Asset Allocation

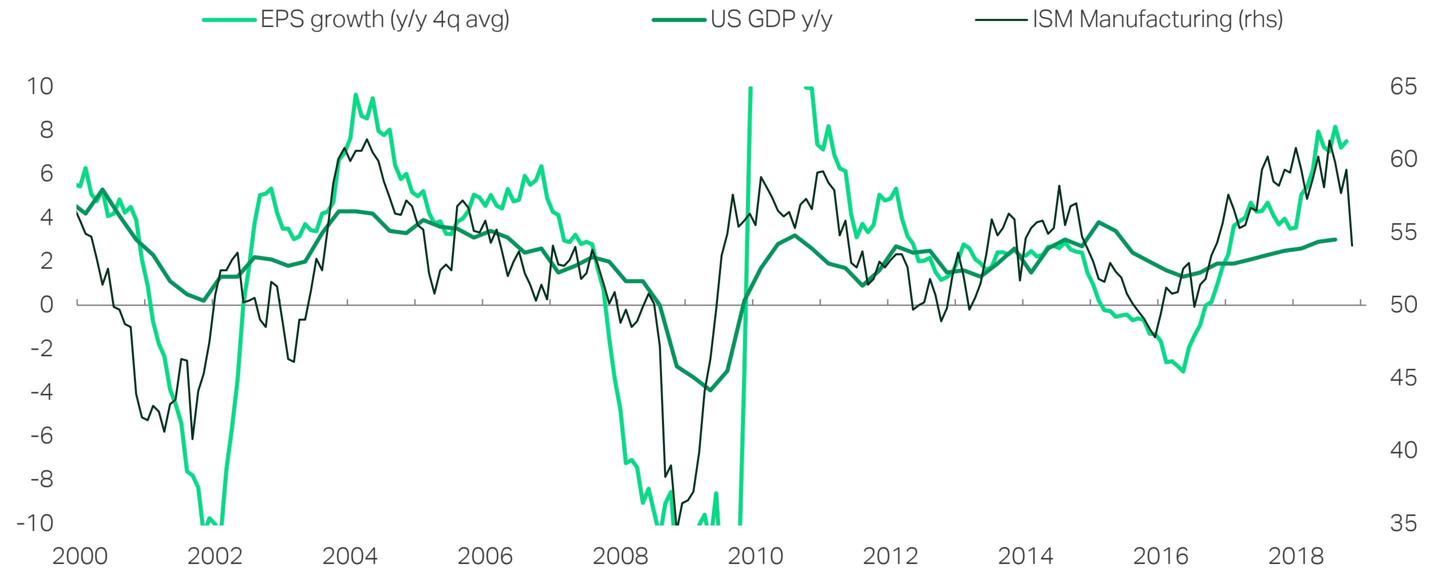
EARNINGS WINTER IS COMING

Global Team

HIGHLIGHTS

- **As the economy cools, earnings will slow more than consensus expects**
- **EPS growth may not go sub-zero, but 5% seems more likely than 10-15%**
- **At 5% EPS growth, S&P 500 trades at 17x earnings (long-term average)**
- **But Fed pause, QT taper mean further sharp de-rating is unlikely**
- **US, China policy responses suggest data should improve in H2**
- **In the near term, however, negative surprises are likely to continue**
- **We cut our equity exposure by 4% to a 3% overweight (all in DMs)**
- **EM equities go to neutral, as we further rotate into EM bonds instead**
- **We reduce duration some more, shifting 7% from DM bonds to cash**

The sharp drop in global PMIs suggests EPS growth will be slower than consensus estimates



Source: Bloomberg, TS Lombard

Key macroeconomic forecasts

- US growth slowing – threatened by trade-war effects, incl. overvalued dollar – 2019 quarterly growth below-trend, but no recession
- Europe slowing sharply, Japan may already be in recession; Germany likely to just avoid one
- Trade war caused China's yuan depreciation – higher dollar and cheaper yuan => savings gluttons and non-oil EMs doubly hurt
- Chinese growth slowing, even though cheap yuan 'exports' some of the trade-war pain
- Downside stock-market risks from trade war threat – globalisation replaced by 'regionalisation'
- Monetary policy less loose with positive real short-term dollar rates, but Fed now on pause – strong dollar restraining growth and inflation
- US stocks no longer on high p/e's – growth & tax cuts boosted earnings through 2018 – Europe less highly valued – both vulnerable to trade-war and slowdown
- EMs damaged by strong dollar, cheap yuan and rising interest rates, but FX & stocks now adjusted, with some benefiting from cheaper oil
- Japanese imbalances & Italy remain potential risks, as well as vulnerable non-oil EMs

Contents

ASSET ALLOCATION

3-to-6-month view. Previous ratings in brackets. Monetary policy outlook changes in bold. Rationale on next page.

	Equities	Govt Bonds	FX vs. USD	Monetary policy
Developed Markets				
North America				
US	+1	-1		**Rates unchanged, QT taper**
Canada	+1	-1	+1	**Unchanged**
Developed Europe				
UK	0	-1	0	**Unchanged**
Switzerland	0		-1	Unchanged
Euro Area			0	**TLTROs in H1**
Germany	-1	0		
France	0	-1		
Italy	0	0		
Spain	+1	0		
Asia Pacific				
Japan	0	0	0 (+1)	Unchanged
Australia	0	0 (-1)	0	Unchanged
Emerging Markets				
Asia				
China	0 (+1)		-1	**Easing bias**
India	+1 (-1)		0 (-1)	**Easier**
Korea	0 (+1)	0 (-1)	-1 (0)	Unchanged
Taiwan	-1 (0)		0	Unchanged
Latin America				
Brazil	+1	+1	+1	**Unchanged**
Mexico	0	+1	+1	**Unchanged**
Europe & Africa				
Russia	-1	-1 (0)	0	Unchanged
Turkey	0	+1	+1 (0)	Unchanged
South Africa	-1	-1 (0)	-1	Tighter

Commodities	
Energy	+1
Industrial Metals	-1 (0)
Precious Metals	0

Corporate Bonds	IG	HY
US	-1	-1
UK	-1	
Euro Area	-1	-1

Key to recommendations

+2 = strongly positive **+1** = positive **0** = neutral **-1** = negative **-2** = strongly negative

Recommendations based on expectations of **normalised local-currency total returns**. FX returns include **carry**. ValuQEST country and sector scores on page 16. **Model portfolio** performance on page 29.

Summary of key recommendation changes

	From	To	Rationale
China equities	+1	0	Chinese growth to slow to 6.2% in 2019 from 6.5% last year. Deflationary pressures will likely cause another China scare like in 2015 before data improve in Q2.
Korea equities	+1	0	Korea is one of the 'big losers' from the trade war. Equities unlikely to do much as the Semiconductors sector continues to slow.
Taiwan equities	0	-1	Like Korea, Taiwan is heavily exposed to the slowing semiconductor business cycle.
Indian equities	-1	+1	India is one of the EMs least exposed to China's slowdown and should outperform.
Australian government bonds	-1	0	Falling Chinese PPI suggests lower Australian CPI and a weakening domestic economy; RBA to remain dovish.
Korean government bonds	-1	0	Trade risk from falling demand for Korean exports could spill over to a slowing domestic economy.
Russian government bonds	0	-1	Scope for potential additional sanctions to target new bond issuance and state-owned banks.
South African government bonds	0	-1	February's budget unlikely to tighten fiscal policy, and guarantee of Eskom debt remains problematic.
JPY vs USD	+1	0	Strong performance in past month has lifted JPY close to the level at which Japanese investors will start cutting FX hedges when buying foreign assets.
INR vs USD	-1	0	Lower oil prices and potential rate cuts to stimulate the economy, encouraging inflows and supporting the rupee.
KRW vs USD	0	-1	Trade surplus is entirely due to semiconductor exports; as these exports are now falling, so will natural demand for KRW. The won could fall.
TRY vs USD	0	+1	Recent stability is a sign that the worst of TRY volatility is past, and 1.5% carry per month is attractive.
Industrial metals	0	-1	A slowing China will continue to weigh on Industrial Metals.

Summary of model portfolio changes

	1-month chg	O/W (U/W)	Comments
DM equities	-1%	3%	We reduce US by 2% (2% o/w), add 1% to Spain (3% o/w).
EM equities	-3%	-	We cut China, Korea and Taiwan, add to India, Brazil.
Government bonds	-7%	(13%)	We cut UST, JGBs by 4% each, add 1% to Australia.
Commodities	+1%	-	We add 1% more to Energy and go 1% o/w.
Cash	+7%	15%	Cash goes up to 15% as we reduce duration further.

Full model portfolio composition and performance from page 29.

MACRO OUTLOOK

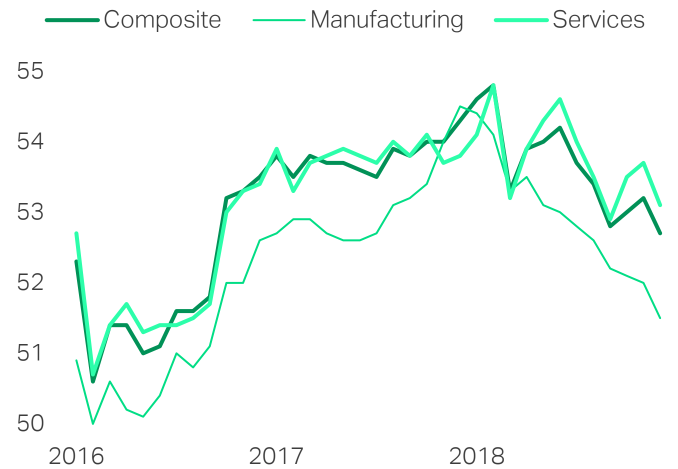
Steven Blitz

- **Fed pauses on the path to an ease to mitigate coming credit crunch**
- **Trade war effects and weak demand weigh down Chinese growth**
- **Slowing central bank liquidity drain, a China-US trade agreement and lower oil prices point to a growth boost coming out of 2019**

Asset prices matter. They determine the economy's trajectory – it is how monetary policy operates – and prices have shifted enough to lower the global economic outlook – though growth is still likely to stabilise at positive levels. The US and China remain its primary drivers, followed by the euro area (EA) and Japan. Emerging markets have gained some relief since being hit in Q3/18 by high oil prices, a strong dollar and a weaker yuan. Risks of recession are no longer trivial for the US, Germany or Japan. To keep the global economy afloat, policy mistakes need to be unwound with conviction, and we believe they will. The Fed tapering the pace of balance sheet reduction and eventually a policy easing, plus a truce in the US-China trade war, should help stymie the slowdown and even get the economy accelerating by year end.

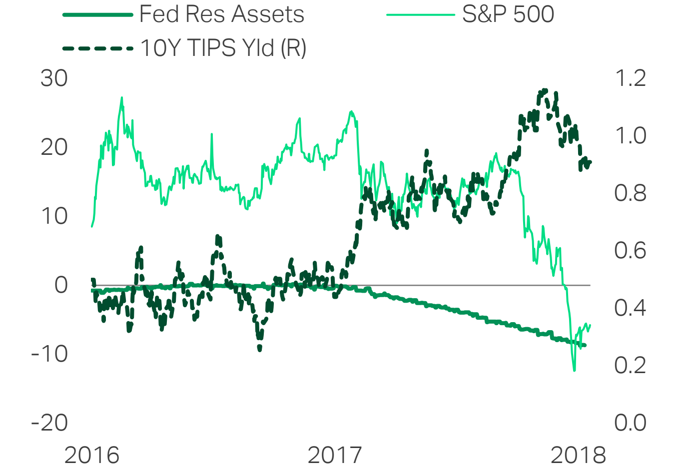
The Fed "eased" when Chairman Powell validated the market's taking out any hikes in 2019. The next step will be slowing the pace of balance sheet reduction (QT), the object being to get some steepness back into the yield curve. Putting QT on the table was a surprise, but its inevitability has been adopted as gospel. Suggesting adjustments to QT, after insisting policy would be managed using the funds rate, makes some sense. The rate of QT was always arbitrary - designed to deliver a balance sheet of a theoretical size by some chosen date. The timetable for transferring responsibility for financing Treasury debt to the private sector was thought to have no material impact on yields. This would have likely been the case if the deficit had remained on its pre-tax cut trajectory. It didn't. Real yields shot up, interest-sensitive sectors of the economy slowed and the equity market repriced. Put another way, had the budget moved into sharp surplus, the clamour would have been for the Fed to quicken the tempo of QT because of a shortage of collateral.

Global manufacturing under pressure



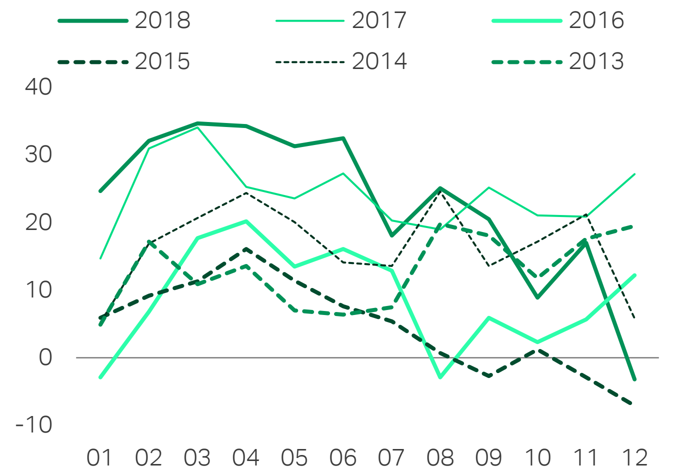
Source: Bloomberg, TS Lombard

Equity market, Fed balance sheet, real 10yr yield



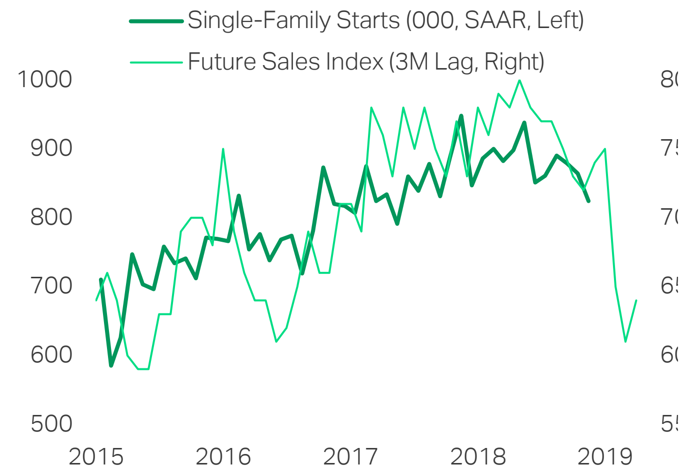
Source: Datastream, TS Lombard

ISM Manufacturing – Net new orders (nsa)



Source: Bloomberg, TS Lombard

Housing starts & builder sentiment



Source: Datastream, TS Lombard

The slowdown in the US economy will become more evident in the coming months as inversion at the short end of the yield curve begins to stifle credit creation. The Powell gambit of resurrecting growth by using the Yellen 2016 tactic of flattening the policy path is not going to work with the funds rate at 2.5% as opposed to 0.5%. And the impact of QT tapering will prove fleeting. Eventually Powell will have to channel Greenspan's 1995 policy operation and cut the funds rate at least once. The timing is hard to call. Between the government shutdown and a correction to the Q4 inventory build-up in advance of the proposed hike in tariffs on Chinese imports, Q1 will look weak. Because both these events are self-correcting (we assume the government will reopen at some point), growth in Q2 will get a boost. This leaves Q3 as the quarter of decision and, by our account, the likely time when the Fed realises that a fed funds rate of 2.5% is above neutral, no longer "just below".

Our call is for US growth to fall to 1.5-2% in 2019, just below trend, with the possibility of a worse outcome if the Fed stubbornly delays its responses. Helping the economy is that the consumer remains in good financial health in terms of leverage but is overinvested in equities. As we are seeing from department store sales, buying dropped sharply in December as the equity market started to lose altitude rapidly. Nevertheless, employment is still strong and wage growth should accelerate in the coming year. Economic indicators from the goods side suggest the US expansion has peaked, but recession is not imminent. ISM new orders have fallen through year-ago levels and builder expectations for housing have slid significantly. Further, if the trade deficit widens as expected in 2019, the burden of adjustment will fall on the non-oil goods sector, especially capital goods ex-autos.

