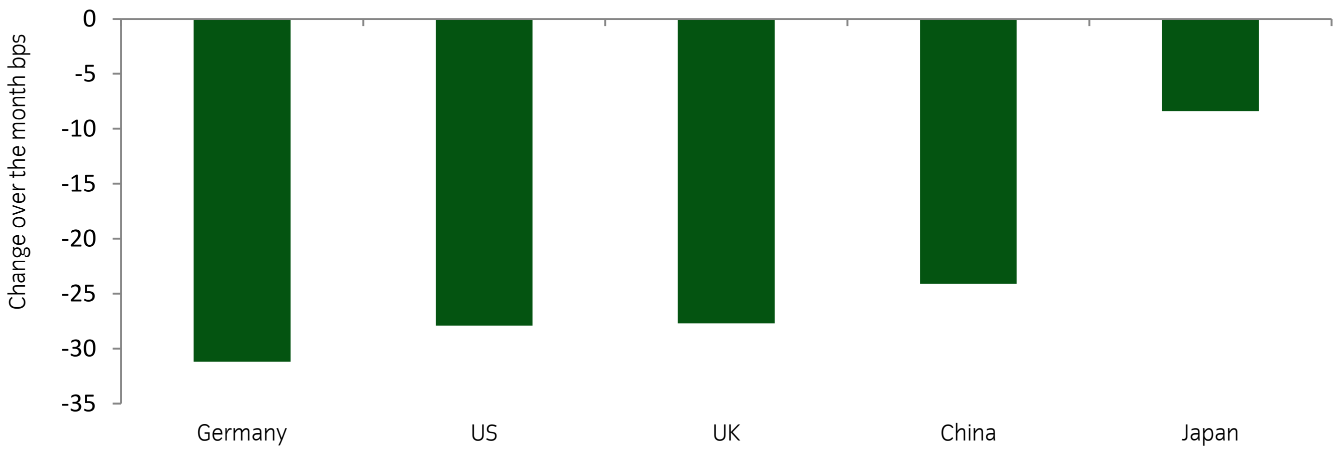
Source: Bloomberg and Insight Investment as of March 29, 2019.

Chart 6: Cross-asset volatility



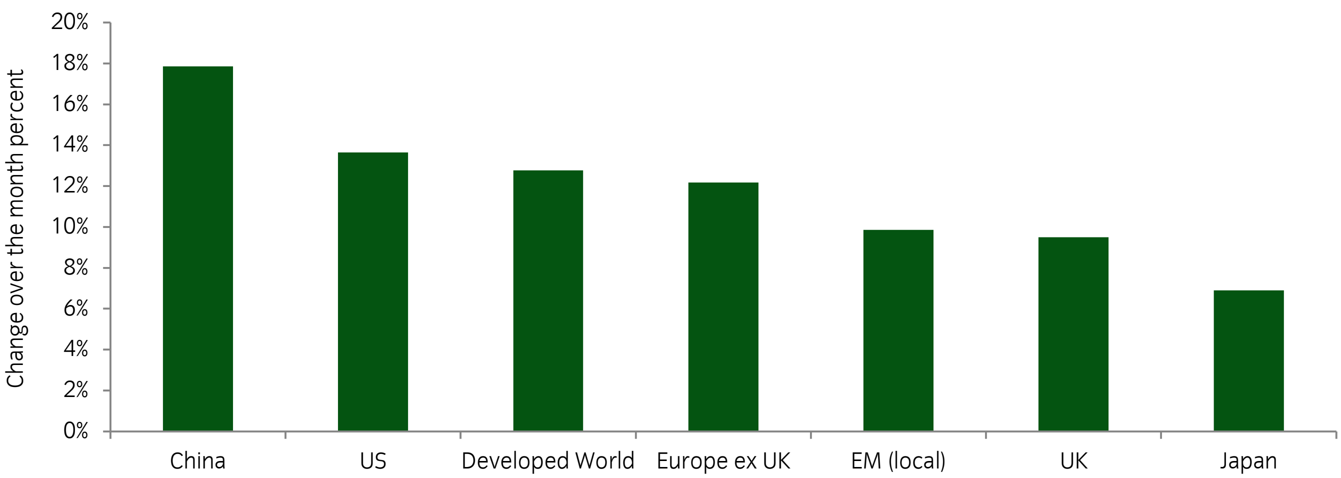
Source: Bloomberg and Insight Investment as of March 29, 2019.

