MACRO MONTHLY

THE FED RECOGNISES ITS ROLE

MARCH 2019

The portfolio remains tilted towards risky assets as the US Federal Reserve (Fed) pauses for breath, China-US trade talks proceed amicably and the odds of a no-deal Brexit on March 29th recede. The data is slowly improving in the rest of world, notably the uptick in Chinese credit, and further signs that we are emerging from the 2018 doldrums will drive the next leg of the rally in markets. We remain positioned for this.

There are broad structural changes taking place in funding markets that reduce liquidity and increase volatility. The abundance of cheap capital that flooded into US Treasuries from FX reserve managers and global QE supressed the risk-free rate and crushed term premiums. This was further compounded by a shrinking US fiscal deficit and led to a huge search-for-yield trade in global markets.

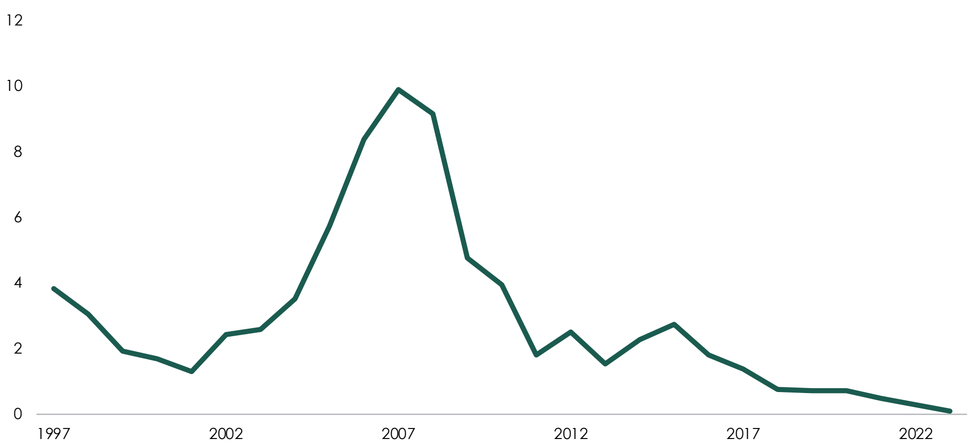
IT'S ALL CHANGE

Fast forward to today and the picture is starkly different. FX reserves are no longer growing as exporters seek to defend their currencies against a strong US dollar. QE is moving into reverse. The price-insensitive buyers of government bonds have been replaced by private-sector savers who are more discerning with their capital and less tolerant of negative real yields, raising the cost of capital for everyone.

China's current account is also a massive game changer. For years China has recycled its current account surplus into US Treasuries, but China is now heading towards a current account deficit. In order to plug this deficit and to take pressure off highly leveraged domestic banks, China is seeking foreign capital – it has been admitted into the Bloomberg Barclays Global Aggregate bond index, made it easier to invest via Bond Connect and is opening up its domestic markets to foreign firms (with the tariff stick accelerating the process). China going from an exporter to an importer of capital reduces liquidity, increases volatility and raises the cost of capital.

SURPLUS TO DEFICIT

CHINESE CURRENT ACCOUNT BALANCE (% OF GDP)