A big risk to our forecast of slower US growth stems from President Trump's various trade wars. As Xi Jinping's chief economic adviser, Liu He, prepares to visit Washington, China is aiming to offer the US sufficient concessions for Trump to be able to claim a market-boosting victory and defer further tariff moves on 1 March, without affecting the economic model on which the Communist Party and XI base their power. The US and China have reason to reach a short-term settlement without abandoning the longer-run trial of strength set off in 2018.

For the leadership in Beijing, the prime concern is to park the trade war so it can focus on deleveraging and rebalancing the economy to provide a stronger, more self-sufficient base on which to pursue state–directed modernisation. It hopes that moves such as the reduction in auto tariffs, increased purchases of farm products and draft legislation to strength IP protection will be enough for Trump to hold off on the next round of threatened tariffs. The focus would then be on US efforts to constrain Chinese technological progress. This, increasingly, looks like the real battleground, spurring Xi and his colleagues to stress the need to build up "self-reliance".

Coinciding with the growth slowdown, this policy imperative, combined with heightened nationalism, will provide a challenge to US companies which have become used to strong sales in mainland China, as highlighted by the downbeat sales report from Apple. It will spur Beijing to seek to strengthen regional trading arrangements, as part of a rivalry that reaches well beyond immediate trade issues and forms part of Xi's longer-term ambition of regional influence. The probability, therefore, is for an agreement to defer the tariff increase that gives Trump and the market a lift, but for a continuing confrontation on the strategic and tech fronts as 40 years of "positive engagement" between the US and China fade into history.

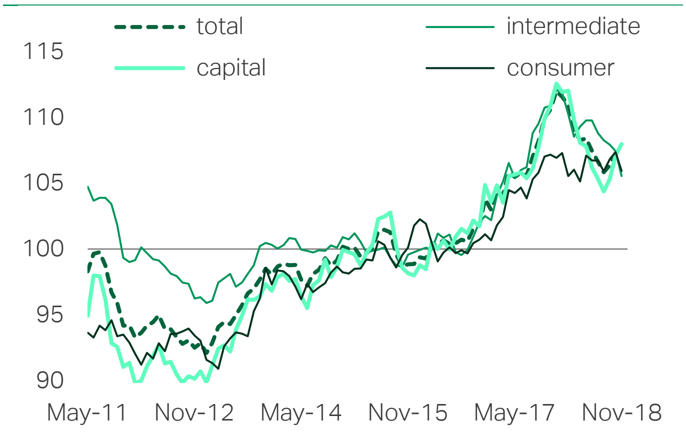
China's economic growth should be at its nadir in Q1 and steady in the second half of 2019 in response to fiscal stimulus and liquidity injections from the PBoC. Right now, Chinese data confirm the start of a downturn in China-US trade, induced with a lag by the new tariffs, which will weigh on global goods flows. Falling Chinese demand in addition to reduced purchases of goods for re-export caused imports to fall 7.6% YoY in December, while Trump's tariffs finally impacted Chinese exports, which fell 4.4% YoY. China's export growth will weaken further and remain negative in H1/19 as domestic and global demand continues to decline. Export growth for 2019 as a whole will be positive, however. Chinese promises to import larger quantities of American agricultural and energy products mean import growth will also recover.

A current account deficit is now almost inevitable. While the temporary tariff ceasefire is positive, any potential deal will involve a significant effort to reduce bilateral trade imbalances. Whatever the outcome of negotiations, China's current account will feel the impact. The trend of exports falling faster than imports and a large services deficit will lead to a deficit of some $20bn in 2019. Amid increased monetary easing, the market will force further depreciation of the yuan.

The trade war winners of 2018 will lose out in 2019. Should the trade conflict continue to moderate, the need to re-route supply chains and to find alternative sources of goods will diminish. Countries that have benefited from the disruption, namely Canada (re-routing) and Brazil (soybeans), will suffer. Commodity exporters such as Qatar and Australia may also lose out as any US-China deal is likely to include provisions to increase imports of agricultural commodities and LNG from America.

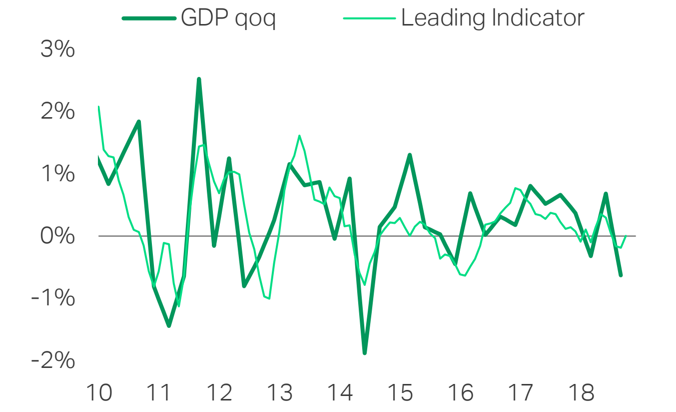
German new manufacturing orders

2015=100, 3mth MAV



Source: Datastream, TS Lombard

Japan's LI still weak



Source: Datastream, TS Lombard

EA and Japanese growth dropped in Q4/18 and a swift turnaround is unlikely. The EA economy is in a bit of a tailspin. Germany's EA consumer orders were down in November, with a sharp fall in intermediate goods orders – a classic sign of recession. Intermediate orders in general fell back, both domestic and non-EA export orders as well as bookings from other EA countries. The possibility of a Q4-Q1 EA recession poses problems for the ECB, as does the most likely source of recovery – falling oil prices. They will only undercut the ECB's inflation objectives. Time may be ripe for monetary ease, but how? Draghi may yet be happy with Italian fiscal stimulus and with France's increased deficit spending in response to the gilets jaunes (yellow vest) protests. Perhaps Germany, with a budget surplus at 1½% of GDP, a confiscation of German consumer spending, will rethink its fiscal stance.

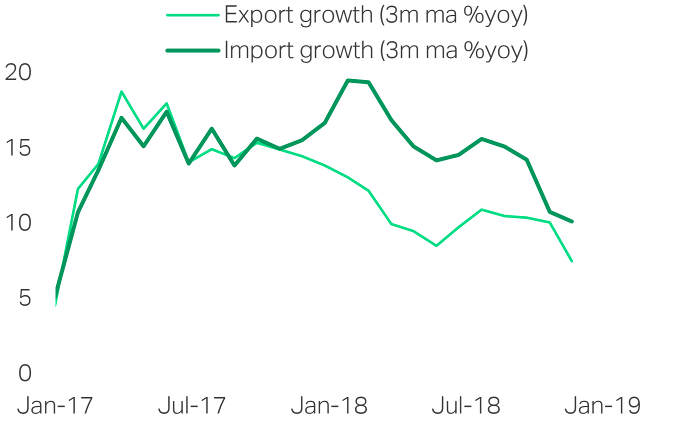
The risks to Japan's outlook are skewed toward recession in the face of mounting trade headwinds and rising household savings. Growth faltered in Q3/18 and the weakness was broad-based. Precautionary household savings rose by about 1% of GDP last year, while the domestic capex cycle is likely to ease following a burst of construction for the Olympics. Hopes for a turnaround in these weakening trends rest with possible new fiscal initiatives.

The lagged impact of the trade war on EMs will take time to subside. Data for EM economies provide evidence of disruption to trade and of the emergence of a China-centred Asian trading bloc. For most EMs, however, export growth has fallen faster than import growth. The latest data have started to show an improvement, but there will probably be several more months of relatively weak EM trade balances.

Deteriorating trade dynamics will weigh on EM current account balances and currencies in the coming months, although there are some exceptions. In Turkey, earlier lira weakness has boosted competitiveness, helping to reverse the current account trend, while in Brazil the gradual recovery from recession has contributed to an improving trade balance.

EM disinflation likely has further to run. We have been highlighting the increasingly benign EM inflation outlook since late last year. EM central banks have not responded decisively to lower headline inflation, which has been falling for several months as a broad-based disinflationary trend takes hold. In India, easier monetary policy is increasingly likely under the new RBI governor. Despite lower-than-expected inflation elsewhere, central banks will probably be reluctant to relax policy too soon given the EM currency risks ahead.

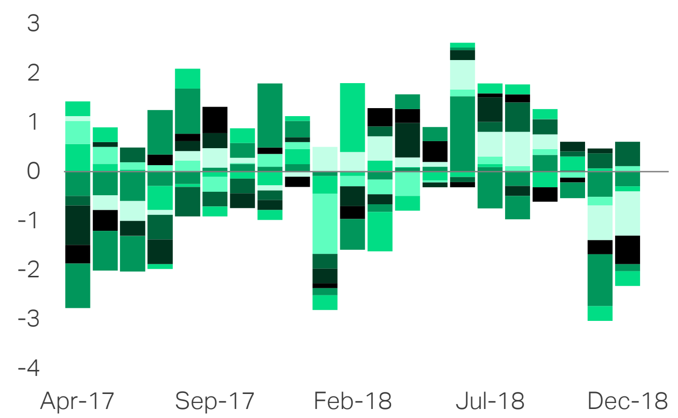
EM export & import growth (simple avg.)



Source: TS Lombard

Monthly change in EM headline CPI

9 EM economies, ex-Turkey



Source: Bloomberg, TS Lombard

CROSS ASSET

Andrea Cicione

- **China likely to get worse before it gets better, despite policy response**
- **Fed pause, QT taper should lend support to equities, weigh on bonds**
- **We further reduce duration, adding 7% to cash for a 15% exposure**

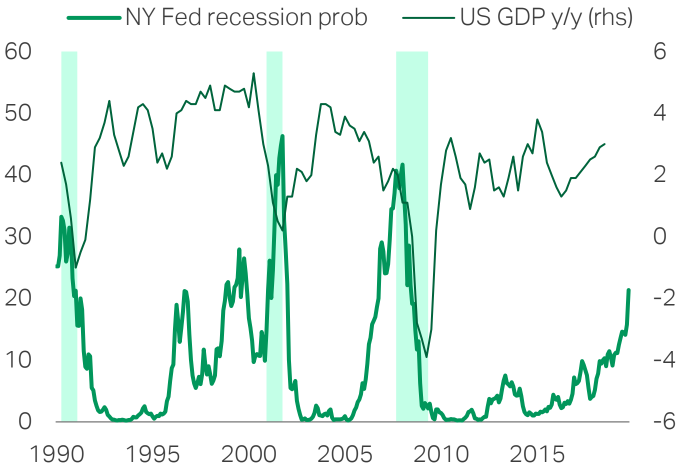
Market gyrations and recession risks

Equities back to where they started. Having to abide to a monthly rebalancing cycle is a curse usually, as it makes it nearly impossible to time the market as precisely as one would like. Occasionally, however, it can be a blessing, forcing us to sit tight and do nothing instead of reacting impulsively to market gyrations – maybe at the worst possible time. The last 30 days have certainly been an example of this: since our last update, US equities dropped about 10%, only subsequently to recover all of those losses; the VIX spiked from 20 to more than 35 – the highest level since the October market peak – but it then fell to below 18; other stock markets experienced similar swings, as did oil prices.

Year-end effects amplified market gyrations… That said, it would be a mistake to attribute all of the market's lurches in the past month to year-end effects. To be sure, there may have been last-minute profit-taking as some investors tried to salvage whatever gains they had made during the year – though fund flow data show that risk reduction had already been going on for some time. And there surely was the usual year-end balance sheet window-dressing, especially at banks. Add to the mix December's characteristically low liquidity, and it becomes clear that market swings were probably larger than they would have been otherwise.

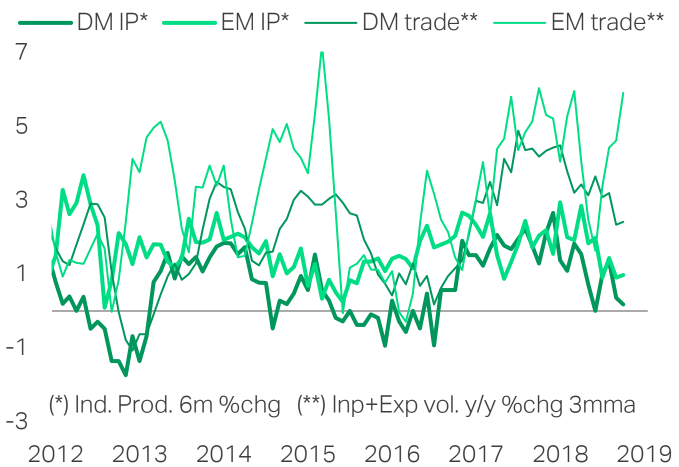
…But did not cause them. However, economic data have continued to deteriorate, especially in Europe but also in the US and China, reinforcing the view that recession risks are rising. And while equities have bounced back strongly, bond yields remain lower than they were late last year, suggesting that something with the "it's all fine" narrative is amiss.

Recession risks rising



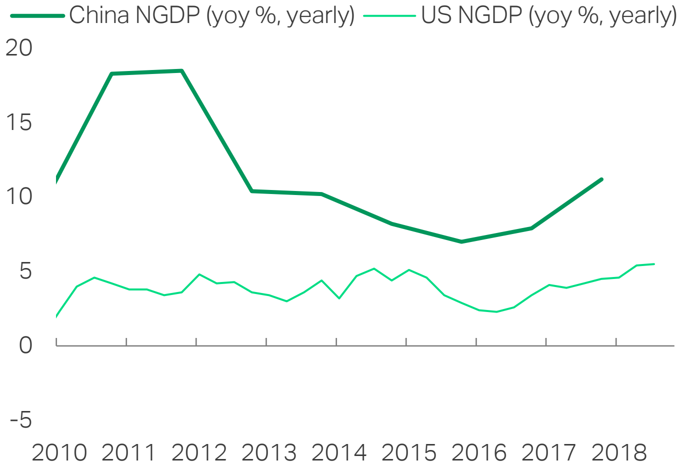
Source: NY Fed, Bloomberg, TS Lombard

Trade war taking a toll on the global economy



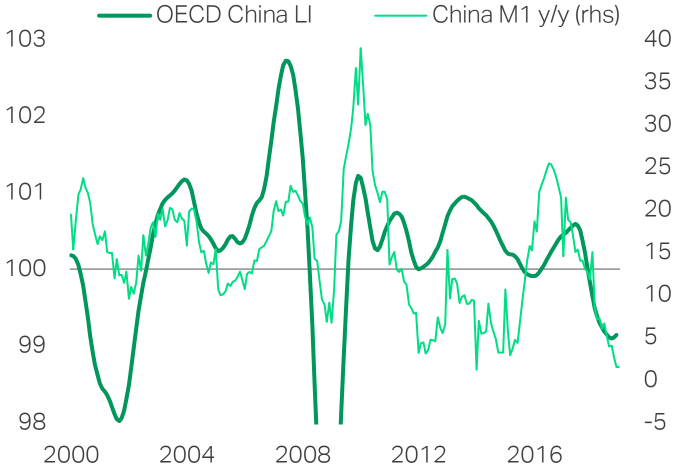
Source: Bloomberg, TS Lombard

Another 2015-style China scare in the making



Source: Bloomberg, TS Lombard

China's leading indicator up, but M1 still slowing



Source: OECD, Bloomberg, TS Lombard

China scare redux

China's rough patch. If there is something investors are worried about above all these days, it's China. It's a well-known fact that US large-cap companies derive nearly half of their revenues from abroad, mostly from China. However, there's nothing like Apple issuing its first revenue guidance cut in more than 15 years (and blaming China for it) to focus investors' minds. A Chinese slowdown has always been inevitable, especially since Beijing made deleveraging one of its key policy objectives. However, the trade war that the US launched against the Middle Kingdom exacerbated the trend.

