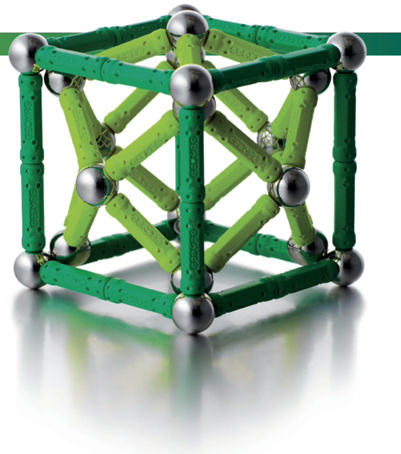


MACRO MONTHLY
STAY LIQUID AND KEEP FOCUS ON THE FED AND THE US DOLLAR

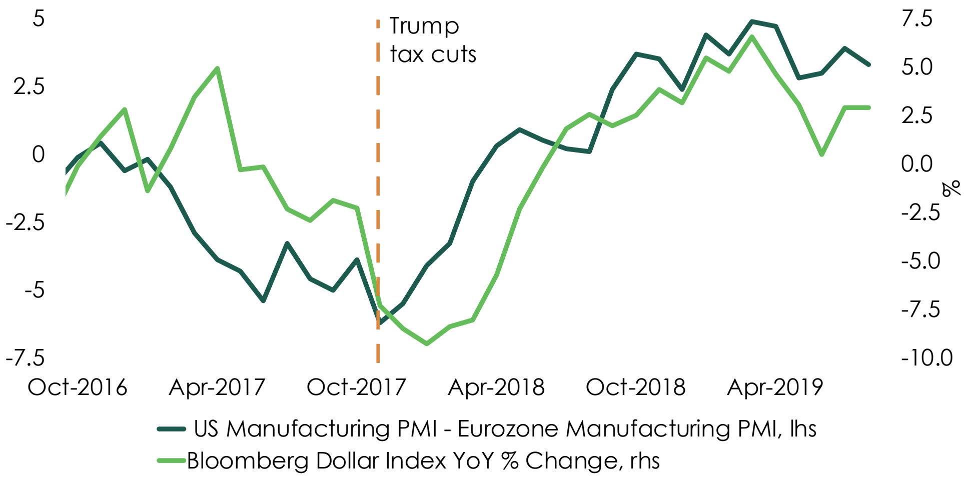
SEPTEMBER 2019

Our thesis remains the same and continues to work. However, given the levels in bond yields and the US dollar (vs DM and EM) it's worth a reassessment and to highlight the dangers that could change our investment strategy. This year in markets has been predictable. In order to achieve consistent positive returns investors have had to take a top down approach with the freedom and flexibility to invest across the fixed-income spectrum. The dominating factors have been global growth levels (not just via the economic data but also via the politics) and US Federal Reserve (Fed) policy.

WHAT'S DIFFERENT THIS TIME

This global slump is unusual as normally the US leads the downturn as the most dominant economy and the rest of the world (ROW) follows. This time US growth is slowing as the 2018 fiscal stimulus ebbs but the bigger slump is overseas as the trade war bites. The resulting growth and rate differential is causing major problems as the strong dollar tightens global financial conditions. The dollar's role in global activity is so dominant that slowing growth outside the US adds hugely to its appeal and local markets don't receive the inflows necessary to support the growth backdrop. Dollar borrowers also look to repay expensive loans and refinancing dries up. The impact is a secular stagnation in a system that so reliant on the dollar and so used to it being weak in the initial stages of a global growth downturn. Thus the `mini cycles' we have been used to over recent years has turned into something more protracted this time round.

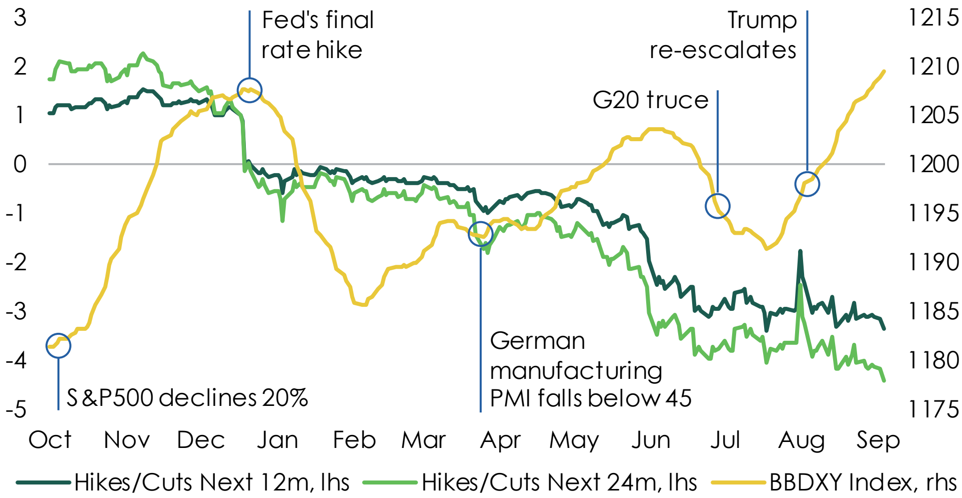
US OUTPERFORMANCE LEADS TO A STRONG DOLLAR



Source: Macrobond as at 03/09/2019.