Chart 7: Global 10-year bond yield change in Q1



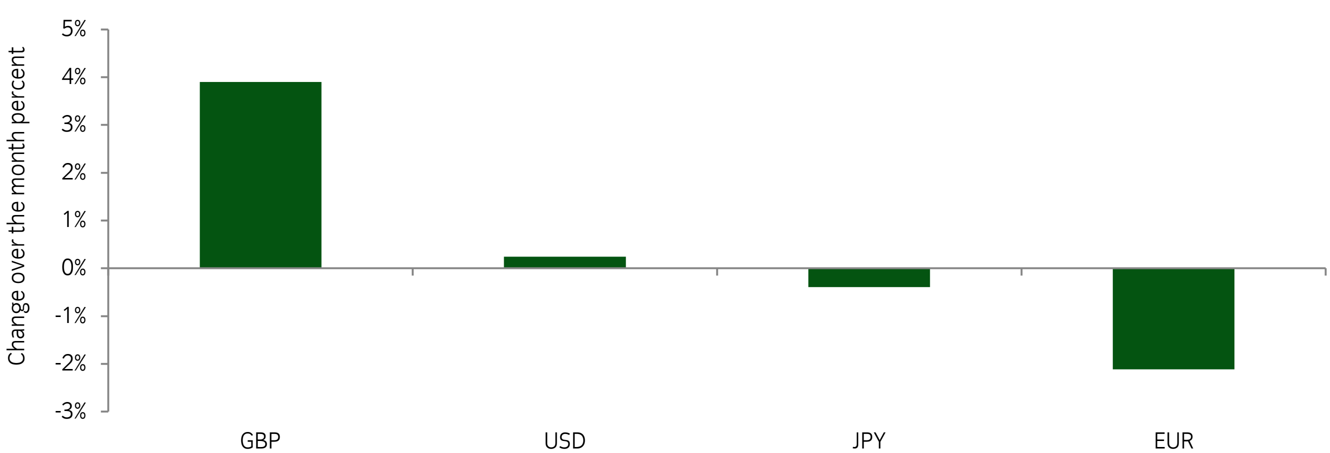
Source: Bloomberg and Insight Investment as of March 29, 2019.

Chart 8: Global change in equity markets during Q1



Source: Bloomberg and Insight Investment as of March 29, 2019.

Chart 9: Global change in trade-weighted exchange rates during Q1



Source: Bloomberg and Insight Investment as of March 29, 2019.

STRATEGY PERFORMANCE AND ACTIVITY

The strategy returned had a positive return over the quarter. Allocations in fixed income and equity were the main drivers of performance. This was followed by smaller yet positive contributions from total return strategies and real assets. A combination of various factors, including an accommodative shift in global monetary policy and positive developments in the US-China trade talks, saw risk assets recover most of their losses from the previous quarter. In addition, continued moderation in global growth ensured downward pressure on government bond yields. Consequently, we were managing the strategy through a constructive backdrop, but one where both equities and government bonds rallied sharply.

This positive sentiment continued in other risk assets including investment grade credit, high yield and emerging market debt.

As equity markets continued to rally despite some intermediate growth concerns, some of our range-bound strategies, originally in place to capture more limited upside, yielded small negative returns. These were more than offset by other total return strategies which were aimed at capturing a sustained upside risk rally.

In a quarter that has seen a complete reversal in risk sentiment, we have been tactically managing exposures to capture this upside. It was also a period where risk assets and traditional safe-haven assets traded with a positive correlation. As a consequence, we maintained strategy duration at a fairly high level to capture returns from our fixed income exposures as well.

Viewed from a more fundamental lens, US growth data continues to outperform the corresponding measures in Europe, which supported the addition of a relative-value trade involving a long position in US equities versus European equities. The bouts of volatility have created opportunities to add new option-based positions that we believe to be attractive.

To this effect, we have added positions aimed at continued range-trading of a number of equity markets. We also added a number of option-based positions in currencies, including for range-bound moves in the US dollar versus the Mexican peso, and downside on the euro versus the Japanese yen.