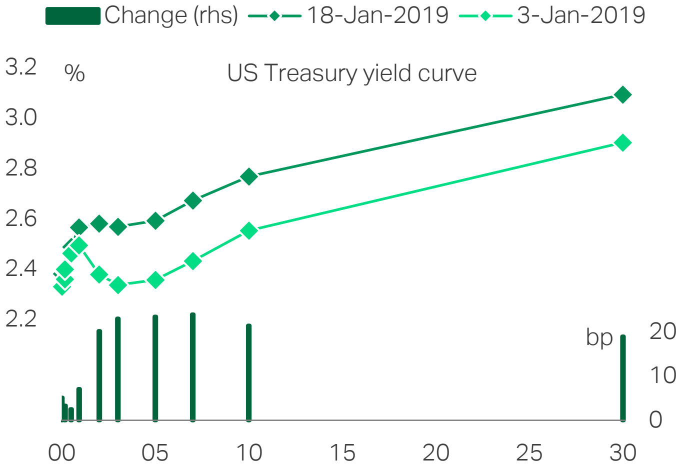
Deflation likely to cause another China scare. As our colleagues pointed out in their latest EM Strategy Monthly, China fears may be overdone. Nonetheless, in the near term markets will face a rough patch. We expect China's current account to move into deficit this year, as goods export growth slows and services imports (i.e. tourism) remain high. Any appreciation pressure on the CNY will disappear, with a depreciation likely (we stay **-1**). Softer exports also mean domestic oversupply and lower prices. Not only will China export deflation, with PPI inflation already down to just 0.9% from nearly 8% in 2017, but domestic prices will fall too. For a country that is trying to deleverage, slower real growth plus deflation is the worst possible curse.

China stimulus will take time to work through the system. The good news is that Beijing got the memo and has shifted to easing mode. It is engaging with the US to stop the trade war, or at least limit the extent of tariff escalation; it has announced corporate and household tax cuts; and it has lowered the RRR to the lowest level since 2007 (and indicated it will cut it further), releasing bank liquidity. The bad news is that anyone expecting a large-scale stimulus to bail the world out is in for a rude awakening. Chinese fiscal and monetary easing will help the economy stabilise in H2, and the OECD leading indicator suggests that M1 growth (a strong global cyclical gauge) should soon find a bottom. But in the short term, economic data are likely to remain weak.

US policy response: too little too late?

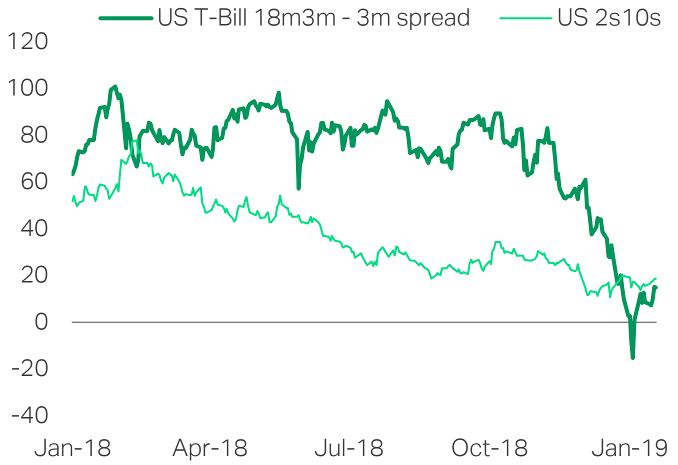
Fed overtightening no longer likely to cause a recession. We've long held the out-of-consensus view that the Powell Fed would avoid repeating the policy mistake several past Fed chairs have made – i.e. overtightening monetary policy when the economy is already slowing. We have forecast since at least last July the pause that the FOMC has now clearly signalled and that is priced in by the market. So, the Fed has listened to market concerns and has responded. But is it too little too late?

US yield curve normalising



Source: Bloomberg, TS Lombard

ST forward spread still too low for comfort



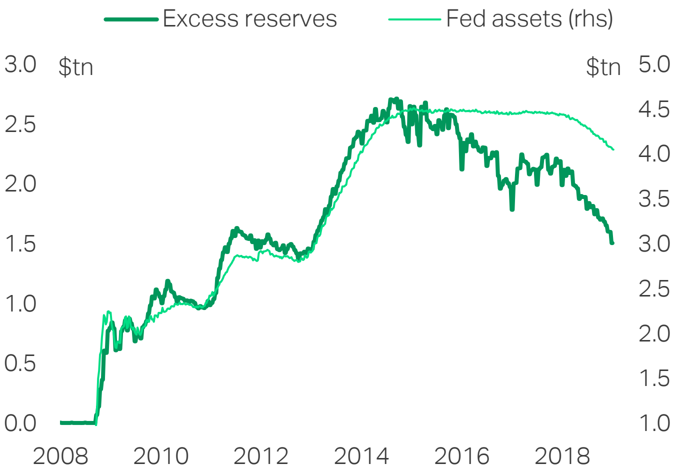
Source: Bloomberg, TS Lombard

US yield curve (2s3s) remains inverted. Powell's signal of a pause has taken future rate rises out of the market, with only a 10% chance of a 25bp hike now priced in for 2019. But the risk-off phase has caused longer-term yields to fall too, resulting in precious little steepening. In fact, certain sections of the short end of the curve (e.g. 2s3s) remain slightly inverted (top-left chart). This risks creating a credit crunch that could tip an already slowing economy over the edge. Also, the Fed near-term forward spread (the difference between the 18-month forward three-month T-Bill rate and the three-month spot), while back in positive territory, remains too close to zero for comfort (top-right chart).

Quantitative squeezing. The market has also been concerned about the impact of QT, forcing the Fed to signal a more pragmatic approach than its previous suggestion that the programme was on autopilot. While the reduction in the size of the Fed's balance sheet has been minimal (about 10% from the peak), excess reserves have fallen nearly by half (bottom-left chart). Banks hold approaching $1.5trn of excess reserves, which may sound a lot. But this figure is probably overstated insofar as it doesn't take into account Basel III reserves, which US banks operating internationally also need to hold.

Credit growth accelerating reserve drawdown. Although the reduced level of excess reserves may not be a constraint just yet, nonetheless the bottom-right chart suggests their

Excess reserves falling faster than Fed B/S

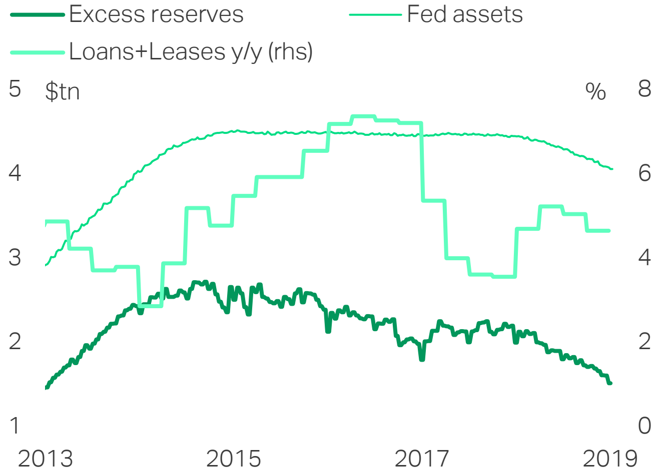


Source: Bloomberg, TS Lombard

Equity valuations affected by falling reserves

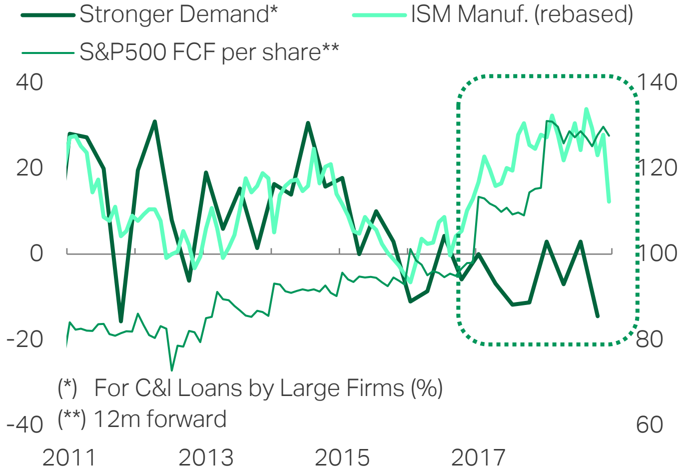
Source: Bloomberg, TS Lombard

Reserve fall compounded by credit growth



Source: Bloomberg, TS Lombard

Weak credit demand due to strong cash flows?



Source: Bloomberg, TS Lombard

drawdown matters. If the Fed persisted with QT at the current pace, credit creation could soon start to face headwinds. As the above-left chart illustrates, excess reserves have fallen faster than the Fed balance sheet when banks have used them up for loans and leases they extended. Whenever credit growth accelerated, the fall in excess reserves picked up pace.

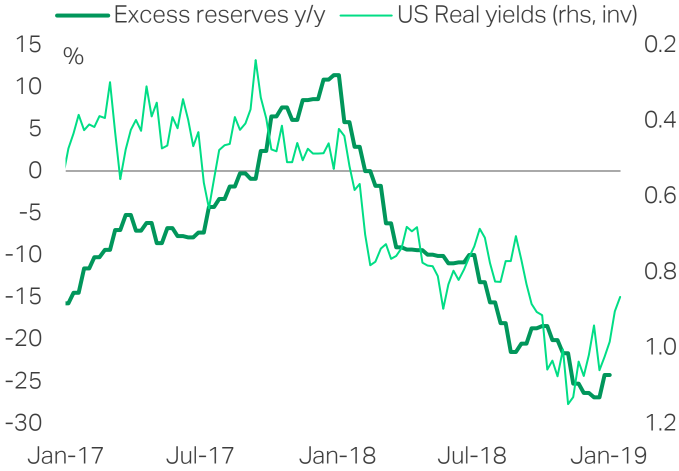
Slower credit growth due to companies generating plenty of cash. While the more sedate credit growth of the past two years may have slowed the drawdown in excess reserves for a while, it has been a reason for concern in itself, hinting that higher rates are starting to weigh on the economy. Banks are still willing to lend and are reporting looser credit standards, so why aren't companies borrowing? The most likely reason is that they don't need to, because they have more than enough internal funds for capex and dividends. The top-right chart shows that the disconnection between stronger demand for credit and the ISM has coincided with a sharp acceleration in free cash flows. If this is indeed the reason for reduced credit demand, it's not something investors should worry about. Capex, at least for large-cap corporates, continues to pick up, especially in Technology – though a slower China and cheaper oil may slow the recovery (see *Equities* section).

Will a QT taper really help steepen the yield curve? The drop in excess reserves has not only had an impact on equity valuations, it has pushed up real yields too. A balance sheet reduction was always meant to undo the effect of QE – i.e. it was meant to normalise the term premium and steepen the curve. Perversely, however, the rise in real yields and the decline in equity valuations have led to a steep fall in breakevens, such that the nominal yield curve hasn't steepened but has instead flattened. So, in a way, the Fed is right to finally pay attention to QT and stop assuming it doesn't matter. But slowing its pace may not be as effective at steepening the curve (and easing concerns about an impending recession) as straight rate cuts would be. Less QT should result in two opposing forces: more reinvestment of proceeds by the Fed, pushing yields down; and, perhaps, a greater risk appetite, which should push nominal yields up. The upshot may still be a steeper curve, but that's far from guaranteed.

We reduce duration further by rotating from DM bonds to cash

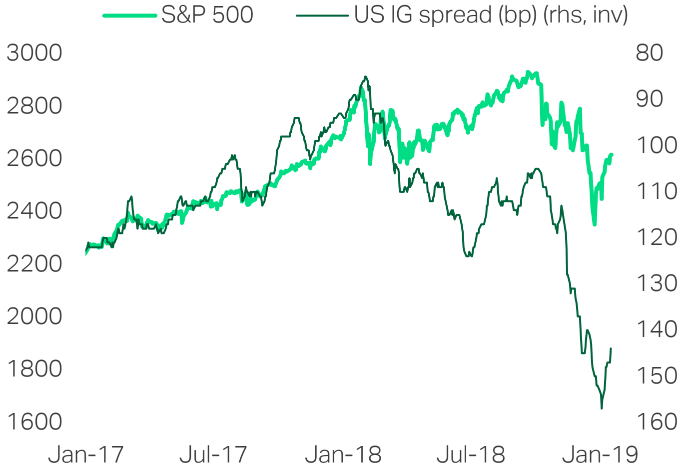
With this in mind, we're keeping our DM bond stance unchanged, with only one upgrade – to Australian bonds, to **0** from **-1**. But we do reduce the DM bond weight in our model portfolio by a further 7%, and move all of it to cash. This follows a 3% rotation from govvies to cash in December, resulting in a 17%-15% DM bonds-cash split. Compared to July last year, when we

Falling excess reserves driving real yields up



Source: Bloomberg, TS Lombard

Credit heading for a bear market?



Source: Bloomberg, TS Lombard

had 3% cash and a 34% DM bond allocation, our fixed income exposure has come down somewhat, and our duration has decreased substantially.

We reduce DM equities by 1% to a 3% overweight. We're making no changes to DM equity recommendations this month: we keep our **+1** on the US, alongside Canada and Spain, with all other markets at **0** except for Germany at **-1**. Nevertheless, in our model portfolio we reduce the weight of US stocks by 2%, and put 1% of it into Spain. As a result, we now have roughly the same overweight in EA stocks as we do in the US (2%). We still have an overall DM equities overweight, but it's 1% smaller than last month.

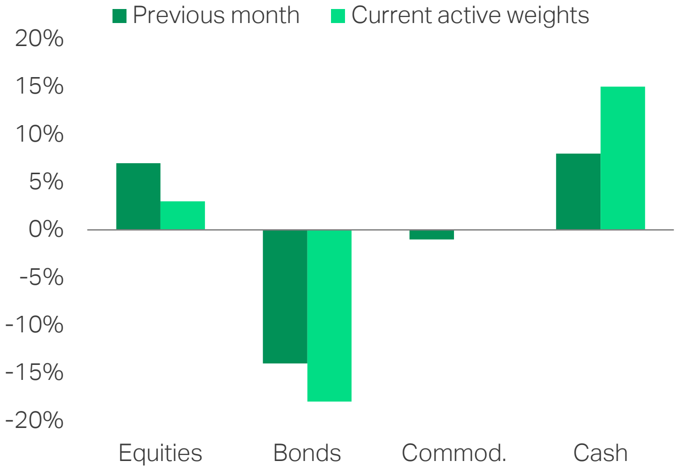
China goes back to 0 from +1, but we upgrade India to +1 from -1. We make bigger changes in EM stocks, where crucially we downgrade China back to **0** and bring our portfolio weight down to a small underweight. As trade data continue to be weak and the semiconductor sector is showing no sign of recovery, we cut Korea to **0** and Taiwan to **-1**, while we upgrade India to **+1** from **-1**. As a result, our EM equity exposure is reduced by 3%, taking it to benchmark weight.

We rotate 3% from EM equities to EM debt. Staying with emerging markets, we upgrade Korean bonds to **0** this month but downgrade Russia and South Africa to **-1**. Despite the one net downgrade, we add 3% to the model portfolio weight, which can be seen as a rotation from EM equities to bonds. This makes EM fixed income our favourite asset class with a 6% active weight compared to our benchmark.

Credit still unattractive. Conversely, corporate credit remains our least favourite asset class. We make no changes this month: all sectors stay at **-1** and we keep an 8% u/w on Investment Grade and a 3% u/w on High Yield. Rising leverage over the past several years and, more recently, higher equity volatility (a reflection of higher asset volatility, which is not observable), continue to transfer value from equity holders to bondholders, resulting in credit's underperformance (top-right chart). A greater risk of falling earnings also means that current net debt-to-EBITDA ratios, already at cyclically high levels, are likely to become loftier still, leading to credit downgrades (in IG) and defaults (in HY). With the credit cycle past its peak, credit remains an asset class better sold on rallies than bought on dips.

