Following the completion of our series on the Global Outlook by our Investment Strategist Peter Lucas, I (DZ) thought it would be interesting to tease out Peter's (PL) shorter term expectations. This we did over a seafood salad on the balcony of the United Club overlooking Jersey's historic Royal Square. The following is a loose transcript of our conversation:

DZ: Peter, thank you for articulating your thoughts on how economic conditions and political decisions may affect financial markets in the future. The key, though, is that these expectations are in the future. How does your analysis translate to how portfolios should be positioned today? We constantly strive to balance our clients' tolerance for risk, exposure to volatility and current and forecast market conditions against the need to provide reliable returns and so your thoughts will provide a valuable input.

PL: *Darren, in the past few weeks, the broader equity market has corrected – largely by going sideways – as doubts have crept in about the speed and sustainability of the economic recovery due to an increase in COVID infection rates in Brazil, India and several US southern states. After such a sharp rally off the lows – in the face of unremitting bad news – a correction of some sort was always to be expected. If there is a surprise, it is the fact that the depth of the correction has been relatively contained. It is always encouraging to see markets display resilience in the face of bad news. The authorities are now clearly committed to doing whatever it takes to get the global economy through this difficult phase, which means that the worse things get, the more stimulus will be applied.*

Markets will find it hard to go down much in such an environment. So, despite the recent resurgence in infections, the underlying story is unchanged: ***the outlook for commodities and equities beyond the very-near term is set fair for some time to come.***

DZ: You emphasise government preparedness to do whatever it takes in the form of further stimulus. Given this means low interest rates and plenty of liquidity can you shine some light on how you might suggest investment managers approach government bond markets at this time?

PL: *Despite the recovery and resilience in equity markets and a significant recovery in the copper price (a reliable economic growth indicator), bond yields remain rooted at the low end of their recent range. With inflation coming, albeit with a lag and with government bond issuance going through the roof, it is only a question of time before bond yields start moving higher. Central banks will no doubt try to fight any such rise, but their efforts are ultimately likely to be self-defeating.*

DZ: You have put your finger on the real issue: "it is only a question of time". A lot of people have gone bust in the last 10 years betting on the so-called bond bubble bursting. Are you saying now is the time?

PL: *Yes, I feel that the top in government bond prices is only weeks or even days away. The divergence between bond yields and say, equities and the copper/gold ratio suggest that something is not right here. Either risk assets are too high, or bond yields are too low. I am sure that many consider the bond market to be correct given the ongoing COVID uncertainty, but we must remember that markets are driven by expectations of where the economy will be in 6-9 months' time not what is happening right now, and I believe that there is considerable room for optimism over that sort of time horizon. Furthermore, recent statistical studies point to a likely peak in infections in the next month or two. In the context of a 40-year bull market, it is a big call to make, but the weight of evidence is very much pointing to higher rather than lower bond yields. My reading of bond yield charts could accommodate one last thrust down in yields, but I believe that any such move would be sharp and short lived.*

DZ: Let's return to this theme later. Given the amount of stimulus in the system I think we can agree that portfolios should be positioned for a more inflationary outlook. Where do you think portfolio investors should look for the less obvious gains?

***PL:** Europe: There are still big question marks regarding the sustainability of the euro in the long run. However, in the short-term, the risks to the euro have all but disappeared. Not only has Germany finally started to employ an expansive fiscal policy (which it should have done years ago if it was a team player) but we also have the makings of a fiscal union, the lack of which was always the main fault line running through the euro concept. This is good news for European equities and the euro, which already have the benefit of falling COVID infection rates.*

Financials: If bond yields move higher and steepen as expected, one of the main beneficiaries will be financial companies. Banks will benefit from wider margins and insurance companies will benefit from higher yields. Financials in countries with negative interest rates should perform particularly well. European financials could well prove to be big performers in this scenario.

Commodities: With a few exceptions (e.g. gold and palladium) commodities are generally quite cheap by historical standards and stand to benefit hugely from improving economic growth and/or rising inflation. As per usual, gold is leading the way in this bull market, but there are probably better commodities to own, at least in the next few months. If bond yields move higher, they will provide gold with a headwind, whilst other more cyclically sensitive commodities draw benefit from the improving economic backdrop. Silver and platinum are relatively much cheaper and may be better performers in the next phase. The next major bull leg for gold may have to wait for a clear deterioration in inflationary expectations.

Japan: The Japan bubble burst thirty years ago, heralding a long period of low growth, deflation and private sector deleveraging, all exacerbated by unhelpful demographics. Although the country still has its challenges, its relative performance has been improving for some time. Indeed, the low point for its relative versus the MSCI World Index excluding USA was as long ago as 2007. A return of inflation and higher bond yields could mark the beginning of a new credit cycle in Japan – with the private sector able to take on more debt than their Western equivalents – to the benefit of economic growth and corporate profits.