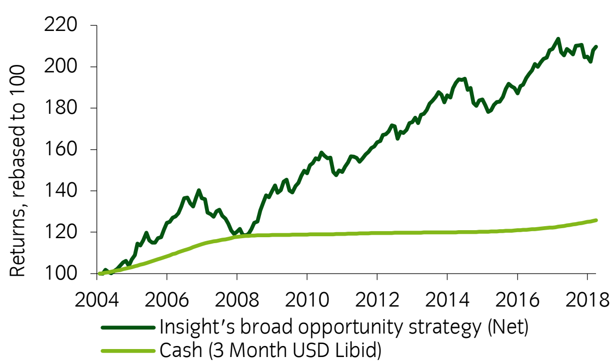
Performance as of end March 2019[1]

	3 month return (%)	1 year return (%)	3 year return (%p.a.)	5 year return (%p.a.)	S.I. return (%p.a.)
Insight broad opportunities strategy (gross)	5.13	4.19	6.01	4.27	5.98
Insight broad opportunities strategy (net)	4.93	3.41	5.37	3.69	5.43
3 month USD Libid	0.65	2.46	1.54	1.01	1.64

Performance as per calendar year

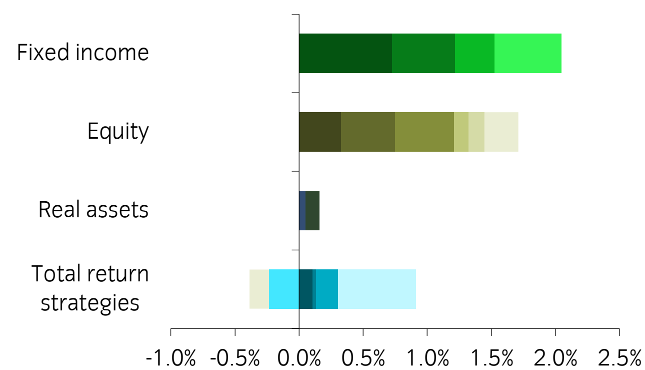
	YTD (%)	2018 (%)	2017 (%)	2016 (%)	2015 (%)	2014 (%)
Insight broad opportunities strategy (gross)	5.13	-3.38	11.31	5.63	-1.51	6.08
Insight broad opportunities strategy (net)	4.93	-4.10	10.73	5.10	-2.00	5.55
3 month USD Libid	0.65	2.27	1.19	0.66	0.22	0.14

Insight broad opportunities strategy performance (USD)[1]



Source: Insight Investment. As of March 31, 2019. Net returns, includes the reinvestment of earnings. Performance is rebased as of December 31 2004, as a result of a change in investment team leadership. Performance shown is the track record of Insight's overall multi-asset strategy and is intended to illustrate the team's capabilities.

Attribution over Q1 2019



Source: Insight Investment. Gross of fees and representative data based on GBP class. Shaded areas are returns generated by different strategies and asset classes within each investment category.

[1]**Past performance is not a guide to future performance. Investment in any strategy involves a risk of loss.** All figures are in USD terms. Net figures are net of 0.5% annual management charge to December 31, 2017 and net of 0.75% annual management charge thereafter. The Insight broad opportunities strategy (USC0840) is shown net of investment management fees and reflects the reinvestment of dividends and/or income and other earnings. Please refer to the important disclosures and index description at the back of this document. Performance presented is that of the Insight broad opportunities strategy which may be managed by an affiliate of Insight North America LLC (INA) and should not be viewed as the performance of INA. Please refer to the disclosures and index definition at the back of this document. The quoted benchmark does not reflect deductions for fees, expenses or taxes. The benchmark is unmanaged and does not reflect actual trading. There could be material factors relevant to any such comparison such as differences in the volatility, and regulatory and legal restrictions between the index shown and the strategy.

ECONOMIC AND MARKET OUTLOOK

FINANCIAL CONDITIONS

The changes in the investment landscape so far this year largely pertain to a change in emphasis in policy (central banks' perceptions on the likely path of monetary policy) and prospects for some de-escalation in US-China trade tensions. The Federal Reserve (Fed) has acknowledged that it has failed to create symmetry around its inflation target while the European Central Bank (ECB) has reaffirmed a belief that negative interest rates can help the economy (so long as negative side effects on the monetary transmission mechanism – banks – can be avoided). As a result we have seen an implicit loosening in policy which we monitor via our financial conditions indicators.

