House View
November 2018

The ECB keeps its word

Ever since 2012, when Mario Draghi announced that the ECB would do ‘whatever it takes’ to save the euro, the market has found comfort in the calm consistency of his guidance. So it was no surprise that the ECB kept its word and began to wind down its massive asset-buying program last month. The eurozone is basking in solid and broad-based growth, eurozone unemployment is at its lowest level in 10 years, and the core countries are at near-full capacity. There’s a blemish to this pretty picture, of course: Italy’s over-the-top spending plans and the hostility of its populist government toward Brussels. However, we don’t think the ECB will change its stance based on developments in a single country. We expect very accommodative conditions for the medium term.

On a tactical horizon we think there is little merit in overweighting Equities versus Fixed Income. At the same time, we maintain our long risk bias, with an overweight in Alternatives.

Overview

<u>Within Fixed Income</u>:

- We continue to underweight government bonds because we think interest rates will rise as developed economies are improving, and because on the margin central banks are starting to tighten their monetary policy.
- Our largest underweight within fixed income is European government bonds.
- This month we have neutralized our overweight to investment-grade bonds, as valuations are negative and the upside is limited.
- We have an overweight in high yield, the main reason being the supportive macroeconomic environment.
- We have a tiny overweight to emerging-market debt as valuation is a tailwind.
- Within securitized debt we prefer Europe, where investor demand and negative net supply both support the asset class.

<u>Within Equities</u>:

- This month our overall view on equities remains cautious and we prefer to express our views within the asset class.
- In our view, sentiment is a negative driver for the overall equity market.
- We like US equities, mainly due to strong fundamentals. Valuations are also a positive factor.
- We view sentiment and technicals as the main negative drivers for Chinese and EM equities; that is why we are underweight in both.

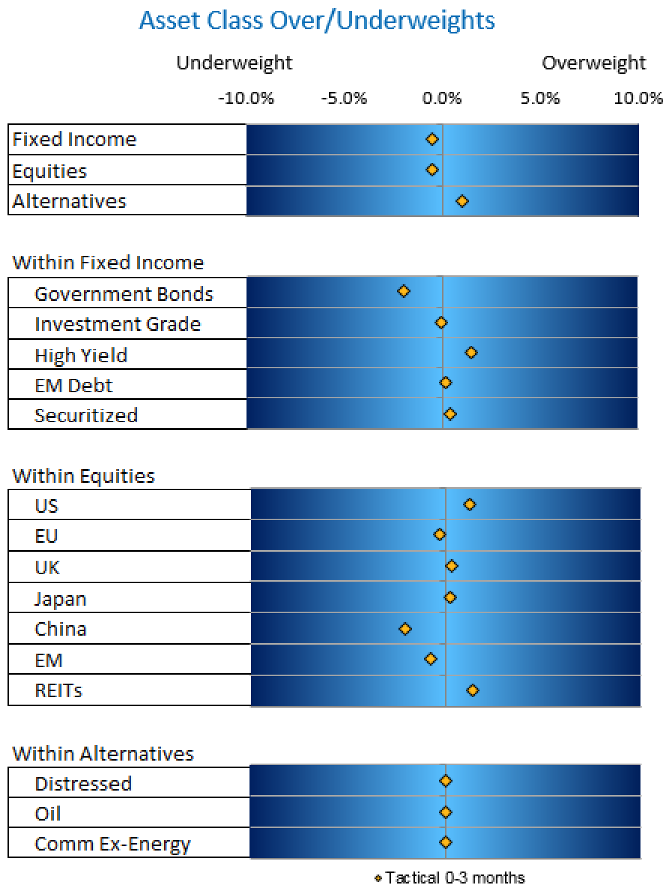

Figure 1: Our asset class overweights/underweights in our model portfolio as of November 1, 2018 on a 3-month horizon. Each percentage reflects the relative weighting of the different asset classes within our model portfolio.

- We have a small overweight in REITs as fundamentals and valuations are tailwinds

Within Alternatives:

- On a relative basis our views on commodities and distressed are quite similar; we are neutral on both within the alternatives bucket.

