

MACRO MONTHLY

BRIGHTER TIMES AHEAD

KEEP WATCHING THE DOLLAR

OCTOBER 2019



We follow on from last month's macro monthly 'Stay liquid and keep focus on the Fed and the US Dollar' with some interesting developments that have made us shift our portfolio stance in line with ideas presented in that piece and all year in this publication.

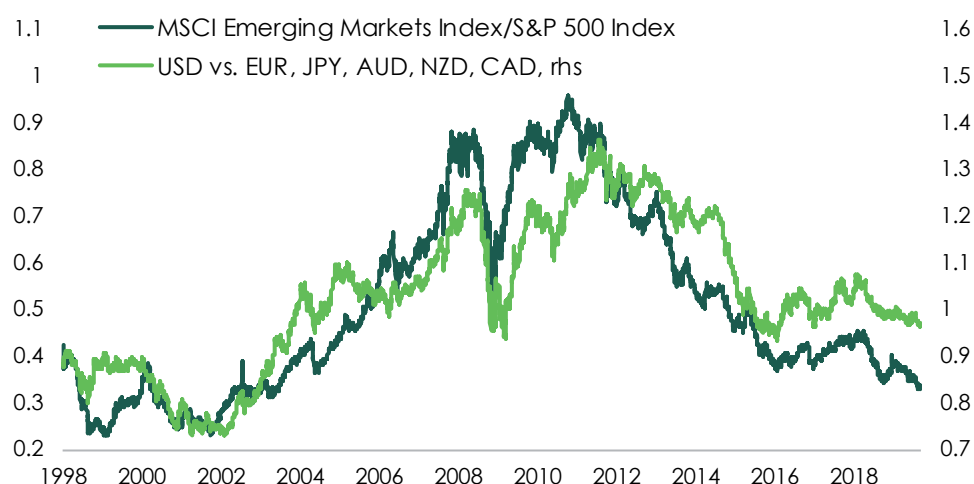
Overall, the core problems facing the global economy have been from three main struts this year: the direct and indirect trade war impact, Brexit uncertainty and a strong US dollar tightening global financial conditions.

Thus our thesis over recent months has been the global macro outlook is severely challenged due to the political backdrop, which is made worse by a too-strong US dollar, therefore long government bonds remain the place to be. Due to events over last two weeks, we seem to have more clarity over the US economic direction, which is opening up opportunity and changing the path for markets.

US VS ROW GAP CLOSING?

An important differentiation over the last year is that the US is not leading but lagging the downturn, and this has altered how the markets operate. US growth is outperforming in the global downturn and causing the dollar to remain strong. The wide rate differential on US and rest of the world rates has primarily caused this, and this gap needs to close to escape the current dynamic. Recent events are suggesting this is happening with weak ISM manufacturing and services data demonstrating that the growth differential is now closing. This is very significant and could be the key to a rotation in global markets and put an end to the global deflationary dynamic that's gripped markets for over a year.

GLOBAL FUNDING CYCLE



Source: Macrobond as at 07/10/2019.

THE DOLLAR PROBLEM

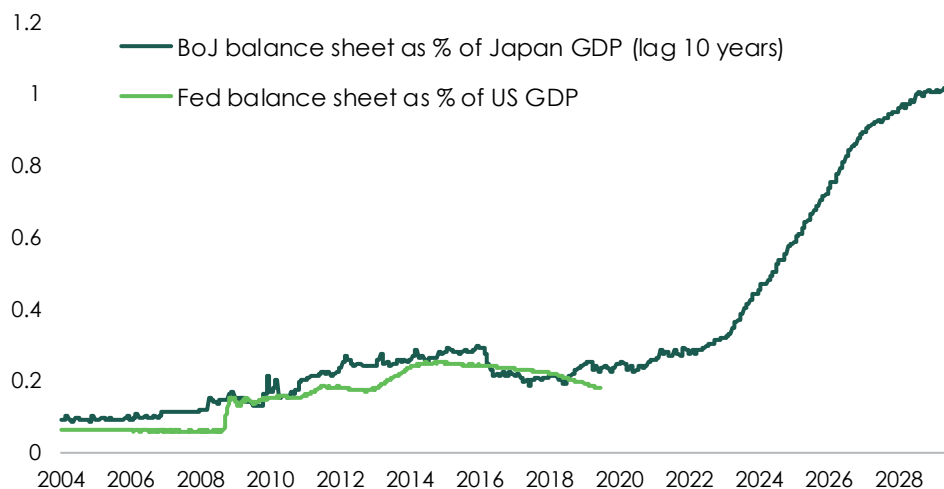
The reason the dollar is a problem is that local central banks cannot ease monetary policy enough to support flagging levels of economic growth. Outflows into the strong reserve currency have the damaging effect of sucking liquidity out of emerging markets – tightening local financial conditions. Most importantly, China is unable to cut interest rates to boost domestic demand from its untapped consumer sector – as it would risk uncontrolled currency weakness. This is a big problem given emerging markets are now 60% of global GDP – having risen meaningfully in the recent decade. The net effect is a lopsided liquidity dynamic hindering the monetary policy response from a very large part of the global economy and underperformance of non-US assets over the past year.