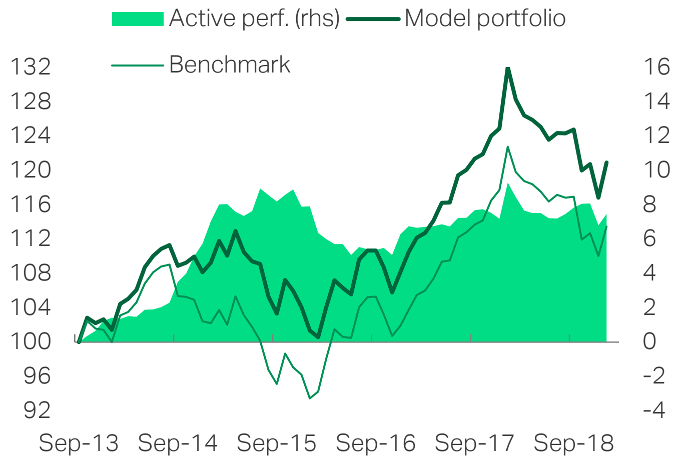
Industrial metals cut to -1 on China. In Commodities we cut Industrial metals to **-1** this month. The move reflects our view that Chinese data will keep disappointing in the near term. As we already had no exposure in our portfolio, the only change in commodities this month is the 1% increase in Energy, talking us to benchmark weight overall.

Model portfolio changes



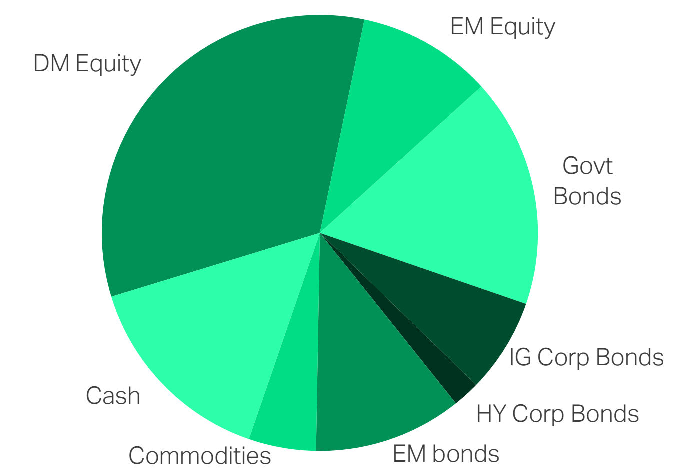
Source: TS Lombard

Model portfolio performance



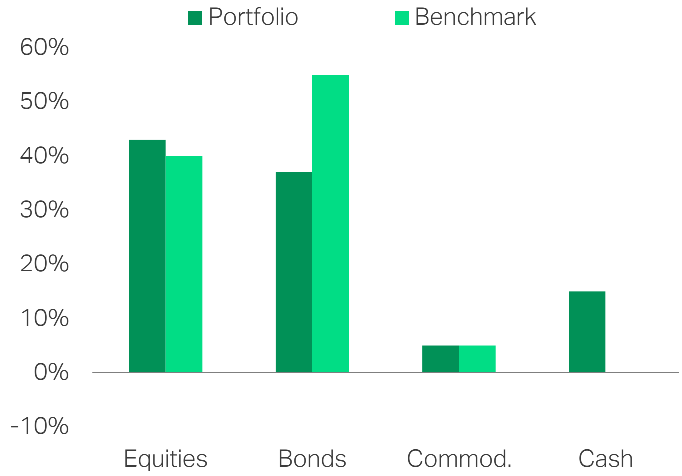
Source: TS Lombard

Model portfolio composition



Source: TS Lombard

Model portfolio vs benchmark



Source: TS Lombard

Cross asset dashboard

	Total Return LC			Volatility			Sharpe Ratio			1Y Correlation			3Y Beta		
	1y	3y	5y	1y	3y	5y	1y	3y	5y	LI	Infl.	Rates	LI	Infl.	Rates
DM Equities	-6.6	11.1	7.0	12.8	10.6	11.1	-0.6	0.9	0.5	28.2	20.7	52.0	9.4	3.2	10.9
EM Equities	-10.8	13.8	6.3	13.0	11.1	11.2	-0.9	1.1	0.5	38.2	22.6	13.0	16.3	4.0	3.1
DM Govt Bonds	-1.3	2.4	1.3	3.1	4.3	4.4	-0.8	0.2	0.0	0.7	16.3	-63.1	0.1	1.2	-6.4
DM Corp Bonds	-2.3	3.4	3.3	4.2	4.4	4.7	-0.8	0.4	0.5	9.7	24.6	-52.4	1.7	1.8	-5.1
EM Bonds	-3.8	7.3	1.0	6.8	7.1	6.9	-0.7	0.8	0.0	16.0	24.4	-25.6	5.7	3.5	-5.0
Energy	-10.0	13.8	-16.7	27.2	30.1	30.5	-0.4	0.4	-0.6	13.2	24.5	40.6	12.4	9.7	21.7
Industrial Metals	-15.2	10.3	-2.7	16.6	16.2	16.3	-1.0	0.6	-0.2	32.0	14.1	2.2	19.8	3.6	0.8
Precious Metals	-4.8	4.8	-0.7	10.9	13.0	14.0	-0.5	0.3	-0.1	-2.3	17.9	-57.0	-1.2	3.8	-16.6
DM Currencies	-4.9	3.9	-13.7	5.7	6.4	6.7	-1.0	0.4	-2.2	11.7	14.6	41.2	2.9	13.4	51.5
EM Currencies	-5.6	0.6	-8.3	4.3	3.9	3.7	-1.5	-0.2	-2.5	24.2	23.4	-14.0	4.7	1.9	-1.7

All figures % except 1y Beta.

EQUITIES

Andrea Cicione

- **Weak growth suggests earnings will slow more than consensus thinks**
- **Positive returns in 2019 are more likely than not, new highs aren't**
- **We cut trade war losers (China, Korea, Taiwan) and upgrade India to +1**

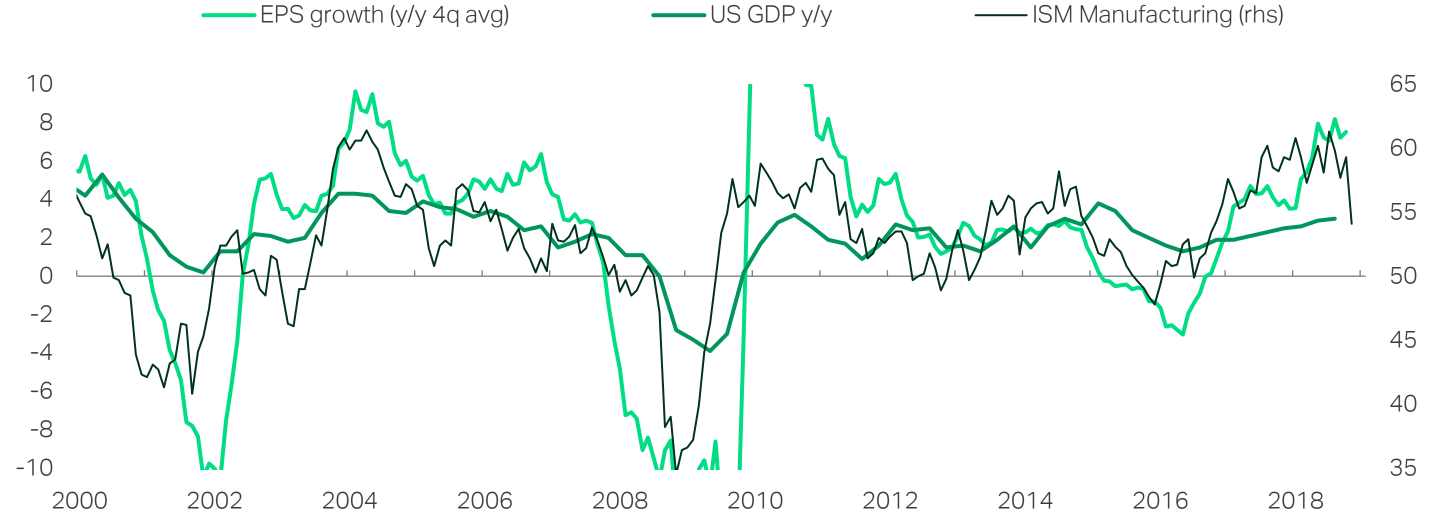
Falling ISM pointing to sharp earnings deceleration

December's sell-off overstates the risk, but volatility cannot be ignored. While equities are largely unchanged from last month, ignoring the volatility in the market in late December/early January would be a mistake. As we argued last month, a normalisation in the VIX (i.e. a sustained decline to below 15) is key if equity prices are to make new highs. Volatility has certainly fallen since it spiked just before Christmas, but at 18 the 'fear gauge' doesn't quite indicate a full recovery is likely.

Drop in ISM manufacturing indicates slower earnings growth. EPS growth was always expected to decelerate from its 2018 pace, as the boost from the tax cuts passed in late 2017 faded. However, the steep fall in the US purchasing managers' index points to an even sharper slowdown. US GDP is also likely to weaken to a below-trend rate in 2019. We are forecasting real growth of 1½-2%. Consensus estimates for GDP at 2-2½% and for EPS at 10-15% seem high.

The good news is that valuations have adjusted to reflect slower growth. We know that, historically, earnings expectations have tended to start high only to be revised lower as the year progresses. The expectation of 15% EPS growth probably leads to the current 12-month forward p/e of about 15x being understated. Absent a recession, this looks too low. But using a more realistic assumption of 5% EPS growth for 2019, stocks trade at nearly 17x forward earnings. This makes them hardly cheap and will likely result in disappointing returns at best.

Earnings winter is coming



Source: Bloomberg, TS Lombard

ValuQEST country scores and LSR directional view

	ValuQEST scores				1m	LSR
	Macro	Valuation	Timing	Total	Change	View
United States	-1.6	-0.8	-1.9	-1.1	-0.2	+1
Canada	-0.9	1.6	-1.7	0.8	-0.1	+1
Japan	-0.4	1.1	-2.5	0.7	0.0	0
Australia	0.7	0.0	-2.0	1.4	-0.3	0
UK	1.4	0.9	-2.3	2.4	-0.3	0
Switzerland	-0.9	-0.5	-2.1	-0.4	0.2	0
Germany	-1.4	0.1	-2.2	-0.6	-0.3	-1
France	-1.0	-0.4	-1.8	-0.3	0.0	0
Italy	-1.0	0.0	-2.2	-0.2	-0.3	0
Spain	-1.4	0.2	-1.4	-0.2	-0.4	+1
Euro area	-1.2	0.0	-2.1	-0.4	-0.2	-
China	-1.7	-0.5	-2.0	-1.1	-0.2	0 (+1)
India	-2.1	-1.4	-0.2	-1.3	-0.2	+1 (-1)
Korea	-1.0	1.2	-2.0	0.4	-0.2	0 (+1)
Taiwan	-3.4	0.6	-2.0	-2.2	-0.2	-1 (0)
Brazil	-0.9	-1.6	1.1	0.2	-0.1	+1
Mexico	-0.2	1.3	-2.3	1.0	-0.1	0
Russia	-0.8	-0.4	0.7	0.7	0.2	-1
Turkey	0.0	1.1	-1.2	1.6	-0.5	0
South Africa	-0.7	0.4	-1.8	0.3	-0.3	-1

ValuQEST scores standardized relative to 7.5y history and across DM/EM. Values above/below 1.5/-1.5 highlighted. LSR view is discretionary. Numbers in (brackets) are previous month's recommendation.

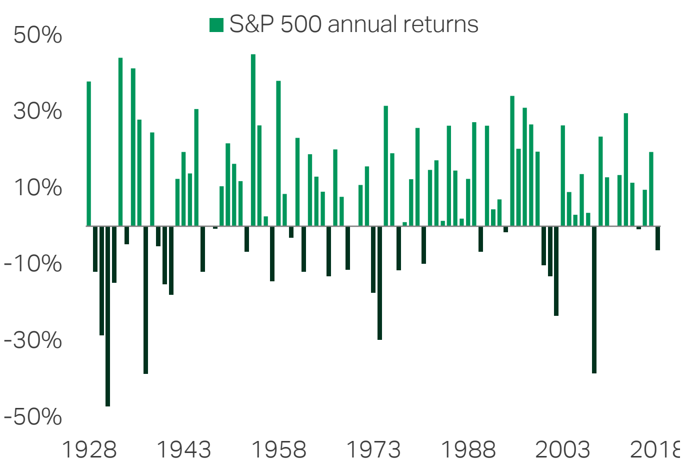
ISM drop may be too extreme, and China may bounce in H2. Of course, it's entirely possible that the ISM, just as it exaggerated the strength of the economy in 2018, may be overstating the extent of the slowdown now. Also, while we expect Chinese data to continue to disappoint in the near term, Beijing's policy response should start to bear fruit in the second half. But that's still a while away and we think it makes sense to remain conservative at this stage.

ValuQEST total sector scores (Full breakdown available at goo.gl/UpFXB5)

	US	Canada	Japan	Australia	UK	Switzerland	Germany	France	Italy	Spain	Euro Area	Brazil	China	Taiwan	India	Mexico	Russia	South Africa	Korea
Market	-1.1	0.8	0.8	1.4	2.4	-0.4	-0.6	-0.3	-0.2	-0.2	-0.4	0.3	-1.1	-2.2	-1.3	1.0	0.7	0.3	0.4
Industrials	-1.3	0.8	0.7	1.4	1.9	-0.2	-1.4	-0.3	-0.6	-0.5	-0.4	-0.7	-1.2	-2.3	-1.2	1.3		0.0	0.5
Energy	-1.0	1.2	1.2	1.1	2.6			-0.3	0.2	-0.2	-0.3	0.3	-1.2	-1.9	-1.0		0.8	0.1	0.7
C. Discr.	-0.6	1.0	1.3	1.4	2.4	-0.1	-1.7	0.2	0.5	0.5	-1.6	0.7	-2.0	-2.3	-2.0	1.6		1.1	0.2
Healthcare	-1.9	0.2	0.0	1.0	1.5	-0.4	-0.6	-1.1		-0.6	-0.5	0.7	-1.2	-2.4	-1.2			0.6	0.2
Financials	-1.2	0.3	-0.1	0.6	2.2	-0.6	-1.5	-0.7	0.1	-0.6	-0.5	0.1	-2.0	-2.9	-2.1	1.4	1.0	0.5	0.5
Real Estate	-1.3	1.1	0.4	1.2	2.2	-0.3	-0.1	-0.3			-0.1	0.0	-0.5	-1.7		0.7		0.1	
Utilities	-1.4	1.0	0.7	2.3	2.3		-0.2	-0.6	0.2	-0.7	-0.9	-0.2	-1.4		-0.4		1.1		-0.1
Tech	-0.2	1.5	1.1	2.4	3.3	0.6	-0.5	0.5		0.8	0.1	1.1	-0.2	-2.2	-0.4				1.4
Comms	-1.0	0.3	1.1	1.1	2.3	-0.8	-0.3	-0.4	-0.2	0.5	-0.5	1.2	-2.1	-3.3	-1.9	0.5	0.8	0.1	0.6
Materials	-1.1	0.9	0.9	1.2	2.4	-0.8	0.2	0.1			0.6	0.3	-0.5	-2.0	-1.0	0.8	1.2	0.3	0.8
C. Staples	-1.2	0.9	0.0	1.4	3.2	-0.7	-0.8	-0.8			-0.8	-0.1	-1.0	-1.5	-1.2	-0.1	0.6	-0.2	0.7

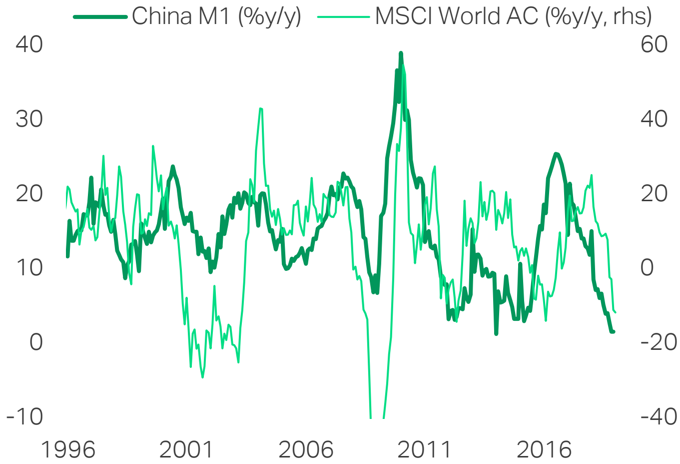
Values above 1.5 and below -1.5 are highlighted

Back-to-back down years not unprecedented



Source: Bloomberg, TS Lombard

China M1 vs equities



Source: Bloomberg, TS Lombard

Consecutive down years are rare in US equities, but not unprecedented. While the near-term outlook remains challenging, it's worth noting that it's fairly rare for US stocks to post two consecutive years of declines. Does this mean that 2019 is going to be an up year? Not necessarily, of course. After all, the drop in 2018 was a lowly 6.2%; and one has only to go back to the early 2000s to find not one, not two, but three consecutive years of negative returns.

