Our credit, liquidity, and money signals already suggest a high probability of weakening economic momentum later this year, leaving fiscal policy as the critical support. Cycles do not typically just die of old age and this one is unlikely to be an exception. The Fed is likely to push too hard on the monetary brakes in response to accelerating inflation, and this will eventually hurt risk assets. EM equities are in the firing line. Underweight equities and bonds with a preference for the U.S. dollar.

Our live theme overlay reinforces the defensive bias. There are a number of bubbles waiting to burst - including large cap equities and bonds - but the equity markets will be the hardest hit. The normalization of the term premium on Treasuries - as the Fed contracts its balance sheet - will be the dominant driver of market returns.

Few asset classes have attractive long-term return prospects. Our factor-based analysis calls for a marginal preference for equities and a mistrust of bonds. Equity value is concentrated in the emerging and frontier markets, which also offer better growth prospects. Excess returns on US equities will be negative.

Bottom Line: Investors should ensure that portfolios are well positioned to withstand the gathering storm that will likely hit asset prices hard in the next 6-12 months. We think investors should be already reducing risk.
1) Macro Overview

The data keeps supporting the late cycle thesis with central banks moving to crack down on moral hazard and provide leeway for rates to fall when the next downturn comes. Beyond the US it is difficult to spot major signs of inflation though, and as the BIS recently noted the path to rate normality without a major financial disruption is very narrow.

The rise in the dollar and the tightening by the Fed, which are mutually reinforcing, indicate that the neutral Fed funds rate may be lower than anticipated. With the fiscal stimulus from last years tax reductions likely to fade over the coming quarter, it is debatable whether the US can continue to be the holdout in the growing global economic slowdown.

A question we get frequently asked is what would happen if the Fed suddenly reversed course, and what would it take to trigger such an eventuality? Our response is not a level of wage growth or of unemployment but two or more increases in the unemployment rate coupled with poor non-farm payroll data. We are not there yet, but it’s worth remembering that U.S. monetary policy is not set in stone.

**Bottom Line:**

- The global business cycle expansion is looking shaky and will threaten earnings
- US fiscal stimulus will fade over the coming quarter resulting in a much tighter monetary and fiscal policy mix.
- Only a sustained rise in the unemployment rate would make the Fed change direction.

- Until then expect the US dollar to remain well bid as the arbiter of a growing shortfall of US dollars.
2) Investment Implications

As per last month, the bias is still to cash with the high probability of a Fed error. Our long-term factor-based forecasts are upbeat on selective parts of the investment universe—including EM and frontier markets—but these are the most vulnerable areas over a shorter horizon. In the past, tightening US financial conditions have hurt the developing markets and while greater exchange rate flexibility provides some latitude, this cycle should be no different.

The weak link in the chain is China (see most important developments) which is struggling to deleverage the system without igniting a credit crunch. This backdrop, along with a growing shortage of dollars in the global system and increased trade tensions, augurs poorly for risk assets, is US dollar friendly, and is hostile to commodities.

Last month, we observed that markets are losing their liquidity tailwind just as the global business cycle peaks. Such treacherous conditions warrant extreme caution, as we note in our most recent thematic piece “The New Eurozone Crisis.” While emerging markets are today’s problem, the eurozone is lined up just behind them. Italy is an accident waiting to happen and cannot grow its way out of a debt trap without fiscal largesse. It will take a market riot to get it.

**Bottom Line:**

- Stay tactically underweight in equities and especially EM and Europe.
- Further, reduce risk asset exposure on any short-term equity rally.
3) The Most Important Developments Over the Past Month

- Further tightening in global monetary conditions - the ECB's announcement to end QE in December but keep interest rates on hold until mid-2019 started the ball rolling followed by the Fed raising rates and announcing a quickening of its rate hike trajectory for this year.

- China remained in the firing line and therefore chose to buck the trend by announcing a reduction in the reserve requirements ratio. This should not be viewed as a monetary easing, however, with the central bank still determined to reduce the underlying gearing in the system. In the presence of exchange controls and directed lending it can simultaneously control the money supply and interest rates, but its heavy-handed crackdown on the banking system is only likely to further encourage fringe banking.

- Calm returned to the European markets, and the 10-year Greek yield premium over bunds shrank as it reached a debt rescheduling agreement. Italian politicians started to tow the line over the euro, but it is just of question of time before another crisis erupts. The country does not have the wherewithal to grow its way out of the debt trap.

- The increase in the quits ratio in the US indicates that people are leaving their jobs at a record pace, which should threaten margins. The earnings cycle after contracting between mid-2015 and 2016 and then staging a strong recovery again appears to be cresting, which combined with tightening monetary conditions is not good news for equities.