This shift in policy followed the Q4 market turmoil. If the risk-asset recovery continues, could there be a quick U-turn? Of course, it's possible. But our guess is that a quick reversal in central-bank messaging seems unlikely.

In his semi-annual monetary policy report to the House and the Senate, Fed Chairman Powell highlighted the need for symmetry around the Fed's inflation target, irrespective of external growth risks. He suggested that "inflation kind of averages around 2% rather than only averaging 2% in good times and then averaging way less in bad times". The point, reinforced recently by other Fed speakers, is that without this symmetry inflation expectations become anchored at a level that is too low. The follow-on implication surrounding (low) inflation is that it is a medium-term concern and a quick reversal in Fed messaging seems unlikely.

European policymakers are well aware of their limited firepower in the face of a downturn and there are limits as to what more the ECB can do to loosen further. Back in 2016 it was recognized that negative interest rates may well be counterproductive and as the 10-year bund yield went negative last month, President Draghi said the ECB needed to "reflect on possible measures that can preserve the favorable implications of negative rates for the economy while mitigating the side effects". Again, we don't see a near-term reversal in thinking.

Of course, the bounce in equity markets has also helped our financial conditions indicators bounce. Even excluding the equity market component in our model, the recent shift in financial conditions is similar in size to the contraction in financial conditions in early 2018. Clearly, our premise is that this easing in conditions will take away some of the economic tail risks that scared investors late last year. For now, markets are buying this thesis but what could de-rail the narrative?

Firstly, not all measures of financial conditions are easing. Many monetary aggregates have yet to show a meaningful uptick and lending standards appear to be tightening across the G3.

Secondly, the fragility of the current system is high with geopolitical risks elevated and world leaders, most obviously in the form of President Trump, prone to unanticipated shifts in stance. The world economy seems ill-placed to cope with another exogenous shock. An impasse in US-China trade negotiations would provide such a hit, while the range of Brexit outcomes is uncomfortably large.

Thirdly, the length of the global expansion phase is getting close to the longest on record and while policy makers aim to extend them for as long as they can, eventually economic cycles exhaust themselves for a variety of reasons.

GROWTH

At the start of the year the IMF lowered its projection for world economic growth for the second time in three months, and it has now lowered its forecast again, from 3.5% to 3.3% for 2019, but retained its forecast for 2020 of 3.6% growth.

As noted earlier, overall economic activity held up well in 2018 with G20 GDP growth holding steady at 3.8%. This, however, masks notable regional differences with strong US growth masking decelerations in the euro area and Japan. Similarly, emerging-market growth varied with softness in China partially offset by growth in the likes of India and Brazil. Of late, however, the forces of deceleration appear to be broadening.

Amid continued trade tensions, global trade volume growth (goods plus services) has slowed. Policy reaction to higher tariffs depends on whether they are seen as a one-off shock to the price level or if there are second-round effects (on inflation expectations and wages, for example). The wider the imposition of tariffs, the more likely second-round effects are. In the short term, a large part of the burden of tariffs may fall on the US consumer in the form of higher prices.

The People's Bank of China has said it will not use the exchange rate to cope with trade tensions, but the perception it might do so could lead other countries to use currency depreciation to maintain trade competitiveness. Sensitivities here will remain high as last year saw sizeable currency depreciations against the US dollar in many emerging markets, specifically those with large and expanding external imbalances. As the US tightening cycle appears to be entering a more gradual phase/ending, the US dollar should face less upward pressure and this could in turn provide an element of support for emerging markets.