Positive returns in 2019 more likely than not, but new highs will be harder to come by. To be fair, equities did fall more than 20% from their October 2018 peak – so arguably a sharp repricing has indeed taken place. And in 2001-2003 the market was adjusting from an unprecedented equity bubble, so the 50% decline (spread out over three years, as it turned out) was virtually inevitable. This means that, if we are right about the economic outlook (a slowdown, not a recession), equity returns in 2019 are more likely to be positive than negative. That said, we will remain sceptical about the odds of the US market making new highs until we see further sustained drops in market volatility.

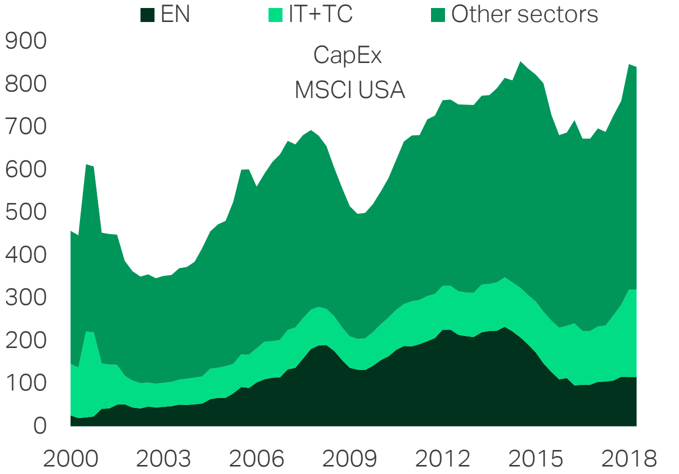
China holds the key

Not MAD. China remains key to the outlook for equity markets in 2019. We turned more bearish last year when it became clear that the tensions between Washington and Beijing would flare up into a fully fledged trade war. The good news is that the escalation that seemed likely in the summer has now been put on hold. Both the US and China have probably realised that further tariff increases would lead to mutually assured destruction – economic, not nuclear, but extremely worrisome all the same.

China fears overdone. Nonetheless, the damage was done: the global economy went from the synchronised growth of late 2017 to a synchronised slowdown. Thankfully, both countries' policymakers have responded, by hinting at a pause in the monetary policy tightening cycle (in the US) and by means of fiscal and monetary stimulus (in China). We now expect Chinese growth to slow to 6.2% in 2019, down from around 6.5% last year. The new stimulus measures should help the economy to bottom out in the next four to six months. Market fears of a deeper Chinese slowdown look overdone.

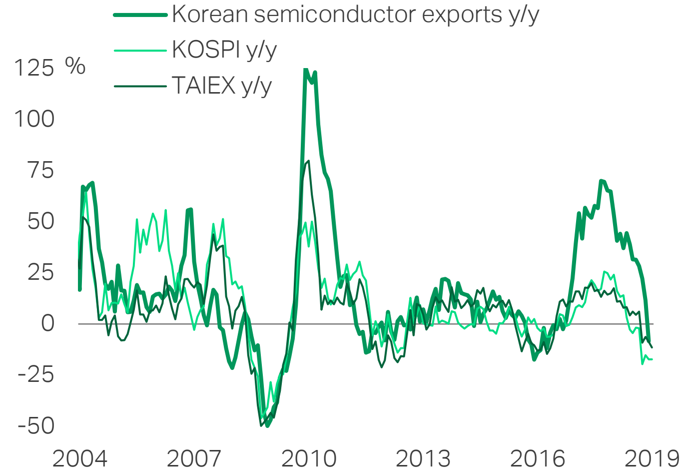
But a rough patch is likely in the short run. Nonetheless, in the near term the data will probably continue to disappoint before they get better, and consequently we downgrade China equities to **0** from **+1** this month.

Is US capex peaking?



Source:

Korea, Taiwan 'big losers' from trade war



Source: Bloomberg, TS Lombard

China matters to the rest of the world. Our colleague Dario Perkins argues in a recent daily note that perhaps strategists pay too much attention to China, and particularly to M1. He has a point when he says that the global slowdown cannot be explained by the collapse in trade alone, and that its causes run deeper. But the correlation between Chinese monetary measures and global equity returns (top-right chart on the previous page) can't be ignored.

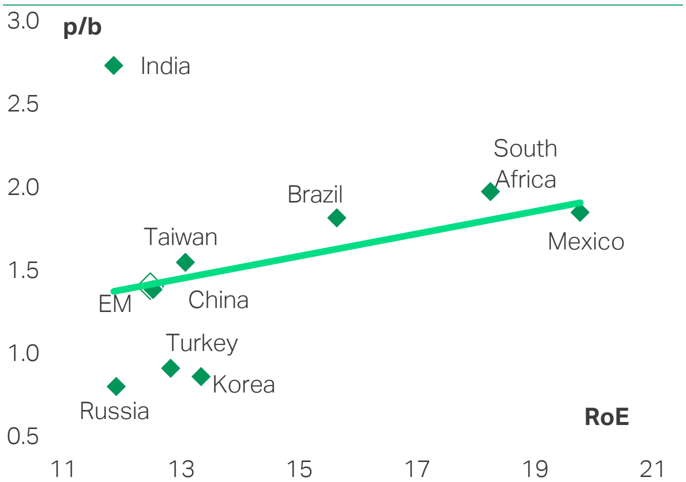
DMs cut by 1% to a 3% overweight. While we make no recommendation changes to DMs this month, we cut the US by 2%. A weaker Chinese economy means slower revenue growth for US companies, especially Tech, Energy, Industrials and Discretionary. This and lower oil prices suggest capex growth in the large-cap sector could soften (top-left chart). Elsewhere in DMs, we add 1% to Spain. These changes trim our o/w to 3% from 4% last month.

EMs: trade war losers cut, India raised to +1. We make more changes in EMs. We downgrade the three 'big losers' from the trade war: China, Korea (to **0** from **+1**) and Taiwan (to **-1** from **0**). Semiconductors account for 25% of total exports in Korea and 22% in Taiwan. When the sector struggles, so do those countries' equity markets (top-right chart), hence the downgrades. At the opposite end of the spectrum of trade war vulnerability, we have India. We upgrade the market to +1 from -1 this month as it'll be better insulated from the trade slowdown. As a result of these changes, our overall EM exposure goes down by 3% to be in line with the benchmark.

DM price-to-book vs RoE

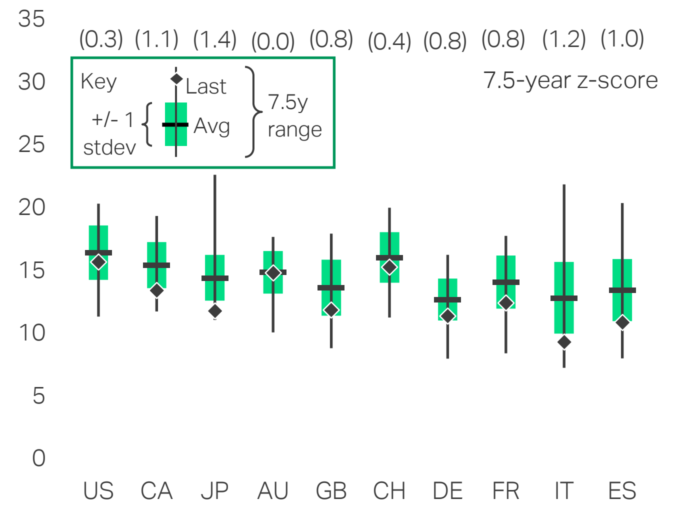
Source: Bloomberg

EM price-to-book vs RoE



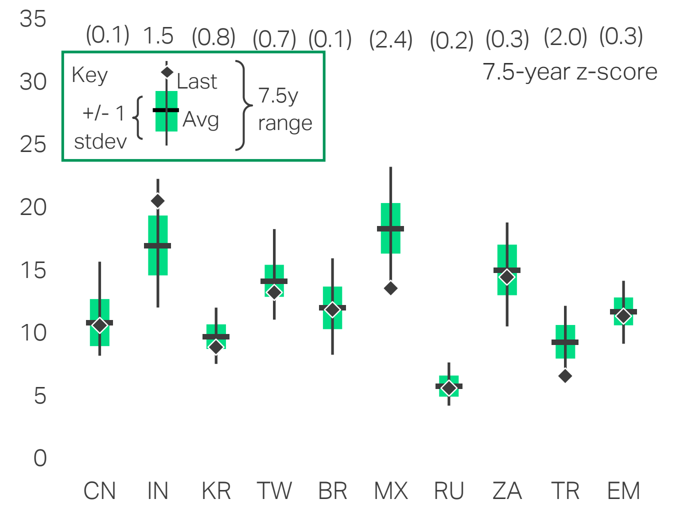
Source: Bloomberg

DM price-to-earnings ratio vs cycle



Source: Bloomberg, TS Lombard

EM price-to-earnings ratio vs cycle



Source: Bloomberg, TS Lombard

Equities dashboard

		MktCap	Total return LC			P/E (x)			P/B (x)			RoE			EPS growth		Dividend yield		
	Memb.	(US$)	1m	ytd	2018	Trail.	Fwd	StDev	Trail.	Fwd	StDev	Trail.	Fwd	StDev	Fwd	3m	Trail.	Fwd	StDev
World (AC)	2756	55,519	3.5	4.9	-9.0	15.7	13.9	-0.6	2.1	2.0	0.2	13.3	12.3	0.6	12.5	3.4	2.7	2.8	**1.0**
United States	620	24,299	3.9	5.4	-4.5	18.1	15.7	-0.3	3.2	2.9	0.8	16.2	16.4	0.7	15.5	3.7	2.0	2.2	0.7
Canada	91	1,491	6.3	6.6	-9.0	15.2	13.4	**-1.1**	1.7	1.6	**-1.4**	10.1	12.8	0.5	13.3	4.6	3.2	3.4	**2.2**
Japan	323	4,385	-2.9	3.5	-14.9	11.9	11.8	**-1.5**	1.2	1.1	-0.3	10.8	8.0	-0.2	0.8	-2.1	2.5	2.6	**1.5**
Australia	69	980	4.2	3.7	-0.5	15.4	14.8	0.0	1.9	1.8	-0.1	11.4	12.5	-0.4	4.1	-2.0	5.1	5.2	**1.6**
UK	96	2,302	1.0	1.7	-8.8	15.8	11.9	-0.8	1.6	1.6	**-1.4**	14.2	10.8	**1.3**	32.7	2.7	5.0	5.2	**3.8**
Switzerland	38	1,263	3.5	5.8	-7.6	22.1	15.3	-0.4	2.4	2.3	0.1	11.3	14.7	0.9	44.2	7.8	3.2	3.6	0.7
Germany	64	1,488	1.7	3.8	-17.7	12.4	11.4	-0.8	1.5	1.3	**-1.2**	7.5	11.1	0.0	9.0	7.4	3.4	3.8	**1.6**
France	79	2,018	0.2	1.6	-7.5	15.0	12.4	-0.8	1.5	1.4	-0.2	10.8	9.9	0.5	20.9	5.7	3.5	3.9	0.6
Italy	23	425	4.0	6.5	-13.3	N.A.	9.3	**-1.2**	1.1	1.0	0.1	9.2	8.6	**1.6**	18.6	12.7	4.3	5.3	**1.6**
Spain	22	566	2.6	4.9	-10.4	13.3	10.9	**-1.0**	1.2	1.1	-0.6	9.7	9.1	0.6	22.7	6.4	4.6	5.0	-0.2
Euro Area	246	5,639	1.3	3.3	-12.0	13.9	11.9	-0.9	1.5	1.3	-0.4	9.5	9.6	**1.5**	16.9	7.0	3.6	4.0	0.8
DM	1632	42,627	3.4	5.0	-8.2	16.3	14.3	-0.6	2.2	2.1	0.3	13.3	11.9	**1.3**	13.7	3.5	2.6	2.8	0.8
China	459	6,128	2.9	5.5	-18.7	12.1	10.7	-0.1	1.6	1.4	-0.4	13.6	12.5	**-1.2**	13.1	9.6	2.4	2.8	-0.3
India	78	1,177	0.1	0.5	1.4	22.3	20.6	**1.5**	3.0	2.7	0.8	13.5	11.9	**-1.9**	8.3	-6.8	1.5	1.6	0.2
Korea	115	1,045	2.6	4.1	-18.7	8.4	8.9	-0.9	0.9	0.9	**-1.9**	10.8	13.3	0.6	-6.3	-12.7	1.6	2.7	**2.8**
Taiwan	86	728	0.1	0.3	-5.3	12.2	13.3	-0.7	1.6	1.6	N.A.	13.6	13.1	**-1.1**	-8.0	-6.7	4.7	4.7	**2.0**
Brazil	52	760	10.5	8.5	16.7	19.2	11.9	-0.1	2.2	1.8	**2.1**	11.5	15.6	**1.9**	61.0	18.9	3.2	4.0	0.4
Mexico	26	255	8.3	5.4	-14.7	19.4	13.6	**-2.4**	2.1	1.9	**-2.5**	11.1	19.8	-0.4	42.8	11.2	2.7	3.1	**3.0**
Russia	23	485	4.7	4.7	17.8	5.3	5.7	-0.2	0.8	0.8	**1.0**	16.0	11.9	0.8	-6.8	-2.8	5.9	6.9	**2.2**
South Africa	49	403	5.0	2.3	-12.0	19.0	14.5	-0.3	2.1	2.0	-0.6	16.9	18.2	0.1	30.7	-2.0	3.2	3.4	0.3
Turkey	18	74	9.7	7.6	-17.3	7.1	6.6	**-2.1**	1.0	0.9	**-1.9**	15.4	12.8	**-1.3**	7.5	12.6	4.8	5.5	**3.3**
EM	1124	12,892	4.4	4.5	-14.5	12.1	11.4	-0.3	1.5	1.4	-0.5	13.1	12.5	0.5	6.2	2.5	2.8	3.2	**1.7**

StDev is the number of standard deviations from the 7.5-year avg (numbers below -1 and above 1 highlighted). All figures % unless stated otherwise. P/e, p/b, RoE and DY StDev from 7.5y average are on 12m forward measures. EPS growth is forward / trailing. EPS 3m growth is on forward earnings.

