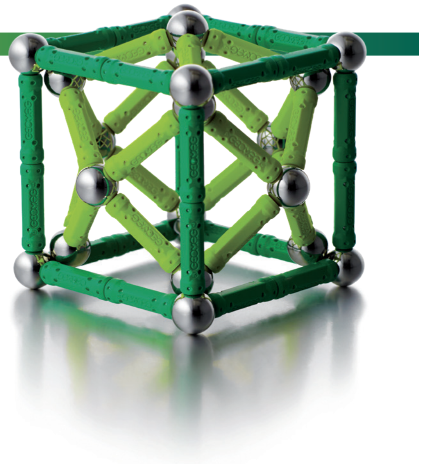


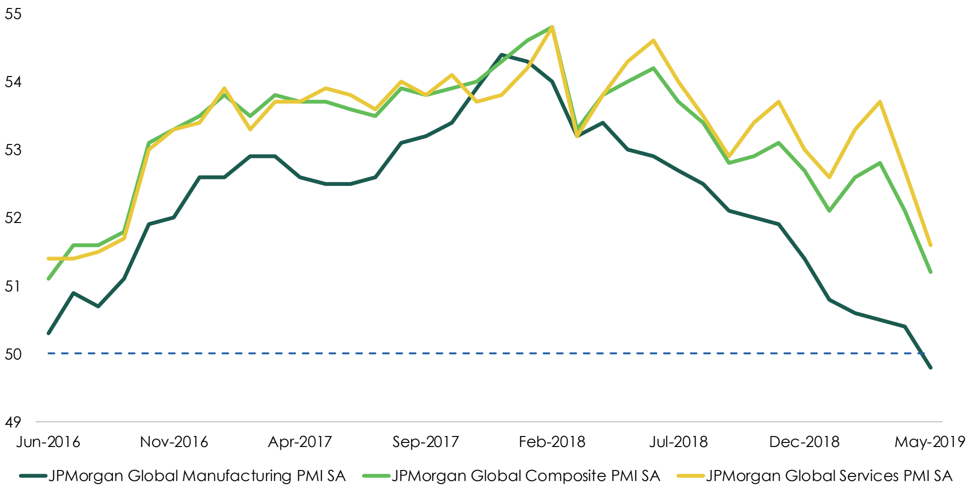
MACRO MONTHLY

US INTEREST RATES NEED TO FALL

JULY 2019

The global economy continues its descent with June PMIs showing no let-up for manufacturing. US, Japan, Chinese and European manufacturing PMI's all came in lower than expected for June as the trade war uncertainty continues to damage investment spending. Services data, being much less trade-based, have held up better but haven't been immune.

GLOBAL ECONOMY FLIRTING WITH RECESSION



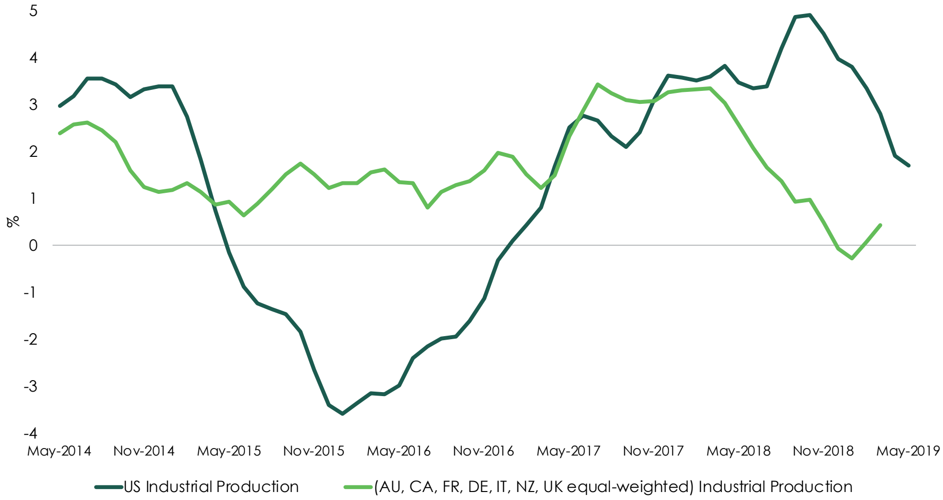
Source: Bloomberg, Macrobond as at 01/07/2019.

Investors are now looking to see if the economic weakness begins to spread, affecting domestic consumption via weaker employment. There are few signs as yet but employment data is notoriously lagging and higher wages are seeing investors hold out hope that this will remain contained. However, with the trade war showing no sign of ending, it feels this outcome is just a matter of time.

US POLICY SENSITIVITY

As we have discussed all year, there are two major problems for markets at the moment. First, the trade war, whose indirect impact has been to take a big chunk out of global growth via the knock to business spending. This impact really kicked in in the second quarter as stock building delayed the severity of the downturn by a few months, but that temporary boost has now waned. What has changed from last year? Well, the US itself is now also slowing as the fiscal stimulus that masked the corporate spending downturn wears off. This brings the US more in line with the rest of the world and so makes US policy much more sensitive to global developments.

AS STIMULUS WEARS OFF AND TRADE WARS TAKE EFFECT, US GROWTH IS TURNING LOWER



Source: Bloomberg, Macrobond as at 01/07/2019.

DOLLAR DIFFICULTIES

The second problem is the strength of the US dollar in a world that is heavily reliant on the greenback as a funding currency. Clearly, a strong dollar that is becoming more difficult to source outside the US will only provoke deleveraging of those borrowings that adds to the negative forces on the global economy. Current US policy by both the government and central bank is resolutely dollar positive. The strong dollar also prevents China (and various dollar-dependent emerging markets) from cutting interest rates; something very negative given slumping growth.