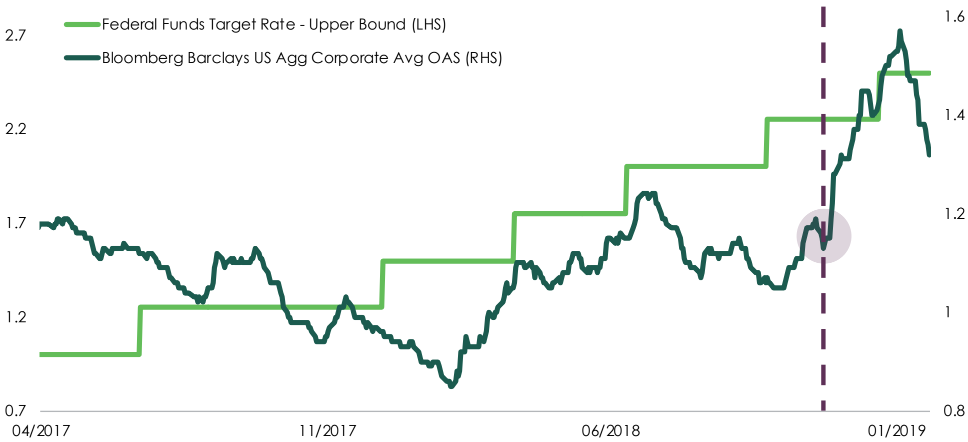
Source: Macrobond as at 01/01/2019.

It was against this capital drainage backdrop that Fed Chair Powell talked about further hikes and leaving the Fed balance sheet on autopilot in December. Markets starved of capital realised that they would be funding more of the US deficit and threw in the towel, sending risk assets into a tailspin.

THE FED GETS IT WRONG

The Fed messed up. It was caught in a conundrum last year-as it hiked, weakness in the rest of the world (partly driven by the Fed itself, see point (iv) below) saw the US flooded with capital, keeping domestic financial conditions loose. By December, however, it was clear that credit spreads were widening and stocks were creaking–with US corporates highly levered, a large proportion of the credit market at risk of being downgraded to junk and with significant rollover risk, the economy could have quite easily tipped into recession.

US CREDIT SPREADS VS. FED FUNDS



Source: Macrobond as at 25/01/2019.

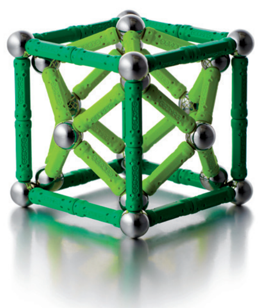
From early January, however, Jerome Powell's Fed recognised its mistakes:

(i)It can't show inflexibility on the balance sheet when funding markets are undergoing such profound change.

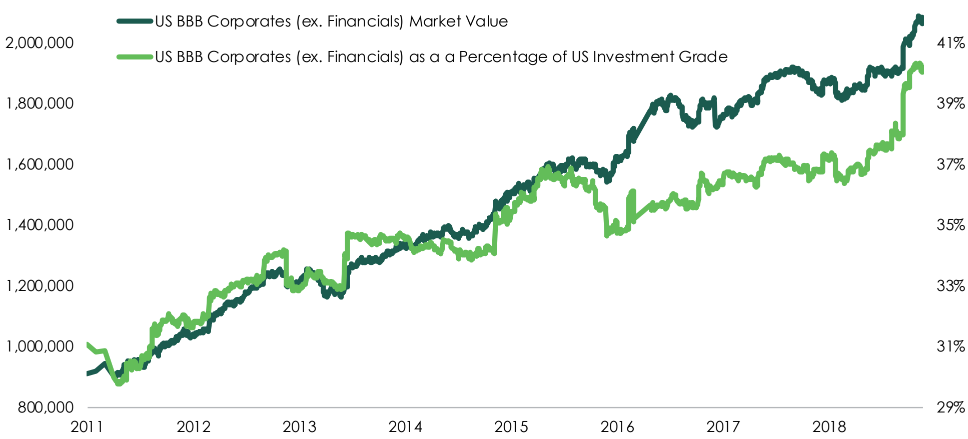
(ii)The transmission mechanism from the Fed to Main Street is increasingly via asset markets rather than banks due to regulation and risk tolerance.

(iii)With corporates borrowing at short maturities, the transmission mechanism is fast. The neutral rate or r*, is probably lower than the Fed believed.

(iv)Monetary policy divergence is a killer for global growth and leads to a vicious cycle as dollar strength feeds on itself. By taking its foot off the gas it allows other countries to run less restrictive policy, notably China. If China had eased it may have pushed renminbi above 7 to the US dollar, triggering US President Trump's wrath and risking domestic capital outflows.