Value and cyclical shares: Despite fabulous long-term performance credentials, value shares (i.e. shares that have low ratings like price to book or p/e ratios) have had a torrid time of it since the financial crisis. An environment of low growth and falling bond yields has been much more favourable for their growth equivalents (i.e. shares with reliable profits growth characteristics, which typically trade on higher ratings). Since December 2007 the US growth index has outperformed the value index by 170%. Looking ahead, there are good reasons to think that this might change: (1) by definition value is always cheap, but the discount today is close to an historic extreme and (2) inflation, growth and bond yields are expected to bottom in the year ahead, providing value with a more fertile environment.

Emerging markets: Valuation-based forecasts of future returns tend to agree on one thing: emerging markets are priced to outperform pretty much everything in the next 10-20 years. Over shorter periods, they should also perform well, with commodity-producing countries benefiting from rising prices and Asian economies benefiting from their proximity to China and the rise of the local consumer market.

DZ: Asian economies have taken a much more conservative monetary approach to dealing with the crisis than the western economies. This feels a little like the difference in approach to the 1970's oil price shock that led to a decade long depreciation of the US Dollar and Sterling against the Yen and the Deutschemark. Does this mean we are looking at a period of strengthening Asian currencies and the Renminbi in particular?

***PL**: Absolutely. There is a good chance that Asian economies will experience what research firm Gavekal refers to as a "triple merit scenario" of strong currencies, low inflation and interest rates, and strong economic growth, which would be very conducive for Asian markets generally.*

DZ: With inflation a concern it seems too obvious to buy inflation-linked bonds when breakeven rates are so high (relative to inflation today). Does it still make sense to incorporate them into a portfolio?

***PL**: Although inflation-linked bonds have outperformed their fixed income equivalents since they bottomed in March, they remain attractive, discounting only modest increases in inflation. That is particularly so in Germany where they are discounting inflation remaining below 1% for the next 10 years. Don't be put off by negative real yields. With debt levels going through the roof, central banks cannot afford to allow interest rates to rise too far and the likelihood is that rates will be held below the rate of inflation for some time to come, a policy known as financial repression.*

DZ: Peter, thanks for pointing out some of the less obvious opportunities. Winning at investment over the medium and long term is as much about avoiding losing trends as participating in winning ones. What would you advise investors specifically to steer clear of today?

PL: *US large cap technology: for all the reasons that value shares are expected to outperform, the expectation is that growth shares, and most particularly large cap technology shares, will underperform the broader market. The largest companies rarely outperform the market for long because (1) it is mathematically difficult if not impossible and (2) when companies become huge, they attract the attention of politicians, who either try to regulate them or break them up. The largest five companies now account for over 20% of the S&P 500, an unusually large proportion of the index. History suggests that they are very unlikely to be the winners of the next decade. As the large cap companies underperform, the equally weighted S&P 500 will outperform its cap-weighted equivalent by a decent margin.*

DZ: We have had a decade of dollar strength but the trade weighted index has turning since its spike at the height of the COVID19 concerns in March. Given what a driver to portfolio performance a view on the dollar has been, what do you expect?

PL: *Not only is the dollar expensive by historical standards, but also it has to contend with the twin US deficits (budget and current account), the prospect of improving global growth (it tends to perform better during periods of volatility and falling markets), and improving confidence in Europe and the euro (its main FX rival). The likelihood is that the dollar will be one of the weaker currencies in the year ahead.*

DZ: Finally, with so many sterling-based clients, I must ask you for your view on the pound?

PL: *Despite being relatively cheap, the pound has more downside as the country heads for a 'no deal' outcome in its ongoing negotiations with the Eurozone. However, if that turns out to be the endgame, the likelihood is that the UK economy will perform better than most currently expect, and the pound will then have a good chance of being promoted to the 'winners' enclosure.*

DZ: Peter, thank you for your insights. I have been managing client assets for 30 years now and its fascination and challenge does not diminish. Our multi-asset strategies aim to protect and enhance the real value of our clients' capital. We are clearly expecting a significant change to the investment environment which, certainly in the shorter term, provides some excellent opportunities for active managers. You bring a breadth of knowledge and historical perspective that provides an invaluable contribution to our process. As well as focussing on the opportunities of the here and now, in forthcoming articles I am looking forward to developing a dashboard of signals which will provide an early warning to reduce risk in portfolios when the trends you see supporting markets over the nearer term become less supportive.

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24 July 2020