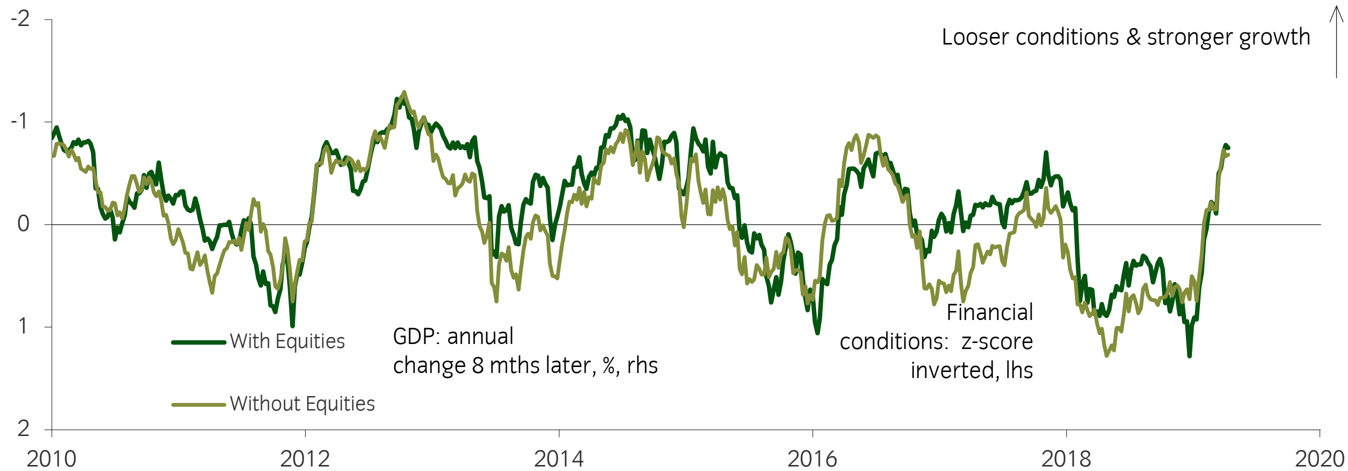
INFLATION

Conventional estimates of economic slack (output gaps and unemployment) suggest that spare capacity is now limited in the major economies so it is reasonable to assume some pick-up in wages and prices. However, inflation expectations appear well anchored and despite the longevity of the expansion cycle, pricing pressures have been subdued – in part because of technological and competitive pressures.

The flatness in Phillips curves has been a subject we have written about in the past, but at some point tight labor markets should lift compensation and that should filter through to prices. That said, participation remains below pre-global financial crisis levels in the US and there is scope for hours worked to rise in other developed economies (such as Europe). Overall it seems that wage and price pressures should move higher in most developed economies but only modestly, trade wars notwithstanding. Beyond financial conditions, the other transmission mechanism or channel by which expansion phases come to an end normally revolves around an erosion of corporate profit margins – this prompts businesses to pare back hiring and investment spending plans with obvious self-reinforcing second round effects.

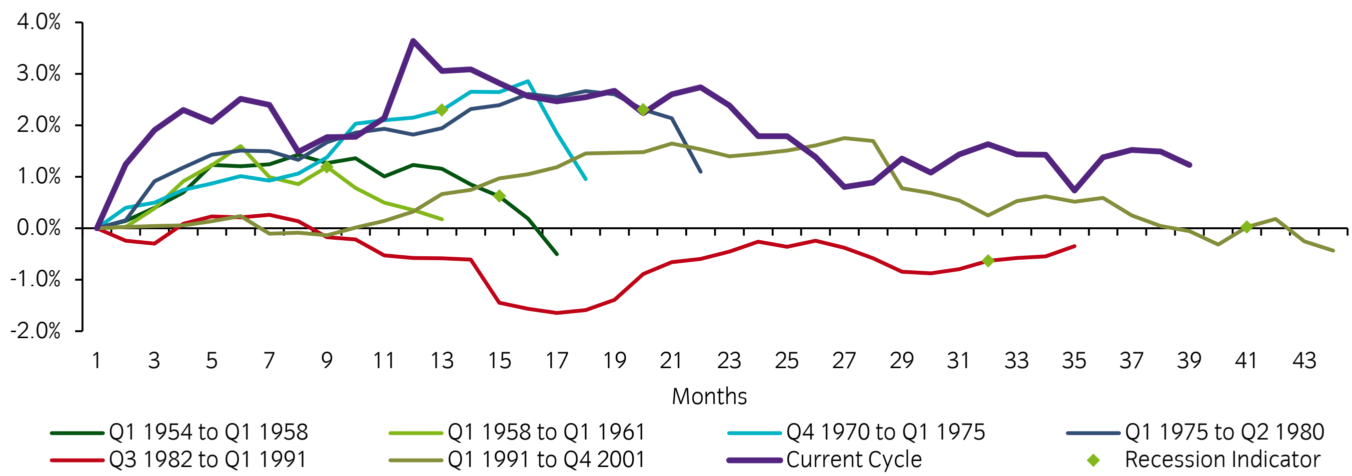
An alternative narrative behind such defensive corporate behavior is a reassessment of the rising costs of business relative to potential return. Clearly, rising unit labor costs are an important factor here. In the US we have seen rising wage costs but, so far, productivity gains ensured those wage gains have been non-inflationary.