For this to change the dollar needs to fall and there are two ways that can happen: first through interest rate cuts from the Federal Reserve (Fed) lowering T-Bill yields, and second with a pick-up in global activity (or trade war/Brexit breakthrough) supporting sentiment. Both have the same effect: capital flows out of US assets into global assets easing conditions and giving global growth a chance. But the picture is not complete, as global activity hasn't picked up much yet nor has there been a meaningful change in the politics.

TIGHTENING IS OVER

The recent developments in the repo market will also accelerate the Fed's easing cycle. The Fed's measure of excess reserves was overestimated and issuance in T-bills to fund the US deficit has left the overnight funding market susceptible to drying up – the Fed effectively lost control of the front end in September. Whether they like it or not, the Fed is going to have to conduct repo operations on a more permanent basis, swapping cash for T-bills, to keep this vitally important part of the market operating efficiently – the deficit funding is only going in one direction and foreign sector funding of the US deficit has stalled as a percentage of issuance. This means that not only is QT over, but that the Fed is going to start increasing its balance sheet again – a policy announcement is expected at the October meeting and this is US dollar negative.

HISTORY REPEATS?



Source: Macrobond as at 07/10/2019.

Lower US interest rates are a positive step towards our endgame scenario, together with the view major economies will do all they can to support domestic demand and will now rely less on global trade.

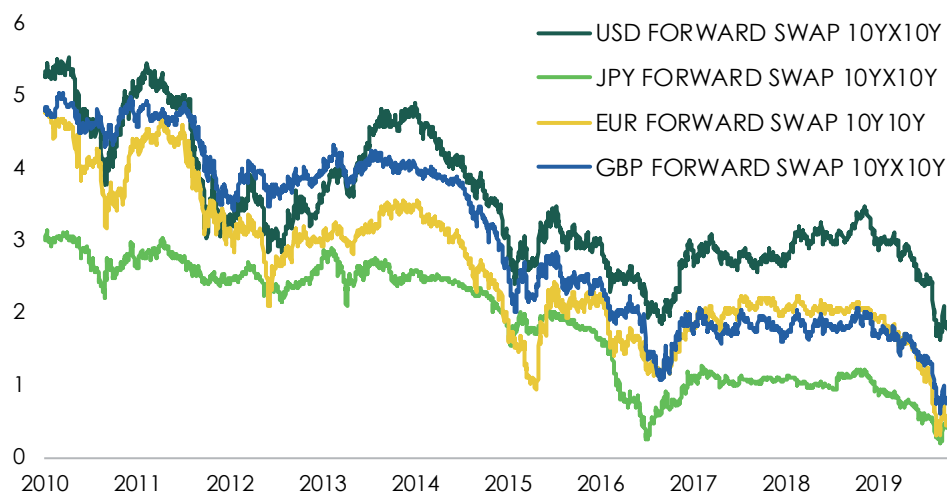
With the Fed getting rates down and weakening the dollar this will allow much needed easing in emerging markets, in global US dollar borrowing conditions and in China interest rates that will support global growth and lower deflation fears.



WHY NO US RECESSION?