US BBB MARKET SIZE SINCE 2011

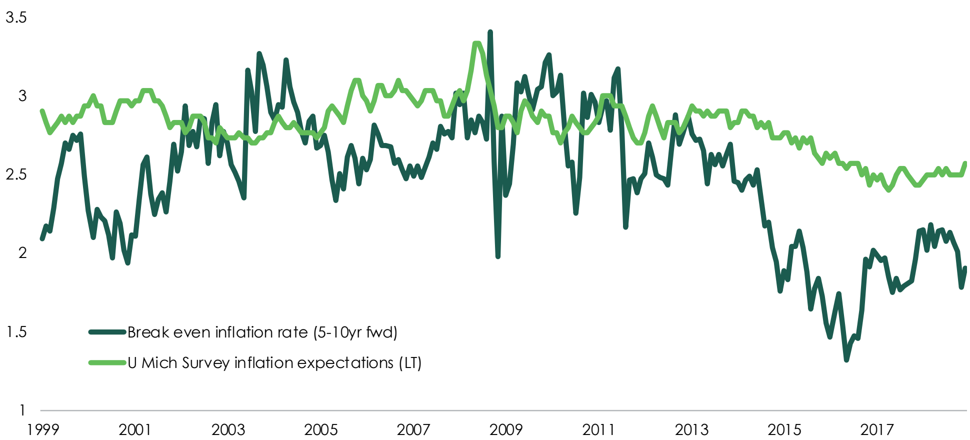


Source: Macrobond as at 01/04/2018.

DOUBLE DOWN ON DOVISHNESS

With core CPI stable, inflation expectations way off their peak and the dollar still overvalued, the Fed has doubled down on its newfound dovishness–and rightly so.

MICHIGAN INFLATION EXPECTATIONS VS US INFLATION BREAKEVENS



Source: Macrobond as at 01/01/2019.

FED FLEXIBILITY

If funding markets, now so important to the US economy's health, are hit from all angles then growth will turn quickly–the Fed needs to show flexibility. Recent comments from Fed officials have been firmly on the dovish side as it takes a deep dive into the suitability of its current policy framework, with the conclusions announced in June. All options are on the table, with discussions taking place about yield curve control and price-level targeting (allowing inflation overshoots to make up for past undershoots)–all point to a Fed willing to let the market run hot and boost inflation expectations. Until we see inflation shooting high we're comfortable in risk assets such as emerging markets rates and FX.

THE ART OF THE DEAL

Adding to the positive vibes being felt in markets is the re-election cycle in the US. No president wants a flagging economy into an election so President Trump has taken personal responsibility for the US-China trade talks, increasing the chances of a positive outcome. The biggest risk is that he faces a backlash if the deal is perceived as soft, as he already has after postponing the tariff hike, and then reneges on an agreement. For now, he believes he can spin it especially if people's stock portfolios are heading higher.

Source: Reuters via Nikkei Asia Review, as at 27/02/2019.

Lastly, the chances of a no-deal Brexit seem to be receding. With the Labour party supporting a second referendum and the threat of rebellion from Tory moderates, the chance of May's deal going through have increased as the eurosceptics may fear no Brexit at all. Should the deal fail, then parliament is likely to push for a delay to Article 50. The odds of an accidental no deal, however, have been dramatically reduced in our opinion and we like being long GBP here.

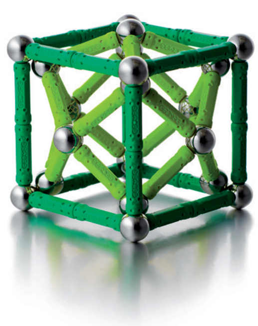
HOW MUCH RISK?