Fixed income – Government bonds

US: *Positive*. Headline unemployment ticked down to under 3.7% in September (which is below the Congressional Budget Office's estimates of the natural unemployment rate) and core personal consumption expenditure (PCE) is almost at the Fed's target of 2%. Therefore, the FOMC has achieved its dual mandate of full employment and stable prices, and is now trying to raise the Fed Funds rate closer to neutral. A minority in the FOMC believes they are already at, or very near, neutral and we share that view. We believe growth in the US has peaked and that the slowdown in growth will cause the Fed to hike at a slower pace. We think the Fed will hike twice next year, not three times.

Fundamentals are somewhat negative for US rates due to rising trade protectionism. Valuations are close to neutral, but yields remain somewhat rich relative to other currency-hedged developed sovereigns. Ten-year yields have broken the ultra-long-term downtrend going back to the early 1980s.

A big change this month was in sentiment, which is now positive: After the recent sell-off, sentiment became very bearish, which suggests we could get a rally. Technicals are negative.

Europe: *Negative.* Economic data has been underwhelming recently. Valuations are negative and German yields are too low based on fair value. Short-term sentiment is negative. Since last month, the ECB has been buying less and this might cause volatility. However, the main reason for negative sentiment is Italy, which still has the potential to enter the sub-investment-grade territory. Technicals are also negative this month.

UK: Positive. Fundamentals are negative as UK inflation remains high. Unemployment is very low, wage inflation is beginning to surface, and there are capacity constraints. Progress has been made on the Brexit talks, but still without a breakthrough on the key issues. Regarding valuations, the long end of the curve has remained well supported. Technicals are neutral. The uptrend in 10-year yields from mid-2016 remains intact. During Q4, pension funds typically look at their long-term, underfunded liabilities and respond by moving into the longer-dated part of the curve. As that demand comes through, we expect the yield curve to flatten.

Japan: *Negative*. Economic activity has picked up recently, but the Bank of Japan is still keeping its policy very expansionary, so fundamentals are negative. At the same time, the Bank of Japan is paying more attention to the imbalances caused by its policy, and it might introduce some counter-balancing elements. The Japanese 10-year rate remains close to zero. Valuations are very unattractive this month, but the curve is getting steeper. Sentiment is neutral. Technicals are negative now. From a long-term perspective, the 10-yr yield is approaching its longer-term downtrend; a break of this trend could put the Japanese bond market into a negative trend.

Fixed income – Investment-grade

US investment-grade: *Neutral*. Fundamentals are neutral. The US economy continues to grow, which is traditionally a good environment for credits. Company results have been positive but leverage is too high. Valuations are slightly negative this month as spreads are through historical averages. Outflows from bond funds have been held in check, but year-to-date the credit index is down. Credit spreads are unchanged and financials are now outperforming industrials. Sentiment remains neutral. The most recent JP Morgen survey is a bit more bearish. Technicals are positive, mainly due to the strong supply after the summer. The market is clearly well positioned.

European investment-grade: *Neutral*. Fundamentals are positive, but growth in Europe seems to be leveling out. Valuations are negative as all-in yields are not attractive enough. We have been in a holding pattern for over a half a year now, and we are moving close to the upper end of that range again. Also, the ECB's investment-grade credit purchase program will soon cease to be a positive driver for this asset class as that program will be wound down. The ECB is still buying corporate bonds, but half as much as before, so technical support is vanishing. Sentiment is neutral, with the usual worries: Brexit, Italy, trade tensions. The global trade war is having a negative impact on investor confidence. Technicals are neutral.

Fixed income – High yield

US high yield: *Positive*. Fundamentals are positive due to steady economic developments, and default rates are well inside long term averages. However, commodity input prices remain a headwind. Valuations are negative this month as the market is still trading well within long-term averages. Sentiment is neutral. Technicals are the biggest driver of this asset class right now: there have been large outflows this year and there is a lack of issuance. There is not a lot of new money coming into the market. Technicals are modestly positive on average.

European high yield: *Neutral*. The credit cycle in the EU has slowed and defaults are still low. That said, fundamentals are still positive. Spreads have widened. Valuations are negative but relative to defaults, high-yield spreads might be considered fair. Sentiment is neutral: Investors are cautious and potential risks are starting to spoil confidence. Technicals are neutral.