Chart 10: Global GDP versus Insight Financial Conditions (with/without equities)



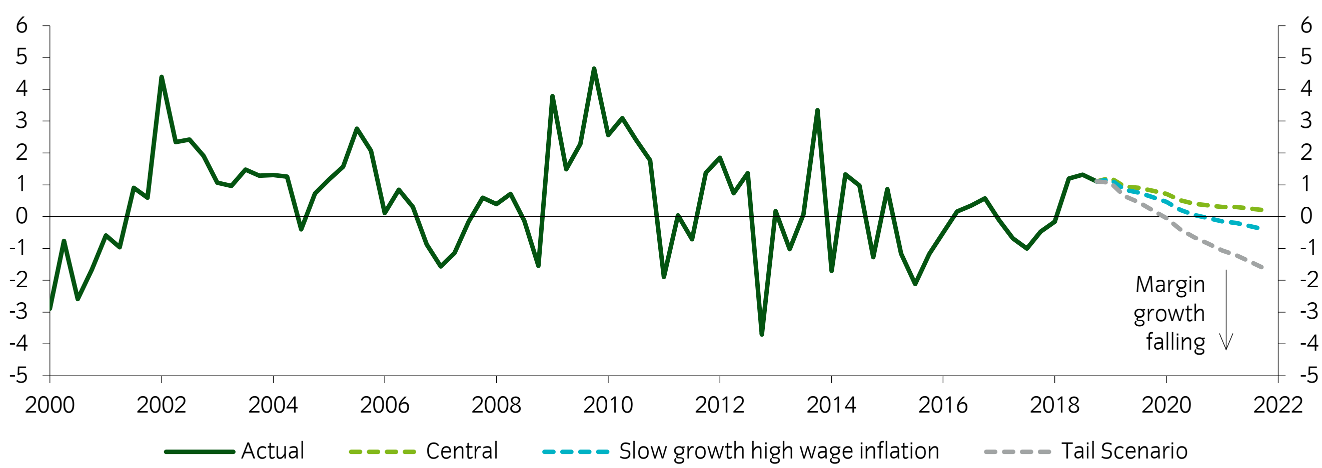
Source: Bloomberg and Insight Investment as of March 29, 2019.

Chart 11: US corporate profit margin cycles – cumulative change in margins versus cycle length, months



Source: Bloomberg, Thomson Reuters and Insight Investment as of March 29, 2019.

Chart 12: US corporate profit margin scenarios



Source: Bloomberg, Thomson Reuters and Insight Investment as of March 29, 2019.

We analyzed a range of scenarios about the likely path of US corporate profit margins. While the medium-term trend should be for some contraction, the timing of this seems far from imminent in all but fairly extreme trade-war induced scenarios. We assessed a range of scenarios with various degrees of adjustment both to demand (shocked downward) and costs (shocked upward) to deviate from a 'base case' of solid but moderating activity in which pricing pressure peaks somewhere in the middle of 2019. To engineer a quick contraction in margins by the summer of 2019 we need some fairly aggressive demand and price shocks.

This is of course possible if the trade dispute between the US and China intensifies, and if the individualist policy agendas in Europe continue unabated, as these forces would undoubtedly negatively impact the economic environment. One would expect policy reaction functions to adapt to avoid such worst-case outcomes but this is where markets, economics and politics come together.

GEOPOLITICS IN FOCUS

In the past, the normal policy prescription for intensified downside risks would be some global form of coordinated action. However, in many countries there is less scope to use macroeconomic policy to stimulate growth than in previous downturns. Moreover, any coordinated approach is threatened by a political environment that has lurched towards protectionism and single country agendas and away from the post-Bretton Woods world order of integration and free trade.

In the US, the medium-term implications of a split Congress until 2020 are that there is little chance of economically positive legislation, whether in the form of tax reform or infrastructure spending. Areas where President Trump can act without interference (such as trade) look set to remain his focal point while he prepares the groundwork to blame the influence of congressional Democrats should the economy show signs of deterioration.

The European outlook for 2019 also looks to be challenging. In the short term, ongoing Brexit uncertainties will be a key concern, and while a no-deal outturn would no doubt be most painful for the UK, there would be ramifications on the continent. Also, populist unrest in France is prompting President Macron to open the fiscal taps (in the form of accelerated spending plans). This is likely to result in an overshoot of France's 2.8% fiscal deficit target for 2019.