MSCI sector weights

%	US	Canada	Japan	Australia	UK	Switzerland	Germany	France	Italy	Spain	Euro Area	Brazil	China	Taiwan	India	Mexico	Russia	South Africa	Korea	Turkey	DM	EM
Industrials	9.6	8.8	21.8	6.3	9.6	7.8	14.6	21.6	9.7	11.4	15.2	4.8	7.1	2.3	5.9	12.9		1.6	9.1	21.9	11.4	6.4
Energy	5.5	19.5	1.0	6.1	15.2			9.6	18.8	6.9	6.2	13.5	3.4	0.9	12.3		61.4	1.2	2.2	8.4	6.0	7.4
C. Discr.	10.4	4.0	18.3	5.4	6.4	4.5	17.5	16.8	13.6	7.1	12.6	5.7	22.8	3.4	10.3	2.1		3.8	9.9	4.6	10.4	13.3
Healthcare	15.0	1.7	8.9	9.1	9.8	38.4	11.8	7.8	1.1	1.9	7.4	0.8	3.2	0.2	4.8			2.7	5.9		13.2	2.9
Financials	13.1	37.6	11.1	37.8	21.5	17.3	15.4	12.4	33.2	35.4	18.6	37.3	27.3	19.0	25.4	15.3	14.7	32.3	13.0	36.1	16.3	27.5
Real Estate	3.1		4.1	7.0	1.2						1.5	1.1	5.0	0.4				5.4			3.2	3.3
Utilities	3.2	2.7	2.3	2.1	3.4		3.7	3.6	18.6	19.7	6.1	4.4	3.5		2.9	1.6	1.0		1.5		3.4	3.0
Tech	20.0	4.2	9.6	0.7	0.8	0.7	12.6	3.8		7.5	8.5	0.7	4.2	53.5	14.1				37.8		14.5	10.8
Communications	10.3	6.4	8.7	3.2	5.7	1.1	6.3	6.1	3.2	10.1	5.6	2.7	16.5	5.5	2.6	15.3	3.2	35.6	7.6	8.1	8.6	11.8
Materials	2.7	9.7	5.8	17.2	9.5	5.4	10.1	5.3			7.2	19.0	2.8	11.4	9.3	15.0	13.8	10.4	7.2	7.4	4.6	7.0
C. Staples	7.0	4.3	8.3	5.3	16.9	24.2	3.7	9.9	1.7		10.4	9.9	4.2	3.5	12.4	34.6	5.9	7.1	5.7	13.5	8.4	6.7

Largest three sectors for each market highlighted

Sector price-to-earnings ratio (12-month trailing)

	US	Canada	Japan	Australia	UK	Switzerland	Germany	France	Italy	Spain	Euro Area	Brazil	China	Taiwan	India	Mexico	Russia	South Africa	Korea	Turkey
Market	17.8	13.9	11.8	14.9	11.4	20.1	11.4	14.7	10.4	12.6	13.1	16.6	11.7	12.1	21.0	18.4	5.2	17.4	7.7	6.9
Industrials	16.9	21.4	12.9	28.6	17.3	18.6	13.7	17.7	16.5	15.1	16.1	34.6	8.8	14.3	26.2	17.1		16.9	10.2	7.1
Energy	17.1	14.7	5.2	24.6	13.1			13.1	10.2	10.7	12.2	19.2	10.1	11.9	13.2		4.6	15.4	8.8	12.9
C. Discr.	21.9	12.9	9.6	18.1	14.3	12.0	7.5	14.8	9.0	21.0	10.6	22.8	27.8	12.3	27.4	20.9		12.7	12.5	13.5
Healthcare	19.9		24.5	36.4	36.3	18.3	12.6	23.6		23.7	17.0	15.6	19.0		22.0			15.8	69.1	
Financials	12.6	11.0	8.5	12.6	15.5	20.9	11.9	7.9	8.7	9.8	9.2	14.8	6.5	10.6	24.4	10.2	4.8	12.9	6.5	4.5
Real Estate	42.1	14.1	16.1	7.8	9.7	19.2	7.4				8.4		6.3	4.9		8.0		14.7		
Utilities	17.4	17.3	14.3	14.0	11.7		7.5	26.5	13.1	15.6	14.8	14.2	14.1		11.0		4.2			
Tech	18.2	29.3	14.4	25.4	15.3	56.9	25.0	19.0		25.5	23.1	7.1	11.6	12.7	20.4				5.5	
Comms	19.1	18.3	9.6	12.4	10.1	16.7	16.9	18.7		11.3	16.5	9.2	22.7	23.2	54.8	32.2	7.8	26.8	19.1	22.0
Materials	14.7	20.2	9.1	15.4	11.4	28.1	9.8	11.2			11.4	15.4	6.5	10.5	15.3	13.7	8.6	15.5	8.9	5.5
C. Staples	18.4	20.2	21.0	23.6	5.4	26.0	17.6	20.8			19.9	26.0	23.7	10.7	47.4	29.2	14.3	21.1	15.8	25.0

Sector 12-month total returns (local currency)

%	US	Canada	Japan	Australia	UK	Switzerland	Germany	France	Italy	Spain	Euro Area	Brazil	China	Taiwan	India	Mexico	Russia	South Africa	Korea	Turkey
Market	-3.9	-3.9	-15.2	4.0	-7.6	-3.0	-17.1	-9.1	-14.6	-10.1	-12.3	1.8	-21.1	-9.1	-0.4	-13.5	-2.0	-11.6	-17.2	-12.1
Industrials	-11.5	7.1	-17.2	4.9	-7.3	-21.3	-23.5	-7.6	-27.8	-3.4	-12.8	-5.2	-16.1	-10.6	-3.6	-3.4		1.5	-8.5	-8.7
Energy	-15.3	-9.4	-22.0	-2.1	-1.1			3.7	-1.9	6.2	2.5	12.3	-0.9	-4.6	8.1		12.9	7.2	-8.2	20.5
C. Discr.	2.2	-10.6	-15.0	0.4	-0.8	-23.4	-21.8	-6.7	-11.3	-15.1	-14.4	-9.4	-36.0	-8.3	-24.0	-22.4		-29.1	-20.2	-15.7
Healthcare	3.0	26.2	1.4	27.9	15.7	11.4	-28.2	1.5		-3.6	-13.5	-26.5	-24.4	-15.8	-8.0			-23.7	-29.2	
Financials	-11.1	-5.0	-20.4	-2.4	-16.1	-16.2	-12.4	-28.1	-25.0	-25.7	-22.6	10.8	-20.9	-0.4	2.4	-6.4	-26.1	-1.4	-22.5	-22.0
Real Estate	7.9	7.7	-7.1	8.9	-8.0	-5.0	8.8	-19.8			-7.8	-9.0	-14.5	6.7		-14.2		-20.0		
Utilities	10.1	-3.6	20.9	3.0	0.5		11.0	0.0	4.1	16.7	8.8	27.5	15.3		-9.7		-20.5		-1.2	
Tech	-2.7	17.3	-25.4	11.2	-16.3		-4.2	-19.4		3.1	-8.5	-62.5	-29.8	-15.2	21.2				-14.3	
Comms	3.2	13.4	-6.3	-8.3	-20.9	-1.1	-0.2	-5.5	-25.3	-2.9	-4.2	-14.9	1.4	2.9	-37.1	-17.1	-19.1	-18.6	2.7	-2.0
Materials	-15.4	-10.6	-26.1	7.2	-4.9	-10.9	-24.6	-14.6			-19.1	11.9	-22.3	3.4	-14.7	-30.3	6.3	0.5	-24.5	-19.9
C. Staples	-7.5	9.0	-4.7	9.6	-15.9	4.4	-12.3	0.9			-4.6	-23.2	-13.8	12.2	17.9	-4.6	-38.1	-15.4	-19.4	3.3

FIXED INCOME

Oliver Brennan

- **Making QT a policy tool is set to weigh on volatility**
- **We upgrade Aussie bonds from -1 to 0, but stay unchanged on the US**
- **We downgrade both Russia and South Africa from 0 to -1**

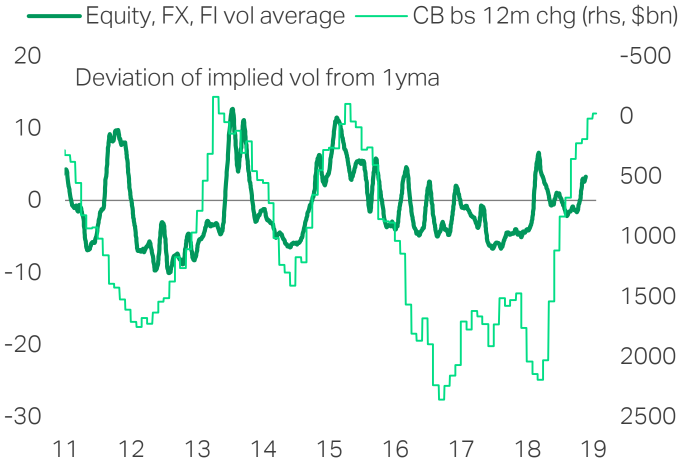
As we wrote in the Macro section, Federal Reserve Chairman Jerome Powell introduced flexibility around the central bank's current pace of balance sheet reduction (quantitative tightening, or QT) this month.

QT flexibility comes from unexpected market impact. Discussions of QT in FOMC meetings have, according to the minutes, focused on the true amount of excess reserves and therefore the target level of the balance sheet. In short, the Fed wants to shrink its balance sheet a lot further, but not to the point that it would create a shortage of reserves and push up money market rates. But Powell's new flexibility is couched in different language – the market impact of the pace of QT set against Treasury bond issuance.

In light of the huge widening in the US budget deficit, *net* Treasury issuance has been greater than the Fed might have initially estimated. This opens up the possibility that the Fed could fine-tune the pace of QT to offset the increased supply of Treasuries. As our US economist, Steve Blitz, puts it, look out for a QT taper.

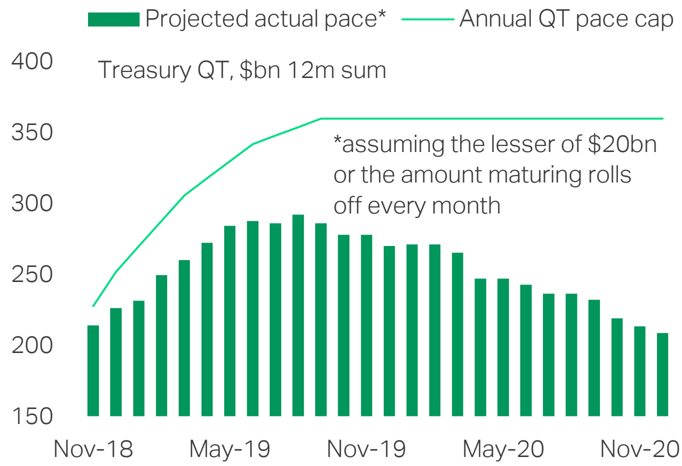
The most significant effect of this will be on volatility. The departure of a price-insensitive buyer, namely the Fed, has increased volatility, as we described in Macro Strategy last year ("Cold turkey", 21-Nov-18). If the Fed resumes participation in Treasury auctions in a small way, volatility will fall. The consequence of falling volatility is higher prices across asset classes. But we still reckon the US yield curve can steepen: if the Fed slows QT the purpose is to mitigate the impact of Treasury issuance, not to overwhelm it.

Less QE equals more volatility



Source: Central Banks, Bloomberg, TS Lombard

QT pace is already running below the cap

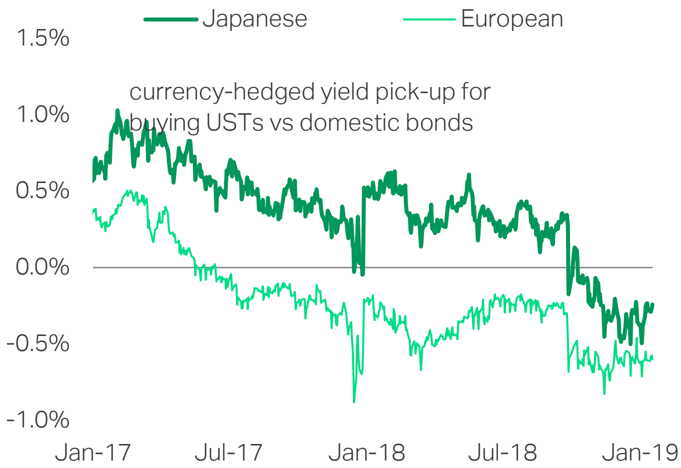


Source: NY Fed, TS Lombard

Falling FX reserves will cut EM Treasury demand

Source: PBOC, TS Lombard

DM investors: no incentive to buy Treasuries



Source: Bloomberg, TS Lombard

In fact, the real pace of Treasury QT is actually only $22bn a month, because the Fed is currently treating its self-imposed $30bn cap as a maximum rather than an average: if less than $30bn of the Fed's holdings of Treasuries mature the balance sheet will shrink by that amount; if more than $30bn matures the balance sheet will contract by $30bn. This leaves room for manoeuvre between the statement of policy and its execution. Announcing a new, slower Treasury QT pace of anything above $20bn/m would amount to no change in policy. By the same calculation, in 2020 the true rate will decelerate further to $17bn/m, ceteris paribus. (We ignore MBS QT in this analysis as it is largely driven by pre-payments, so it is both unpredictable and relatively unimportant to market liquidity.)

The Fed's balance sheet is still shrinking. Of course, to paraphrase former Fed Chair Janet Yellen in 2013, "tapering is not easing". But that did not stop the Fed losing control of policy during the taper tantrum back then, when US 10y yields rose from 1.7% to 3%. And the Fed must surely be cautious in going about any easing of monetary policy. Any error in signalling or execution could easily cause an inversion of the yield curve - something which is already very close but which we still think the Fed wants to avoid.

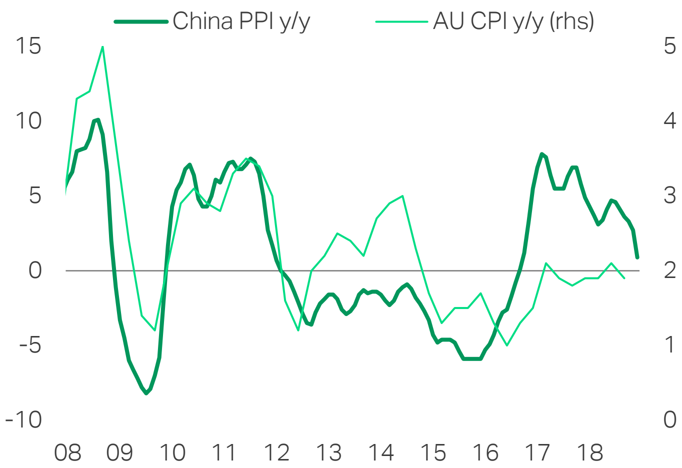
Recalibrating the pace of QT is the first step in Fed policy easing. We reckon rate cuts are the next step but, because of the disruption caused by the government shutdown, they may come into play only in Q4, once the Fed has a handle on Q3 'real' activity data.

Despite our view of an easier Fed, we remain underweight Treasuries this month. Two main factors suggest the neutral value for Treasury yields is closer to 3% than 2.5%. First, there are the effects of record Treasury issuance at a time when buyers are scarcer than before. In emerging markets, falling FX reserves imply reduced demand for US government debt, while in developed markets the currency-hedged Treasury yield for portfolio investors is negative. Second, the recent rally can be traced to an unwinding of speculative short positions combined with a fall in breakeven rates sparked by the drop in oil prices. Fundamentals (growth, current inflation, supply and demand) point to higher yields. Considering all this, the balance of risks warrants a continued underweight stance.

The unlucky country

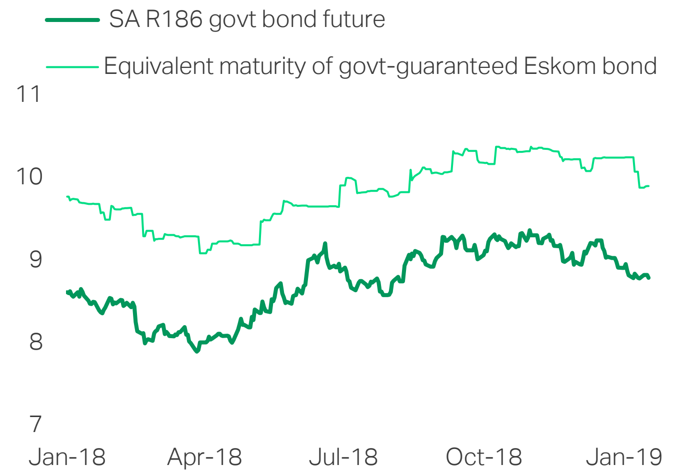
We remain negative on Treasuries, but this month we **upgrade Australian government bonds from -1 to 0**. Although the supply/demand balance in the US suggests a further rise in yields, recent developments in Australia make underweight positions look less attractive.