In terms of portfolio positioning, we have taken some risk off the table from last month as valuations are not as compelling. Our directional bias is the same though, with short positions in core duration, long the European periphery, long in EM (with more of a bias towards local debt) and long inflation-linked assets. We continue to run sizeable US dollar shorts as economic and monetary policy reconverges to the rest of the world. As data surprises in Europe, Japan and China start to turn up, we expect the dollar strength to reverse quickly.

THE MODEL PORTFOLIO

ALPHA FACTOR	CONVICTION WEIGHTS (PER SECTOR)	DIRECTION	Exposure (weighted duration or %)	Risk Cont. (TE,bps)	Risk Cont. (%)
CREDIT		NET SHORT	-0.40yrs	25	10.1
US / EUR Coco bonds	45%	LONG	0.30yrs	15	6.1
Buy USD CDX HY Protection	30%	SHORT	-0.45yrs	6	2.4
Buy USD IG CDS Protection	25%	SHORT	-0.25yrs	4	1.6
Developed Market Rates		NET SHORT	-1.05yrs	64	25.9
US	10%	LONG	0.60yrs	-8	-3.2
Japan	5%	SHORT	-0.55yrs	2	0.8
UK	20%	SHORT	-0.75yrs	19	7.7
Germany	20%	SHORT	-1.20yrs	10	4.0
France	5%	SHORT	-0.35yrs	5	2.0
Greece	10%	LONG	0.20yrs	11	4.5
Italy	20%	LONG	0.20yrs	17	6.9
Spain	5%	LONG	0.40yrs	3	1.2
Cyprus	5%	LONG	0.40yrs	5	2.0
Hard EM Rates		NET LONG	0.15yrs	11	4.5
Argentina	60%	LONG	0.10yrs	9	3.6
South Africa	40%	LONG	0.05yrs	2	0.8
Local EM Rates		NET LONG	0.85yrs	41	16.6
Brazil	10%	LONG	0.05yrs	3	1.2
Indonesia	25%	LONG	0.25yrs	13	5.3
Mexico	25%	LONG	0.25yrs	11	4.5
Russia	15%	LONG	0.10yrs	3	1.2
South Africa	25%	LONG	0.20yrs	11	4.5
FX (vs. USD)		NET LONG	17.50%	65	26.3
Australian Dollar	5%	LONG	1.00%	5	2.0
British Pound	10%	LONG	2.00%	7	2.8
Chinese Yuan	15%	LONG	3.50%	7	2.8
Euro	10%	SHORT	-0.50%	-2	-0.8
Indonesian Rupiah	15%	LONG	3.00%	11	4.5
Japanese Yen	5%	LONG	3.00%	2	0.8
Korean Won	5%	LONG	1.00%	3	1.2
Mexican Peso	20%	LONG	2.50%	16	6.5
South African Rand	10%	LONG	1.00%	11	4.5
Swedish Krona	5%	LONG	1.00%	5	2.0
Inflation-Linked Bonds		NET LONG	2.70yrs	41	16.6
Japan Breakevens	10%	LONG	0.60yrs	4	1.6
European Breakevens	45%	LONG	1.05yrs	16	6.5
US Breakevens	45%	LONG	1.05yrs	21	8.5
			Total	247	100

Source: Merian Global Investors, as at 26/02/2019.



FUND MANAGERS

Mark Nash and Nicholas Wall have managed the Merian Global Strategic Bond Fund (GSB) since 1 August 2016.

MARK **NASH**

Mark is head of fixed income at Merian Global Investors (MGI). He joined MGI on 27 June 2016 from Invesco, where he had worked since 2001. At Invesco, he was most recently head of global multi-asset portfolios. Mark is a CFA charterholder and has a chemistry degree from the University of Nottingham.

NICHOLAS **WALL**

Nicholas joined MGI as portfolio manager in July 2016. Prior to joining the business Nicholas worked as a fund manager in the global macro team at Invesco, since 2006. He is a CFA charterholder and has an economics degree from the University of York.

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