**Bottom Line:**

- Growth has been losing momentum outside the US, and US inflation has been climbing.
- China is paying the price for using non-market means of conducting monetary policy and is storing up a debt crisis.
- EM is in the firing line as US financial conditions tighten with exchange rate flexibility only partially compensating.
- Upward pressure on US Treasuries will be contained by the flight to quality keeping yields below 3%.
- Small cap US equities could gain at the expense of large caps as the dollar climbs.

![Figure 8: The ECB needs to reverse increasingly hawkish communications](image)

![Figure 9: European growth is already faltering](image)
4) Integrated Portfolio Strategy

Summarised in Figures 10-15, ClearMacro’s model portfolio aims to maximise relative performance across investment horizons, whilst integrating both investor judgment and ClearEngine’s multi-horizon systematic investment ratings. Anchoring on our SAA model, the Engine identifies critical performance risks and untapped opportunities, and our strategist team then utilises a Portfolio Diagnostic simulation tool to select the final portfolio.

Highlights

- Looking out beyond a 0-6m time horizon, return prospects are not inspiring for any asset class and while there is a marginal preference for equities over bonds, investors should be reducing total portfolio risk levels and moving to an underweight bond and equity position.
- ClearMacro’s model portfolio is overweight cash, and underweight both equities and govt bonds against a balanced benchmark.
- EM and the Frontier markets rescue long-term equity returns, but the tactical outlook for the developing world in a rising rate environment is precarious.
- We keep EM equity exposures light in the model, but EM exposure is enhanced via local govt bonds and EMFX.
- Despite medium-term concerns, EM currencies still look attractive long-term, driven by a long-term view of superior growth.
- No China and US equities.
- DM Govt bonds will be hurt by rising inflation expectations and the restoration of the term premium on long-term debt.

CM Bottom Line:

- We expect to de-risk the portfolio further either on additional equity price gains or on a deteriorating short-term risk appetite outlook.

This Month:

- We take advantage of the recent Greek debt deal to take profit on our long in Greek local bonds.
- We also reduce our U/W in US IG and UK equities.

Figure 10: Model vs cash bogey

Figure 11: Model vs balanced bogey
Figure 12: ClearMacro’s Investment Ratings rank investment universe return prospects by analysing return prospects across different investment horizons. An uninspiring outlook suggests caution.

Figure 13: These investment ratings, the benchmark selection, and investment horizon preferences drive our integrated portfolio construction. The objective is to maximise outperformance prospects across multiple time horizons. The below model is vs a cash benchmark.

A further breakdown of ClearMacro’s Multi-Horizon Investment Ratings and Model Portfolio is available on request (please click here).
Figure 14: The outlook for Global Equities is uninspiring. The US is the lowest ranked developed market.

Figure 15: We also show below the model portfolio vs a 60/40 Equity/Bond benchmark.
5) Strategic Asset Allocation (3-5+ years) Portfolio Strategy

A systematic growth, income, and value factor framework.

Summarised in Figures 16-20, ClearMacro’s SAA model portfolio optimises ClearEngine’s long-term return projections. These are built up from the expected contributions to each asset class and market, of growth, income and value factors. Based on a set of target risks and constraints, the Engine identifies an efficient portfolio to maximise risk-adjusted returns over the long-term.

Highlights

- Developed market bonds will be hit by the shrinkage of the Fed balance sheet and rising inflation expectations.
- Inflation-linked bonds will benefit from rising inflation and falling real rates, while EM bond returns are superior to DM owing to the income effect.
- High Yield valuations are expensive with mean reversion likely as the cycle matures. Negative excess returns are projected.
- Neutral on global equities, with better growth prospects and superior valuations driving a slight bias to EM and the Frontier markets.
- Commodities lose out due to slowing growth and rising rates.
- ClearMacro’s model SAA has a projected return of over 9%.
- Global equity allocation of 50%, but no US equities and only moderate exposure to China.
- Negligible exposure to DM govt bonds but significant weighting to EMFX.

CM Bottom Line:

- Low returns for passive asset class allocations.
- The best long-term return opportunities are in EM and relative value within asset classes.

Figure 16: SAA model vs cash bogey

Figure 17: Long-term projected returns for EM credit have moved more than any other asset class over the last 12m

Figure 18: Prospects for Swedish equities have risen more than any other country
A further breakdown of ClearMacro’s Long-Term Investment Ratings and Model SAA Portfolio is available on request (please click here).
6) Thematic Overlay (6-12+ months view)

ClearMacro’s thematics framework integrates qualitative long-term investment themes with our quantitative global macro screening process. Themes fit into one of three categories:

- **Within-cycle** - typically early-, mid-, and late-cycle plays.
- **Cyclical** - two or three themes dominate over the cycle such as Large Cap equities and IT during the 1990s, and housing and commodities during the first decade of the new millennium, which often become bubbles.
- **Multi-cycle** - which are ordinarily indicative of structural change.