Australian inflation facing headwinds



Source: Bloomberg

South Africa yields face upside risk



Source: Bloomberg

The domestic Australian economy continues to face well-known headwinds, not least from housing. Home loan and investment lending growth are now negative year on year, and house prices in Sydney and Melbourne are falling at an annual rate of more than 7%. The RBA will remain defensive in this environment, and policy rate cuts are more likely than hikes. Australian CPI is already at the low end of the RBA's target range. Surging online shopping, which accounts for 6.6% of total retail sales, up by one-fifth since last year, is likely to weigh further on inflation. Externally, the prospect of PPI deflation in China will pile more pressure on Australian prices and increase the chances of rate cuts.

We also **upgrade Korean bonds from -1 to 0**. With the semiconductor cycle rolling over, Korean exports will slow. The central bank need no longer take a hawkish stance, and we return to neutral on the country's bonds.

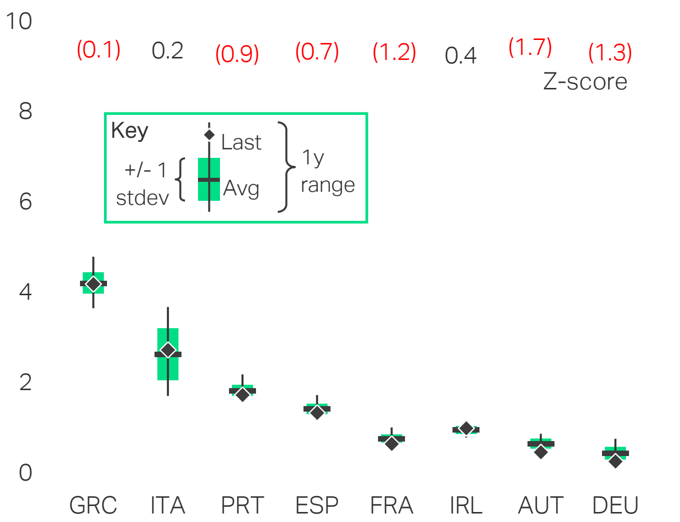
EM downgrades on risk outlook

Sentiment in favour of harsher sanctions against Russia is building. Draft legislation in the US Congress targets new Russian government bond issuance as well as state-owned banks. Whether and when new sanctions will be imposed remains uncertain, but Russia is unlikely to escape. We **downgrade Russian bonds from 0 to -1**.

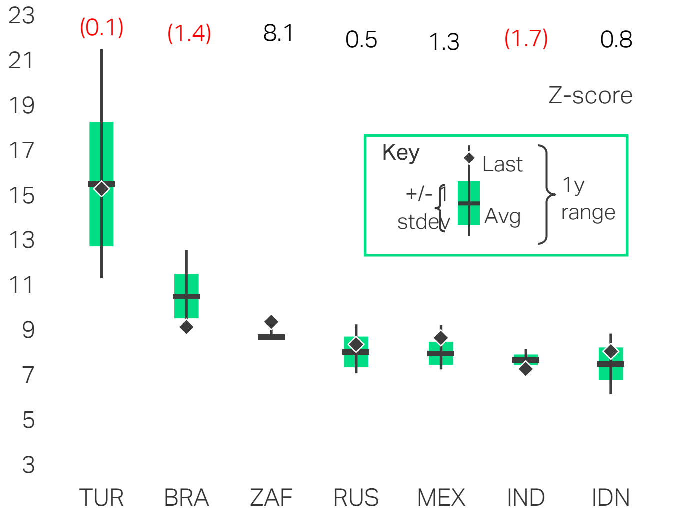
In South Africa, the lead-up to next month's budget speech dominates the risk outlook. In October's medium-term budget policy statement, the finance minister increased his deficit forecast to 4% and, with elections looming in May, the government is unlikely to tighten fiscal policy. Instead, the risk is of further loosening as Eskom – the SOE for which the government guarantees $30bn of debt – needs bailing out. The utility has proposed a 15% annual electricity tariff hike for each of the next three years to generate revenues to pay down debt, but this proposal would still leave $7bn of debt outstanding.

Socialising Eskom debt – which trades around 100bp above the equivalent-tenor government bond – would risk South Africa's creditworthiness. With the country's sovereign rating deemed investment grade by only one major rating agency (Moody's), the outlook for public debt is negative. We **downgrade South African government bonds from 0 to -1**.

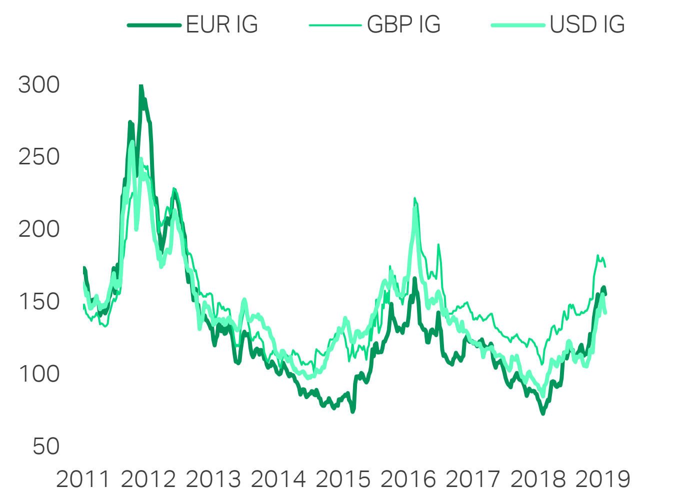
Euro area bond yields (%)



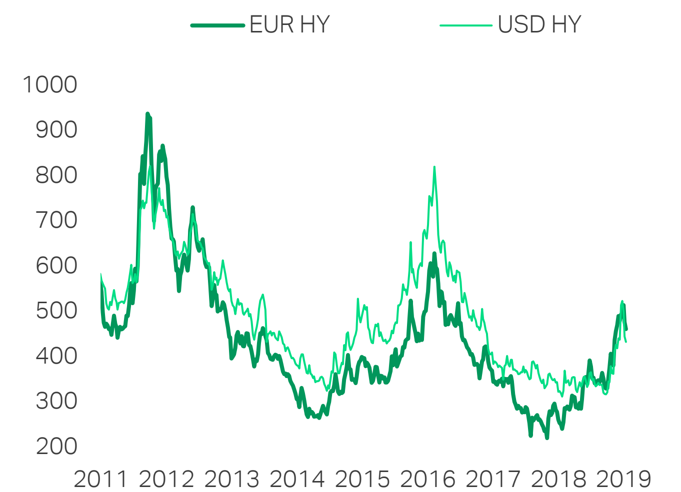
EM bond yields (%)



IG corporate spreads



HY corporate spreads



Government bond dashboard

	Policy	Inflation		2y yield		10y yield		7-10y total return			5y CDS (bp)		Money grth		Budg	Debt	GDP
	rate	Rate	Target	Last	StDev	Last	StDev	1m	ytd	2018	Last	StDev	Narrow	Broad	%GDP	%GDP	y-y
US	2.50	1.9	2.0	2.58	2.0	2.76	1.0	0.1	-0.6	1.7	47	N.A.	22.9	4.5	-4.2	82	3.0
Canada	1.75	1.7	1.0-3.0	1.91	1.4	2.00	0.1	-0.1	-0.4	4.0	47	N.A.	4.9	5.6	-0.4	90	2.0
Japan	0.10	0.3	2.0	-0.17	-0.9	0.02	-1.0	0.1	-0.2	1.3	86	N.A.	4.8	2.4	-2.6	236	0.0
Australia	1.50	1.9	2.0-3.0	1.84	-0.7	2.32	-1.1	0.8	-0.2	5.9	23	-0.9	4.2	1.9	0.5	42	2.8
UK	0.75	2.1	2.0	0.82	0.6	1.36	-0.7	-0.5	-0.5	2.0	36	N.A.	N.A.	0.8	-1.8	87	1.5
Germany	0.00	1.6	<2.0	-0.58	-0.9	0.26	-0.9	0.3	0.1	3.0	15	-0.4	6.7	3.7	1.0	64	1.1
France	0.00	1.6	<2.0	-0.47	-0.8	0.66	-0.9	0.6	0.4	1.4	38	-0.4	6.7	3.7	-2.7	97	1.4
Italy	0.00	1.6	<2.0	0.31	-0.5	2.74	-0.3	0.1	1.0	-2.9	207	0.1	6.7	3.7	-2.4	132	0.7
Spain	0.00	1.6	<2.0	-0.25	-0.8	1.34	-0.9	0.5	0.9	1.9	78	-0.6	6.7	3.7	-3.1	98	2.4
Brazil	6.50	3.8	2.5-6.5	7.81	-1.2	9.17	-1.4	-0.1	-0.3	11.9	180	-0.4	1.8	7.0	-7.1	84	1.3
Mexico	8.25	4.8	2.0-4.0	8.39	2.1	8.69	2.5	0.2	-1.0	3.3	132	0.3	9.0	5.5	-1.4	54	2.5
Russia	7.75	4.3	4.0	7.78	-0.2	8.41	-0.2	6.5	3.5	-14.0	137	-0.9	11.2	11.9	-1.7	19	1.5
Turkey	24.00	20.3	5.0	18.21	1.8	15.93	2.0	2.4	2.9	-1.9	344	1.7	N.A.	N.A.	1.5	29	3.1
S Africa	6.75	5.2	3.0-6.0	7.20	0.5	9.40	1.6	1.1	-0.1	8.6	203	0.0	5.2	5.7	0.2	53	1.1
Korea	1.75	1.3	2.0	1.79	-0.7	1.98	-1.1	-0.8	-0.1	0.5	34	-1.1	8.2	7.5	1.7	40	2.0

StDev is number of standard deviations from the 7.5-year average (numbers <-1, >1 highlighted). All figures % unless stated otherwise.

CURRENCIES

Oliver Brennan

- **EUR balance of payments signals strength but growth outlook signals wait**
- **We downgrade KRW from 0 to -1 on collapse in semiconductor demand**
- **But we are optimistic elsewhere and upgrade INR to 0 and TRY to +1**

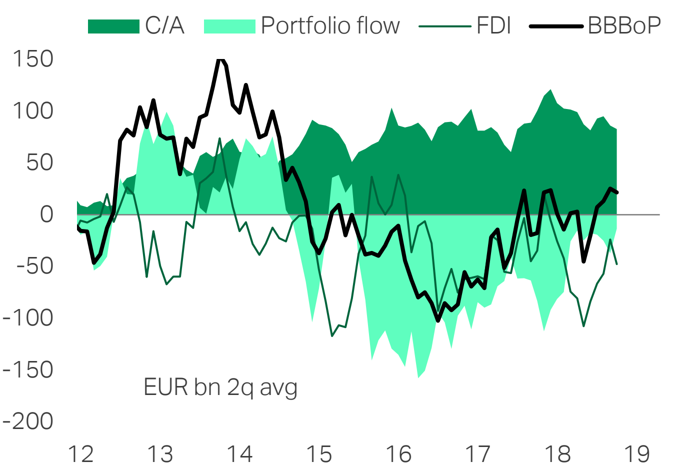
The euro area's broad basic balance of payments is in surplus (BBBoP: current account plus FDI and portfolio flows), for the first time since 2017. The shift is due to a slowing in portfolio debt outflows, which have almost ground to a halt as net flows to France and Germany have turned positive, and a pick-up in inward FDI. Last time the BBBoP swung from deficit to surplus, EUR rallied by 8%.

But the single currency is doing the opposite this time: the trade trade-weighted EUR index is 3% below its September high. This does not mean the bullish signal from the balance of payments is incorrect, but it does mean that other forces at work on the EUR are muffling the signal.

EUR's fair value depends on which part of the euro area one considers. The trading value of EUR is some weighted average of all the fair values. In Italy, fair value is probably below 1.10 whereas in Germany – an ultra-competitive economy when EUR is cheap – fair value is probably above 1.20. When Italian risks resurfaced last year, Italy become the dominant driver of EUR and the single currency fell towards that country's fair value.

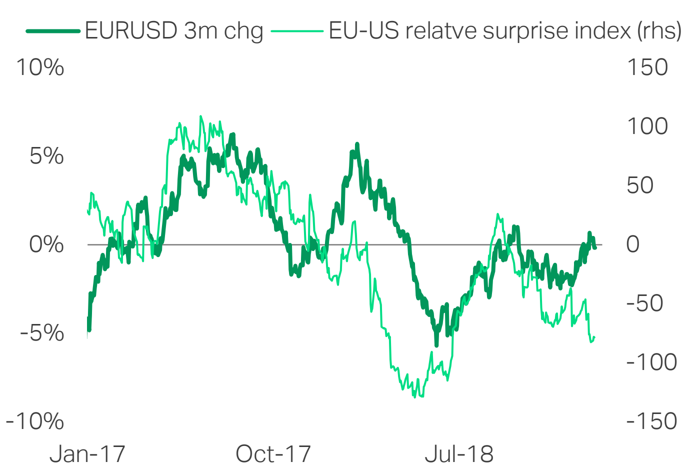
EUR stagnant despite lesser Italian risks. That is because, at the same time, Germany's fair value level has effectively declined due to a slowdown in the economy. After the negative GDP print in Q3 there was a risk that the country entered a technical recession in Q4; the Destatis full-year GDP estimate suggests Germany narrowly avoided a second consecutive quarter of negative growth. On balance, EUR has remained broadly unchanged. Unless and until the outlook brightens, either via growth expectations improving or the euro area surprise index

EA BBBoP in surplus is bullish EUR



Source: ECB, TS Lombard

But weakening data is bearish EUR

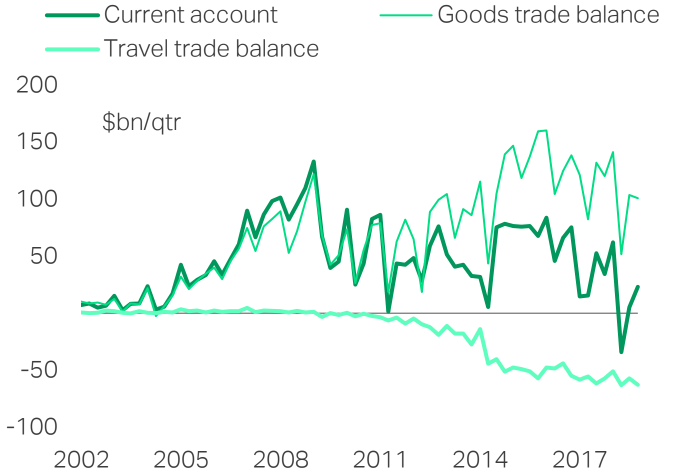


Source: Citigroup, Bloomberg, TS Lombard

Declining excess reserves have supported USD

Source: Federal Reserve, Bloomberg, TS Lombard

China's current account headed for deficit



Source: SAFE, TS Lombard

beginning to rise, the bullish signal from the BBBoP will be offset by the bearish signal from growth. As an aside, usually the bearish signal from growth would *cause* the BBBoP to fall, as portfolio investors sought better returns elsewhere, but the end of ECB QE has distorted this transmission channel.

Swedish export data suggest further weakness in German activity over the next few months, but we reckon the outlook should improve in the second half of the year and expect EUR to do the same: the single currency is likely to rally, but not yet.

Another factor which may lend support to EUR in time is the fate of the Fed's QT programme. In the Fixed Income and Macro Outlook sections we discuss Powell's QT put. If the Fed goes ahead with slowing the pace of balance sheet contraction, excess reserves are also likely to fall more slowly, eroding one of the dollar's props.

CNY depreciation pressure to increase. While EUR has so far confounded underlying financial flows, CNY has merely confounded our expectations. We turned negative on the renminbi last August as we feared a currency war was about to break out. Since then, we have become less pessimistic about developments in the US-China trade war, but we still expect renminbi depreciation as a necessary consequence of the looming swing of China's current account into deficit (Daily Note "China trade: worse to come in Q1", 14-Jan-19). China's goods trade surplus is likely to fall in coming quarters while its services deficit (mostly tourism imports) continues to swell.

The unexplainable boom in imports from Hong Kong – up 106% YoY in December (chart overleaf) – echoes a similar surge in 2015/16, when exporters used overinvoicing to disguise capital outflows. If the same is happening again, downward pressure on the renminbi will increase. We remain more bearish than the market consensus, which, according to Bloomberg, expects USD/CNY to end the year at its current level, and we retain our -1 stance on CNY.