With European parliamentary elections in May 2019, the tussle between a more populist approach to policy versus the current orthodoxy will come into even sharper focus. A shift in the balance of power would affect key EU policy agendas such as trade, budgetary matters and the appointment of senior personnel. The results may also have repercussions for national politics impacting the prospects for eurozone reform.

On top of this we have Chancellor Merkel withdrawing from the political scene and the possibility of elections in Germany, Spain and Italy along with a change in stewardship at the ECB in the form of President Draghi's successor.

MARKET OUTLOOK

Since the beginning of the year we have adopted a more tactical approach to managing our broad directional exposures against a background where asset price moves were likely to be driven more from position extremes and policy responses, rather than tracking the trends in economic data. Ultimately, the broader trends in the macroeconomic data are likely to dictate market movements but, at turning points, asset-allocation decisions can become more nuanced. Implicit in that assessment is that we might be at such a point where the deceleration in economic activity evident for much of 2018 may transform, at least, into some form of stabilization. For now, the jury is out but we see sufficient signs to stick with our hypothesis. With a policy mistake (of over-tightening) unlikely in the near-term, we see some combination of rising costs and falling revenues (a margin squeeze) as one of the most obvious ways in which more defensive corporate behavior (in the form of hiring and investment) could lead us to a downward tipping point. However, to generate such a squeeze this year or even early next requires some extreme assumptions both on costs and demand. It is of course possible, but for now a more clearly identifiable catalyst seems to be needed for us to make that our central case.

From a risk-asset perspective, our broad equity exposure has come up towards our average holdings in recent years while we have also been adding to areas where we see specific value (US dollar emerging market debt, European dividends). Where we go from here is highly data dependent. During the first quarter rally, the oversold conditions evident at end 2018 evaporated. Macro and microeconomic support (in the form of the Q1 2019 earnings season) will be required to justify further progress. US earnings-per-share expectations are subdued (-3% for the S&P 500 Index) but companies are normally expected to beat (lowered) guidance. Against these risk-asset holdings, we retain a reasonable amount of duration. The lack of inflationary pressure combined with the clear guidance of lower-for-longer in central bank policy settings continues to re-affirm the attraction of government bonds within a multi-asset strategy. Admittedly, we did not anticipate the extent of the March rate rally, but if growth anxieties deepen, we believe duration will prove helpful. On the other hand, the extent of any retracement in yields, should the green economic data shoots of growth proliferate, seems likely to be tempered by medium-term central bank direction.

Real assets, despite a negative contribution over March from infrastructure exposures, retain attractive attributes. The long-term predictable revenue stream, combined with lower levels of economic sensitivity and an element of inflation linkage, offer benefits for strategy diversification. In the current uncertain market environment the wide range of strategies that we can employ within the total return strategies component offers particular attraction and we continue to run above-average exposures to total return strategies. We generally aim for a range of strategies across equity, currency and bond markets that either offers a high degree of asymmetry in their pay-off profiles, or wide buffers to protect us should risk asset price weakness return. The extent of the risk asset rally last quarter makes us less concerned about significant further up-side moves from here so we have strategies in play that should benefit from more modest movements within broader ranges. Our exposure to modest reversals in risk appetite is fairly limited.

THE INVESTMENT TEAM

Insight's broad opportunities strategy is managed by a team of 10 dedicated portfolio managers. They sit within Insight's investment division which comprises over 200 front-line investment professionals[1]. The team is able to harness investment ideas from all the specialist investment units within the firm ensuring that the strategy benefits from a rich source of investment ideas. The team is specialized in asset allocation, macroeconomic analysis and portfolio construction and has developed a clear and transparent investment process that allows ideas to be channeled into a robust portfolio specifically designed to meet its objectives.

FIND OUT MORE

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3-month USD Libid: Libid (the London Interbank Bid Rate) is the average interest rate at which major London banks borrow eurocurrency deposits from other banks. Libid is calculated through a survey of London banks to determine the interest rate at which they are willing to borrow large eurocurrency deposits. 3-month USD Libid is calculated as a monthly return based on the average month’s daily 3-month USD Libid annualized rates. The average is deannualized and then compounded on a daily basis for the month.

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