Global recessions are caused by a tightening in financial conditions either through higher inflation causing central bank rate hikes or problems with the credit mechanism that deny credit access for the economy. The tightening in dollar financial conditions fell in the latter category, presenting a credit blockage that posed a serious risk to growth. This helped explain the extreme moves in bond yields and inflation expectations in the market. In fact as things stand the markets price in considerable risk of Japanification of the global economy, European rates sub Japanese rates and US yields at record lows.

10YR10YR FORWARD RATES



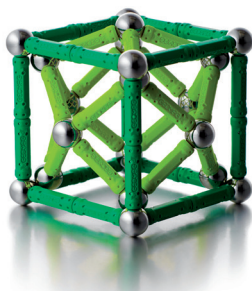
Source: Macrobond as at 07/10/2019.

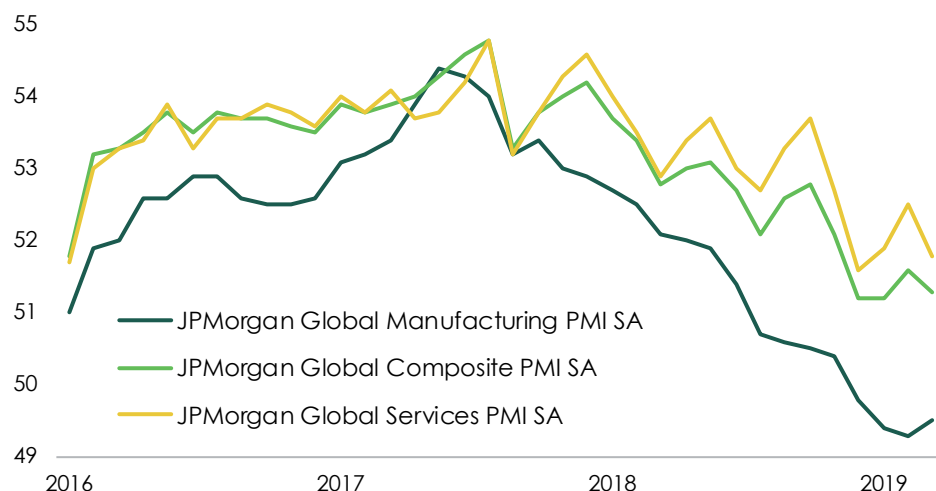
If this impact starts to wane with an easier dollar then government bonds may underperform (although, to be clear, we like the US front end in order to achieve this) regardless of the fact the US economy is slipping.

In any case we believe that the current political backdrop and the rise of populism won't allow this outcome when governments can borrow at such low cost. In short the global private sector having reduced debt since the crisis remains in good shape with access to credit – these are not normal recessionary conditions. It is of course possible for self-inflicted political moves to cause pain (oil shocks) but trade uncertainty is more a slow burn than a shock that can be countered by policy offsets (lower rates and fiscal spending).

NOT GUNG HO YET

We concede that a key necessary step for reflation and more market positivity is a stabilisation in the global economy. Manufacturing has led the way down with some fleeting signs that services, consumption and employment are also coming under pressure. Newsflow could worsen before any pick up and sentiment could remain on edge as the market tries to determine how bad the global economy is. However, given extreme deflationary pricing the outlook is improving, and we can't emphasize enough signs of a thaw in global dollar conditions is a positive if it continues. Signs that growth isn't slumping meaningfully will likely see a positive risk tone for yield hungry markets. And it goes without saying any good news on the political side will see dramatic moves given investor sentiment and the world looking radically different on a tweet.



GLOBAL ECONOMY FLIRTING WITH RECESSION

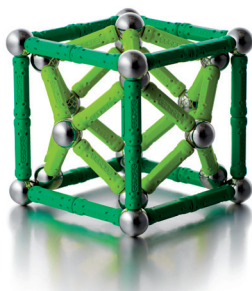
Source: Macrobond as at 07/10/2019.