TRADE WAR RUMBLES ON

The trade war doesn't look to be ending any time soon. We have been expecting a truce and this weekend's development are not a surprise to us given the easy win-win outcome for both leaders. It wasn't difficult for the US to agree to ease back on Huawei restrictions (let US corporates sell them software) and for China to agree to buy more US goods (agriculture products). However, just as this is a short-term boost centred upon their common ground, it also demonstrates how far apart they are on all the other issues. The bottom line is that a permanent deal remains very difficult to obtain given the damage it would do to both leaders.

FED LOOSENING THE ONLY OPTION

What these problems all amount to is that the US Federal Reserve's (Fed's) monetary policy is too tight given the state of the global economy; the Fed needs to cut short-term interest rates by 75-100bps at least. This will not only support domestic growth – which now clearly needs it – but will also correct the over-tightening the Fed inflicted on the US last year. It will also help weaken dollar and thereby support growth outside the US. A weak global economy and high US interest rate boost the dollar – that is bad for both the US and overseas. The Fed does not seem to grasp this.

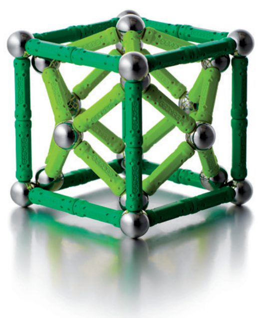
FED FUND EXPECTATIONS HAVE COME DOWN DRAMATICALLY

Source: Bloomberg, Macrobond as at 01/07/2019.

The Fed has attempted to get dovish and talk about them delaying hikes/pausing/insurance cuts but it doesn't take long for weakness outside the US to catch up – thus propping up the dollar once again. If the Fed refrains from easing, faltering US growth and tightening financial conditions via a strong dollar will hit US credit and equity markets, much like the pain seen in the final quarter of 2018. The recent Fed tack to back an insurance cut was deemed a success in heading off this risk aversion. However, until the Fed realises it needs to do a lot more given slumping global growth, markets will stay under pressure. Given this, it's clear to us that barring a miraculous improvement in growth in the rest of the world, the US front end and with it the US dollar need to fall. If the Fed doesn't act soon or at least support the markets' pricing of this – the collapse in risk sentiment and falling markets will force their hand. Slumping growth and too-tight financial conditions makes this inevitable.

LONG FRONT END, SHORT USD

So whilst we are cautious on risk given the above, the clearer trade here is long the front end of the USA and short the dollar. Once the Fed does the right thing, only then will risk markets be a much safer bet (as the end game is easier policy globally enabled by a weaker dollar). We admit we have recently – after the big bond rally – been considering duration shorts as we try to judge whether the repricing has been sufficient given the state of the global economy. However, recent terrible PMI prints, trade war developments and the lacklustre rally in risk markets lead us to think more needs to be done as central banks attempt to recalibrate on the back of the changing political backdrop. Interest rates in the US need to fall.



THE MODEL PORTFOLIO

ALPHA FACTOR	CONVICTION WEIGHTS (PER SECTOR)	DIRECTION	Exposure (weighted duration or %)	Risk Cont. (TE,bps)	Risk Cont. (%)
CREDIT		NET LONG	0.40yrs	55	19.2
US / EUR Coco bonds	100%	LONG	0.40yrs	55	19.2
Developed Market Rates		NET LONG	0.35yrs	42	14.6
US	20%	LONG	0.75yrs	-14	-4.9
UK	5%	LONG	0.25yrs	-6	-2.1
Germany	15%	SHORT	-1.50yrs	7	2.4
France	5%	SHORT	-0.40yrs	0	0.0
Cyrpus	10%	LONG	0.40yrs	5	1.7
Italy	15%	LONG	0.55yrs	15	5.2
Greece	25%	LONG	0.50yrs	32	11.1
Sweden	5%	SHORT	-0.20yrs	3	1.0
Hard EM Rates		NET LONG	0.15yrs	6	2.1
Saudi Arabia	100%	LONG	0.15yrs	6	2.1
Local EM Rates		NET LONG	0.80yrs	32	11.1
Indonesia	40%	LONG	0.35yrs	15	5.2
Mexico	30%	LONG	0.25yrs	9	3.1
Russia	30%	LONG	0.20yrs	8	2.8
FX (vs. USD)		NET LONG	15.00%	84	29.3
Australian Dollar	10%	LONG	2.50%	11	3.8
British Pound	15%	LONG	4.00%	14	4.9
Chilean Peso	10%	LONG	1.50%	10	3.5
Euro	5%	LONG	3.00%	8	2.8
Indonesian Rupiah	10%	LONG	2.50%	9	3.1
Japanese Yen	15%	SHORT	-2.00%	1	0.3
Mexican Peso	10%	LONG	1.50%	8	2.8
Polish Zloty	5%	LONG	1.00%	5	1.7
Russian Ruble	10%	LONG	2.00%	11	3.8
South African Rand	5%	LONG	1.00%	9	3.1
Swiss Franc	5%	SHORT	-2.00%	-2	-0.7
Inflation		NET LONG	3.20yrs	68	23.7
European Inflation	40%	LONG	1.15yrs	35	12.2
Japanese Inflation	10%	LONG	0.55yrs	2	0.7
US Inflation	50%	LONG	1.50yrs	31	10.8
			Total	287	100

Source: Merian Global Investors, as at 27/06/2019.

FUND MANAGERS

Mark Nash and Nicholas Wall manage the Merian Global Strategic Bond Fund and Merian Strategic Absolute Return Bond Fund.

MARK **NASH**

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

NICHOLAS **WALL**

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

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