US leveraged loans: *Positive*. Things feel good in this market, which has attracted inflows all this year. Fundamentals are neutral as earnings are generally meeting expectations. However, leverage has increased. Valuations are neutral. Certain pockets of value are appearing and coupons are going up. Sentiment is positive: The September hike of the Fed Funds rate and expected future increases have caused LIBOR to increase steadily. Recent CLO pricing activity has also been supportive. Technicals are neutral, despite slightly positive mutual-fund flows. CLO creation has increased as the arbitrage still works in order to get the return.

Fixed income – Emerging market (EM) debt

Emerging markets: *Negative*. Fundamentals have failed to improve over the last month as tighter financial conditions and intensifying trade tensions have damaged the risk environment for emerging-market debt. The rise in spot and forecasted oil prices has also occurred against this backdrop of worsening fundamentals. Higher oil prices merely offset the downside risks in activity in oil-producing economies and widen the current-account deficits of oil-importing economies. Valuations are positive and modest spread tightening is expected on a tactical horizon.

Overall risk sentiment for emerging-market debt is negative. Growing concerns that the US is implicitly 'weaponizing' the US dollar and US trade as the world's largest economy increase the risks across emerging markets. China's policy response to renewed escalation of trade tensions and tariffs with the US will also impact the emerging-market growth outlook and asset performance. If US-China trade tensions remain unresolved, contagion risk to the rest of emerging markets is unavoidable.

Outflows have resumed and the pace of emerging-market sovereign and corporate bond issuance has significantly slowed down since June. In general, however, technicals are supportive because net financing is minimal to negative in all regions except China.

Fixed income – Securitized

US securitized: Positive. Fundamental tailwinds are the healthy housing market, affordability, and strong consumer fundamentals. Valuations are slightly negative. Spreads have rallied, so all-in yields are low. Agency mortgage-backed securities (MBS) remain rich. Nominal spreads are wider month over month, but remain 1.2/1.4 standard deviation below the trailing 3yr/15yr average. Sentiment is neutral.

Technicals are supportive because the Fed's absorption of mortgage-backed securities still offers support. We are slightly more negative about ABS. Issuance remains slightly ahead of last year's pace, but pent-up demand (both reinvestment and outright) continues to drive oversubscriptions. Issuance increased upon the start of Q4, but it's being met with strong demand. In the secondary market, liquidity remains somewhat challenged as dealer inventories remain light and it's hard to source bonds.

European securitized: *Positive.* Fundamentals are moderately positive as the European economy continues to expand. Wage inflation is finally catching up. ABS fundamentals are also healthy. House prices are rising, except in the UK. The ECB is keeping its options open by cautiously normalizing monetary policy.

Valuations keep coming down and are now close to zero. Spreads seem to have stabilized after the volatility over the summer. UK ABS/RMBS continue to react to Brexit-related issues, but spreads are broadly stable. For select sectors, we prefer credit risk over duration.

Sentiment for European securitized debt is positive: There is a lack of high-quality long-duration assets and we see lots of new mandates. Technicals are negative as demand from the European Central Bank and from banks is waning. The arbitrage works a lot less than in the past. Negative net supply in legacy supports some sectors, but is overshadowed by primary issuance. Expect a higher level of GBP-denominated supply pre-March 2019.

Equities

Equities overall: *Cautious.* Our overall view of equities remains cautious and we prefer to express our views within the asset class. Fundamentals are still neutral to positive for most regions. Sentiment also remains negative for the overall asset class. Fundamentals and valuations are a tailwind for US equities. For Chines and emerging markets, sentiment and technicals are the main headwinds.

US: *Positive*. Reflationary deficit spending should drive nominal growth and support corporate earnings growth. The strength of the dollar could be a headwind for companies with multinational earnings. The market is pricing in around 22% and 10% consolidated EPS growth for 2018 and 2019, respectively. Potential wage inflation could put pressure on margins. The US equity market is close to fair value. Sentiment is negative and technicals are positive.

Europe ex-UK: *Negative.* The current stage of the macroeconomic cycle in Europe is supportive for equities, but further upside is limited. Valuations are mixed and close to neutral on average. Sentiment is negative based on a combination of indicators. In particular trade war tensions are still weighing on sentiment. Technicals are slightly negative too.