EM OFFERS OPPORTUNITY

If we are correct and liquidity flows from US asset markets to more risk-seeking avenues in Emerging Markets (EM), this will naturally support investment in these assets as well as buoy growth. Considering the market's perception that recession risk has risen with the weak US data, EM ownership might seem counterintuitive – however this isn't a normal downturn. Due to the liquidity squeeze over the last year as discussed above, EM is under-owned. As flows return there should be little to stop a trend igniting. Usually when a downturn hits, the US has low relative rates and pre-emptively has been cutting rates, and this has pushed the market long EM. Not this time round, due to the extraordinary narrowing of the US vs EM growth gap over the last year. Clearly further slumps in growth data and there are dangers to risk assets but any calm and dips should be bought for the medium to long term.

FALLING DOLLAR IS GOOD START

To sum up, we have now closed our duration longs but to be more confident in the global reflation theme some better news on the geopolitics is needed. Until this comes we keep risk levels low but a falling dollar is a good start as it has been a key source of the deflationary problems the world has been facing over the past year. If these stars align then the market would be pushing on an open door as everyone is long government bonds, gold, the dollar and under-owned in risk assets outside the US. Moving long global risk assets, long inflation, yield curve steepeners and long EMFX should open up good upside. We are remaining long US front end, Italy and Greece and more cautious longs elsewhere.



THE MODEL PORTFOLIO

ALPHA FACTOR	CONVICTION WEIGHTS (PER SECTOR)	DIRECTION	Exposure (weighted duration or %)	Risk Cont. (TE,bps)	Risk Cont. (%)
CREDIT		NET LONG	0.05yrs	32	9.1
US / EUR Coco bonds	55%	LONG	0.30yrs	17	4.9
Buy USD CDX HY	45%	SHORT	-0.25yrs	15	4.3
Developed Market Rates		NET SHORT	-2.25yrs	109	31.1
US	20%	SHORT	-0.60yrs	19	5.4
UK	5%	SHORT	-0.25yrs	5	1.4
Germany	20%	SHORT	-1.65yrs	19	5.4
France	10%	SHORT	-0.70yrs	12	3.4
Spain	5%	LONG	0.05yrs	3	0.9
Italy	10%	LONG	0.40yrs	11	3.1
Greece	20%	LONG	0.55yrs	37	10.6
Australia	5%	SHORT	-0.25yrs	8	2.3
Canada	5%	LONG	0.20yrs	-5	-1.4
Hard EM Rates		NET LONG	0.40yrs	41	11.7
Angola	25%	LONG	0.10yrs	10	2.9
Ghana	15%	LONG	0.05yrs	5	1.4
Ivory	15%	LONG	0.05yrs	5	1.4
Nigeria	20%	LONG	0.10yrs	11	3.1
South Africa	25%	LONG	0.10yrs	10	2.9
Local EM Rates		NET LONG	0.55yrs	10	2.9
Indonesia	35%	LONG	0.15yrs	6	1.7
Mexico	40%	LONG	0.30yrs	2	0.6
Russia	25%	LONG	0.10yrs	2	0.6
FX (vs. USD)		NET LONG	16.50%	84	24.0
Australian Dollar	10%	LONG	2.00%	8	2.3
Brazilian Real	10%	LONG	1.50%	9	2.6
British Pound	5%	LONG	1.50%	6	1.7
Chilean Peso	5%	LONG	1.00%	6	1.7
Euro	15%	LONG	4.50%	10	2.9
Indonesian Rupiah	10%	LONG	2.00%	5	1.4
Japanese Yen	5%	SHORT	-2.00%	3	0.9
Mexican Peso	10%	LONG	1.50%	8	2.3
New Zealand Dollar	5%	LONG	1.00%	4	1.1
South African Rand	15%	LONG	2.00%	17	4.9
Russian Ruble	10%	LONG	1.50%	8	2.3
Inflation		NET LONG	2.75yrs	74	21.1
European Inflation	40%	LONG	0.90yrs	40	11.4
US Inflation	50%	LONG	1.30yrs	31	8.9
Japanese Inflation	10%	LONG	0.55yrs	3	0.9
Total				350	100

Source: Merian Global Investors, as at 03/10/2019.



FUND MANAGERS

Mark Nash and Nicholas Wall have managed the Merian Strategic Absolute Return Bond Fund since 1 August 2016.



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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GLOBAL INVESTORS

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