Themes are assigned investability ratings - based on the credibility, pricing, and the overall return environment’s alignment with each theme - and can be monitored in our stand-alone theme portfolio.

**Highlights**

- There are cyclical bubbles in equities and bonds fuelled by QE that threaten to unravel as policy is tightened.
- But the **secular bull market in bonds is not over**. Yields may rise on a cyclical basis to correct overvaluation, but the structural forces of excess savings, globalization and technology remain substantial obstacles to sustained high inflation.
- **Trade friction** represents an assault on the rules-based institutional framework that has governed economic relations in the post-war period. The entrepot ports remain very vulnerable.
- **The eurozone is a financial timebomb** as Italy struggles in a debt trap. It cannot grow its way out of the problem, and it will need a central eurozone Treasury function to resolve the issue.

In the face of German resistance, this is unlikely without a market riot.

**CM Bottom Line:**

- Our themes are signalling a bearish tilt to EM based on their aggregate alignment.

Figure 21: The possibility of a eurozone breakup is rising.

Figure 22: Italy’s immediate future looks bleak.

Figure 23: And the political uncertainty has already done a lot of damage.
7) Tactical Portfolio Strategy (0-12 months)

A semi-systematic approach driven by rigorously tested indicators which are assigned ratings based on their historical reliability. We screen for opportunities that have both attractive medium-term return drivers (valuation support and strong cycle prospects) and where shorter-term dynamics are also favorable (a greater reliance on technical indicators). We assess the appropriate level for total portfolio risk based on an assessment of the outlook for investor's risk appetite.

Highlights

- The US dollar is king. Overweight cash, underweight bonds, and equities. Any short-term market bounce from technically oversold positions is an opportunity to lighten equity exposure further.
- EM and frontier markets as the highest beta equities should be shunned as US financial conditions tighten.
- The Fed is not supplying enough dollars to the global financial system and this should also hurt credit spreads.
- US core inflation at 2.8% is worrying for Treasuries, though they should continue to benefit from a flight to quality.

CM Bottom Line:

- It is a late cycle financial environment which will see further rises in the VIX.
- Overweight U.S. equities versus European and EM equities. European equities are demandingly priced, and growth is slowing rapidly.
Figure 27: ClearMacro’s Short and Medium-Term Investment Ratings are integrated to rank tactical return prospects on a 0 to 12 month time horizon. The outlook is cautious, but still supported in the near-term by strong activity and sentiment data. As we look out further towards 2019 however, prospects dim, with risks centred on EM and Frontier markets. Long $.

A further breakdown of ClearMacro’s Tactical Investment Ratings and Model Portfolio is available on request (please click here).
8) Tactical Trade of the Month (0-12 months)

Short EM versus US equities

We threatened to do it last month but chose to short the euro, but this time we are shorting EM versus US equities. Although the US business cycle expansion is more mature than the EM, there are several worries about the structural and cyclical frailties in the developing world including:

- A sharp slowdown in export growth even before Trump's trade policies begin to bite. In most cases, export to GDP ratios in the EM is at least twice the US ratio, and in the case of Singapore and Hong, the ratios are 172% and 187% respectively. China's ace would be to threaten supply chain disruption, but along the way, there will be major uncertainty.
- Credit tensions have been climbing. Turkey and Argentina have both been in the firing line, and there are several countries which are funding their current account deficits through short-term capital inflows. This did Thailand in during the Asian crisis of 1997/8 and South Africa in 1984. Any increase in economic uncertainty could quickly result in credit and liquidity problems.
- Politically, tensions in the EM have been climbing as our geopolitical indicator highlights, and they will almost certainly be exacerbated by trade tensions.
- China is tightening its policy stance and compensating by allowing the renminbi to depreciate and effectively exporting its deflation.

- The Chinese indices, and in particular, the Composite Shanghai index will the indices to monitor. While conditions look very oversold; it is also at levels which predict a major breakdown.

Further details of ClearMacro's TAA Overlay Portfolio is available on request (please click here).

Figure 28: EM economic sentiment dropping like a stone

![Figure 28](image1)

Figure 29: Sharp trade slowdown bad news for EM

![Figure 29](image2)

Figure 30: China Geopolitical risk at record bearish levels

![Figure 30](image3)
ClearMacro is an independent WealthTECH solution empowering smarter investment decisions.

Imagine... A centralised, modular platform generating forward-looking, global, multi-asset investment insight to power investment decisions across short, medium and long term investment horizons. Integrating systematic and thematic investment frameworks using a global macro screening capability. Your portfolio running LIVE - with profitable opportunities and risks highlighted.

This is ...ClearENGINE™... ‘Next Generation’ Investment Framework.