UK: *Negative.* The outlook for the UK economy remains challenging due to Brexit, and the next few months will be crucial. The range of outcomes remains wide and uncertain and the political risk is high. As a result, fundamentals are neutral on the whole. Equity returns have been highly dependent on the pound. Valuations are close to neutral. Sentiment and technicals are negative.

Japan: *Negative*. Structural reforms will help a little bit to increase growth, and overall fundamentals are slightly positive this month. Earnings are expected to grow 3.6% in the coming 12 months, which is lower than before. Valuations remain marginally positive: The Japanese equity market become a bit more expensive since last month, but it's still relatively attractive. Sentiment and technicals are negative.

China: *Negative.* Earnings revisions have peaked and are currently in negative territory with strong negative momentum. The global economic pickup is positive and the PMI level is over 50 and supportive. Valuations remain close to neutral this month. Sentiment is negative: the Chinese volatility index has been high all year. Technicals are a headwind.

Emerging markets: *Negative*. Economic fundamentals for emerging markets are negative and there are no signs of relief in the short term. Emerging-market PMI manufacturing sentiment has declined further, approaching the critical 50 level, which might trigger a further downgrade in fundamentals going forward. Valuations are positive: the developed-market discount has narrowed slightly, but it's still high on a relative basis. Sentiment remains negative. Technicals are neutral.

Alternative Assets

REITs: *Modestly positive*. Fundamentals are neutral: the sector remains vulnerable to interest-rate movements, but longer-term rates should stay under control. The employment outlook is good. Trade sentiment is negative. The demand/supply seems in balance and results show evidence of office-rental growth. Logistics seems overbought. But the retail sector has suffered from continued disruption from e-commerce and quality might be oversold.

Valuations are positive. The EBIT yield for real estate versus equity is above average (due to the US), but slightly below its own history globally. The dividend yield for real estate is still attractive versus equities, mainly in Europe and Japan and in the US as well. The dividend yield for this asset class versus credits is slightly negative due to the US market, while it's attractive in Europe and Japan. Sentiment for REITs is neutral this month and technicals are negative.

Distressed credit: *Positive.* Fundamentals are positive as there are no obvious risks to derail the modest global growth. Default rates are below historical averages, and are expected to remain flat or decline over the next 12 months. Inflation concerns are increasing due to late-stage, positive economic growth and the potential for tariffs from China and other countries.

Valuations are neutral because yields are within their historical average. Valuations aren't far from fair value. The percentage of bonds trading at distressed levels is near historical lows, except in emerging markets. Lower quality has outperformed higher quality through 2018, and this is expected to continue in 2019.

Sentiment for distressed credit is now neutral. Technicals are also neutral. High-yield bonds have experienced outflows this year, and this has accelerated recently. New issue supply has been muted all year, and the forward calendar among lower-quality issues looks light as well.

Commodities – oil: *Positive*. Overall macro developments and accelerating global growth are supportive for oil prices. Fundamentals are solid due to decreasing inventories and OPEC production cuts. Valuations are positive as the oil-futures roll yield is positive. Sentiment is neutral. But with reduced inventories and higher usage of OPEC's space capacity, the risk of price spikes is rising. Technicals remain positive.

Commodities – ex-energy: *Negative*. Fundamentals for the asset class are neutral. The cyclical picture remains stable but consumption and exports have been mixed. Valuations are negative: the roll yield is negative and lower than the seasonal historical average.

Sentiment is now neutral. Analyst readings are somewhat bearish for sugar and neutral for the rest of the ex-energy commodities. Stress in the ex-energy spectrum has increased recently, probably driven by trade disputes between the US and China on metals and soybeans. Technicals are close to zero on a tactical horizon. Ex-energy commodities have been trading sharply down recently. The Relative Strength Index (RSI) is currently 38, which is a neutral signal.

About the House View

Aegon Asset Management operates from centers of expertise in North America, the UK, Continental Europe and Asia. The Aegon Asset Management House View is updated on a monthly basis, and is an excellent example of how we leverage our international expertise. First, we collate a global set of asset class views from our international teams. The asset class views are subsequently reviewed from macro, rates and asset allocation angles and an overarching committee then establishes the global House View. The outcome of this disciplined global process provides portfolio managers with latitude while at the same time ensuring that our products and solutions remain aligned.

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