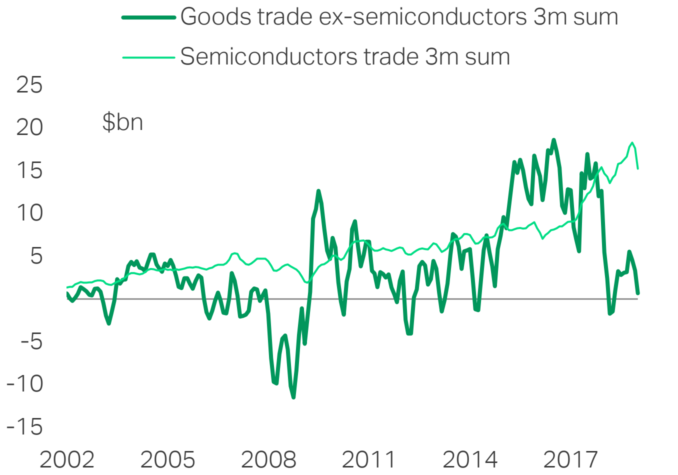
Changes this month: 2 down and 2 up

This month we **downgrade JPY from +1 to 0**. The yen has rallied by almost 5% since we upgraded in December and, after accounting for the downward-sloping forward curve, the USD/JPY rate one year out is around 105. This is the level at which Kampo said it would begin to buy unhedged foreign bonds, because hedging currency exposure at that rate eliminates any positive return, making it uneconomic. If Kampo is true to its word, other Japanese lifers will likely

Imports from HK may spell more capital outflows

Source: SAFE, TS Lombard

Korean trade surplus is entirely semiconductors



Source: BoK, OEC, TS Lombard

be looking to follow. There may be a little more upside to the yen, but the risk/reward calculation compels us to move to neutral.

We also **downgrade KRW from 0 to -1**. In this week's Macro Strategy ("Trade boom bust risk in KRW, AUD", 16-Jan-19) we showed how the entirety of Korea's trade surplus is thanks to its exports of microchips. Accordingly, the recent fall in semiconductor shipments – probably a symptom of the slowdown in smartphone demand which has also caught Apple by surprise – is likely to cut Korea's trade surplus and expose the won to depreciation pressure.

In the same note we also initiated a short AUD/CAD position. We turned bearish on AUD in last April's Asset Allocation ("Trade tensions and tech troubles", 17-Apr-18), only moving back to neutral in November ("Pause for thought", 16-Nov-18) on the risk of a long USD position unwind. But the currency is not out of the woods yet as the housing market continues to slow and Australia's trade is highly exposed to China. The risk of excessive exposure to China is all the more acute as we reckon any trade truce could include China agreeing to import more LNG from the US instead of Australia.

Our JPY and KRW shifts net off to a broadly risk-neutral stance, but our final two changes this month reflect increased optimism over the fate of some emerging market currencies.

In India, lower oil prices have arrived at just the right time to provide stimulus to a slowing economy. But we believe there is still the possibility of an interest rate cut as early as February. One MPC member voted to ease in December, so if new RBI Governor Shaktikanta Das adopts a dovish stance at his first meeting next month, it will take only one more vote to trigger a rate cut. Although this would reduce carry for currency investors, the positive impulse for equities and attendant capital inflows would probably outweigh any negative impact on the rupee. We **upgrade INR from -1 to 0**.

Talking of positive carry, investors brave enough to sell USD/TRY are rewarded with 1.5% interest per month. Of course, this could be wiped out on the first day of a Turkish military offensive in Syria or a renewed onslaught against journalists. Nor can we simply ignore the JPY flash crash, when USD/TRY rose by 8.9% in the twilight zone. But we reckon the recent stabilisation in the exchange rate – apart from Jan 3rd TRY has traded between 5.25 and 5.50 against USD since November – is a sign that the worst of the volatility is past. And if, as we suspect, the flash crash was triggered by Japanese retail investors covering short JPY/long carry positions, it is unlikely to be repeated in the near future. We **upgrade TRY from 0 to +1**.

Currencies dashboard

	FX	12m	Spot chg		REER chg			Policy	Inflation		CA %GDP		ToT		Money grth		Budg.	Debt	GDP
	spot	fwd	ytd	y-y	ytd	y-y	StDev	Rate	Rate	Target	Last	StDev	Last	StDev	Narrow	Broad	%GDP	%GDP	y-y
USD	96.10	–	-0.08	6.19	-1.1	4.5	1.2	2.50	1.9	2.0	-2.3	0.3	-14.3	0.8	22.9	4.5	-4.2	82	3.0
EUR	1.140	1.176	-0.62	-6.88	-1.1	-0.5	0.1	0.00	1.6	<2.0	3.3	0.9	-4.9	1.0	6.7	3.7	-1.0	86	1.6
JPY	109.5	106.1	-0.20	-1.48	0.3	5.3	-0.3	0.10	0.3	2.0	3.8	1.0	-18.5	0.9	4.8	2.4	-2.6	236	0.0
GBP	1.294	1.317	1.5	-6.9	1.1	-0.1	-1.0	0.75	2.1	2.0	-3.8	0.3	8.2	0.7	–	0.8	-1.8	87	1.5
CAD	1.327	1.317	-2.68	6.88	2.0	-4.9	-1.3	1.75	1.7	1.0-3.0	-2.8	0.8	2.3	-0.9	4.9	5.6	-0.4	90	2.0
AUD	0.718	0.722	1.84	-10.27	1.2	-6.3	-1.2	1.50	1.9	2.0-3.0	-2.2	1.1	21.4	0.3	4.2	1.9	0.5	42	2.8
CHF	0.994	0.959	1.23	3.68	-1.0	1.1	-0.4	-0.75	0.7	<2.0	10.0	0.2	-6.4	1.1	0.1	2.8	0.4	43	2.4
SEK	9.004	8.749	1.7	12.29	-1.1	-4.6	-1.3	-0.25	2.0	2.0	2.1	-1.9	-6.2	1.1	4.8	4.8	1.6	41	1.6
NOK	8.539	8.416	-1.17	8.82	1.7	-0.3	-1.0	0.75	3.5	2.5	7.9	-0.4	44.9	-0.6	-1.5	5.1	5.3	37	8.8
SGD	1.356	1.344	-0.52	2.64	0.1	0.6	-0.8	N.A.	0.3	–	18.5	-0.4	-3.4	1.0	0.4	3.5	8.6	111	2.2
CNY	6.772	6.812	-1.54	5.49	1.2	-1.3	0.1	4.35	1.9	3.5	0.4	-1.9	-12.6	0.8	3.6	8.1	-3.7	48	6.5
BRL	3.746	3.851	-3.32	16.23	2.5	-7.9	-1.0	6.50	3.8	2.5-6.5	-0.8	1.3	-6.1	-1.0	1.8	7.0	-7.1	84	1.3
INR	71.14	74.34	1.96	11.40	-2.4	-4.8	0.8	6.50	3.8	2.0-6.0	-2.4	-0.1	-32.2	0.4	13.6	10.2	-4.0	70	4.7
RUB	66.39	69.55	-4.77	17.47	5.1	-7.8	-1.0	7.75	4.3	4.0	5.5	1.7	37.9	-1.1	11.2	11.9	-1.7	19	1.5
ZAR	13.79	14.42	-3.87	13.69	4.2	-3.3	-0.5	6.75	5.2	3.0-6.0	-3.5	0.3	17.4	-0.1	5.2	5.7	0.2	53	1.1
MXN	19.06	20.18	-3.0	2.4	3.1	4.1	-0.9	8.25	4.8	3.5	-1.5	0.7	12.2	-0.2	9.0	5.5	-1.4	54	2.5
KRW	1122	1105	0.55	4.81	-1.7	-2.3	1.0	1.75	1.3	2.0	4.6	-0.3	-20.7	0.8	8.2	7.5	1.7	40	2.0
TWD	30.84	30.10	0.43	4.34	-1.7	-0.9	1.2	1.38	-0.1	–	12.7	0.5	N.A.	N.A.	6.4	3.1	0.2	35	2.3
PLN	3.768	3.732	0.81	10.78	-0.2	-4.9	-0.5	1.50	1.1	1.5-3.5	-2.1	-0.2	-4.0	1.3	12.5	8.8	-1.4	51	5.1
CZK	22.42	22.16	-0.05	8.22	0.3	-2.3	0.7	1.75	2.0	1.0-3.0	0.4	0.4	-6.4	1.1	12.3	9.4	1.5	35	2.4
HUF	280.0	273.6	0.04	11.16	-0.2	-4.3	-0.7	0.90	2.7	3.0	1.8	-0.7	-2.9	1.2	15.2	12.7	-2.2	70	4.9
TRY	5.368	6.400	1.5	42.5	-1.2	-8.0	-1.6	24.00	20.3	5.0	-5.6	0.0	-15.2	0.5	N.A.	N.A.	1.5	29	3.1
IDR	14187	15007	-1.41	6.29	0.9	-1.6	-0.5	6.00	3.1	3.5-5.5	-2.8	-0.6	-6.7	0.7	5.0	6.6	-1.8	29	5.2
THB	31.67	31.32	-2.70	-0.84	1.3	3.8	1.5	1.75	0.4	0.5-3.0	7.6	0.5	-16.7	0.9	6.6	4.8	0.3	42	3.3
MYR	4.113	4.127	-0.50	3.99	0.0	-1.7	-0.8	3.25	0.2	–	2.6	-0.7	-8.0	-1.2	3.3	7.4	-4.4	54	4.4
CLP	671.2	670.3	-3.24	10.76	2.6	-4.4	-0.8	2.75	2.6	2.0-4.0	-2.3	0.0	23.1	0.2	9.5	12.1	-0.3	24	2.8
COP	3133	3184	-3.58	10.03	2.7	-5.3	-1.3	4.25	3.2	2.0-4.0	-3.2	0.7	33.0	-0.6	N.A.	N.A.	-5.4	49	2.6

StDev is the number of standard deviations from the 7.5-year avg (numbers below/above -1/1 highlighted). All figures % unless stated otherwise

MODEL PORTFOLIO

Nikol Hearn

- **The model portfolio outperformed its benchmark by 29bp this month**
- **We decrease our government bond allocation by 7%, rotating into cash**
- **We reduce EM equities by 3%, rotating that into EM bonds**

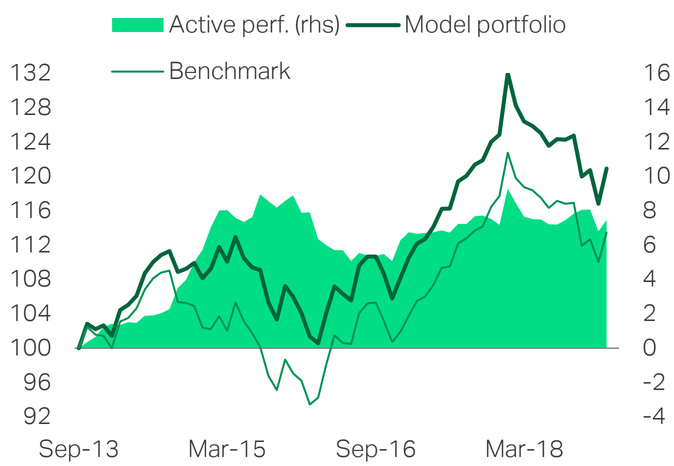
- Since the last update (14-Dec-2018), the portfolio has outperformed its benchmark by 29bp, gaining 1.76% vs 1.47%. Year to date, the portfolio is returning 3.50%, compared to the benchmark's 3.11%.
- The main source of relative outperformance in the past month was our EM Equity and Bond overweights of 3% each, which added 59bp and 43bp respectively. Our Brazilian and Mexican o/w positions were the biggest contributors, adding 22bp of outperformance to EM bonds and 23bp to EM equities.
- Our underweight exposure to DM bonds handed us a relative loss of 7bp. This was largely attributable to being u/w in US and UK bonds, which cost us 6bp and 4bp respectively.
- This month we cut our Government bond exposure by 7%, led by a reduction to US Treasuries and JGBs. This increases our u/w of long-duration assets. Conversely, we add to short-duration money markets and increase our cash allocation by 7% to 15%.
- We reduce our EM equity allocation by 3%, led by a downgrade to Chinese and Korean shares, and rotate that into EM bonds.
- We retain our overall o/w in equities. However, we have moved closer to a neutral positioning. We maintain our u/w in bonds, preferring cash to duration.

Model portfolio statistics

	Model Portfolio	Benchmark
Returns (since Sep-13)	20.9%	13.5%
YTD	3.50%	3.11%
2018	-6.4%	-6.5%
2017	15.4%	15.5%
Annualised return	3.6%	2.4%
Volatility	7.0%	6.8%
Sharpe Ratio	0.43	0.26
Sortino Ratio	1.02	0.65
Beta	0.98	
Alpha	1.3%	
Tracking error vol	1.8%	
Information ratio	0.66	

Source: Bloomberg, TS Lombard

Model portfolio performance



Source: TS Lombard

	Portfolio	Benchmark	O/W (U/W)	1m change
DM Equities	**33%**	**30%**	**3%**	**-1%**
US	19%	17.4%	2%	-2%
Canada	2%	1.1%	1%	-
UK	2%	2.4%	(0%)	-
Switzerland	1%	1.1%	(0%)	-
Germany	-	1.1%	(1%)	-
France	2%	1.1%	1%	-
Italy	-	0.3%	(0%)	-
Spain	3%	0.4%	3%	+1%
JP	3%	2.5%	1%	-
Australia	1%	0.8%	0%	-
Others	-	1.8%	(2%)	
EM Equities	**10%**	**10%**	**-**	**-3%**
China	2%	2.7%	(1%)	-3%
South Korea	-	1.5%	(2%)	-3%
Taiwan	-	1.3%	(1%)	-1%
India	3%	0.9%	2%	+3%
Brazil	3%	0.8%	2%	+1%
Mexico	1%	0.4%	1%	-
Russia	-	0.4%	(0%)	-
Turkey	1%	0.1%	1%	-
South Africa	-	0.7%	(1%)	-
Others	-	1.4%	(1%)	-
Government Bonds	**17%**	**30%**	**(13%)**	**-7%**
USTs	4%	12.0%	(8%)	-4%
Canada	1%	0.4%	1%	-
Bunds	2%	1.7%	0%	-
Gilts	-	2.3%	(2%)	-
JGBs	4%	6.6%	(3%)	-4%
OATs	-	2.1%	(2%)	-
BTPs	2%	2.1%	(0%)	-
BONOs	2%	1.2%	1%	-
Australia	2%	0.4%	2%	+1%
Others	-	1.4%	(1%)	-
IG Corporate Bonds	**7%**	**15%**	**(8%)**	**-**
US	6%	8.6%	(3%)	-
EA	1%	3.0%	(2%)	-
UK	-	1.1%	(1%)	-
Others	-	2.4%	(2%)	-
HY Corporate Bonds	**2%**	**5%**	**(3%)**	**-**
US	2%	2.8%	(1%)	-
EA	-	0.9%	(1%)	-
Others	-	1.3%	(1%)	-
EM Bonds	**11%**	**5%**	**6%**	**+3%**
Brazil	4%	0.5%	4%	+1%
Mexico	4%	0.5%	4%	+2%
Russia	-	0.3%	(0%)	-1%
Turkey	3%	0.4%	3%	+2%
South Africa	-	0.5%	(0%)	-1%
South Korea	-	-	-	-
Others	-	2.9%	(3%)	-
Commodities	**5%**	**5%**	**-**	**+1%**
Energy	5%	3.5%	1%	+1%
Industrial Met	-	0.3%	(0%)	-
Precious Met	-	0.2%	(0%)	-
Others	-	1.0%	(1%)	-
Currency Hedging	**-**	**-**	**-**	**-**
JPY	-	-	-	-
GBP	-	-	-	-
EUR	-	-	-	-
AUD	-	-	-	-
Cash	**15%**	**-**	**15%**	**+7%**

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