Our investment thesis in this new environment has been very simple, judging whether the Fed is too tight relative to the global growth backdrop. This is because it's the Fed that maintains the dollar's appeal as the US Treasury churns out T-Bills at 2%+ yields. As the poor growth news emerges, the Fed needs to cut interest rates to lessen the dollar's allure, or risk aversion will occur as global conditions tighten and the dollar strengthens. So as President Trump releases his trade barrages via Twitter, the market shifts to buying bonds and selling risk as the Fed is reluctantly forced by the market to adjust.

SAFE HAVEN OR CARRY TRADE?



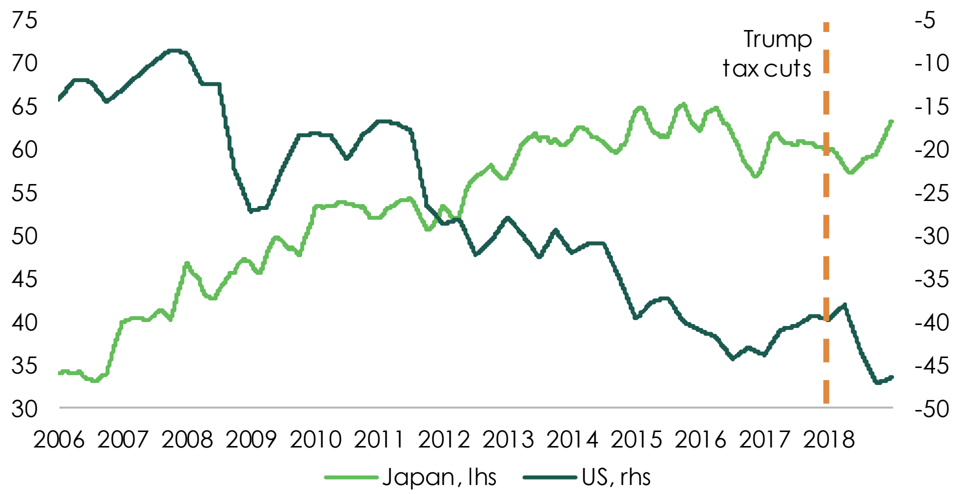
Source: Macrobond as at 03/09/2019.

GROWTH BACKDROP WEAKENS FURTHER

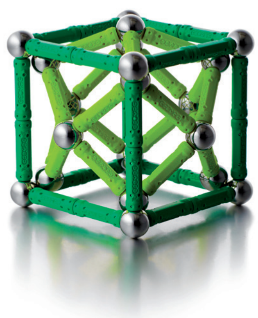
Judging the growth outlook via Tweets is certainly new and difficult, however the growth backdrop continues to decline with signs the weakness in global manufacturing is now spreading to global services and consumption as global business weakens. If confirmed, this will be a new leg in the downturn and release new downside for both bond yields and risk assets.

What can halt this is pretty clear in our view. First off the Fed can find religion and get ahead of things and cut much harder and get the dollar down. Given US data–especially the consumer side–remains pretty solid and employment strong, this seems unlikely. It's clear to us that the Fed committee remains in disarray trying to manage policy for an outperforming US while wary of the global risks. Secondly, and taking the Fed's inaction into account, US policy from all quarters remains resolutely dollar positive and so only some form of capital controls might be inevitable in the end as the dollar ratchets up higher. This could come in the form of tax on foreign inflows into dollar assets. This might seem far-fetched but trade and capital flows are the different sides of the same coin, and so if trade policy damages the US via the rising dollar then curbing inflows makes sense. A cross-party bill has been put to the US House for just this and is worth monitoring. At present, regardless of the monster US deficit–demand for US assets remains very strong and so fiscal funding is not an issue–a tax might make sense to US policymakers. Finally, better news in ROW and signs of stability would see the dollar fall as growth recovers. Unfortunately evidence here is lacking at present as the trade war rumbles on.

US VS JAPAN NET INTERNATIONAL INVESTMENT POSITION (% OF GDP)



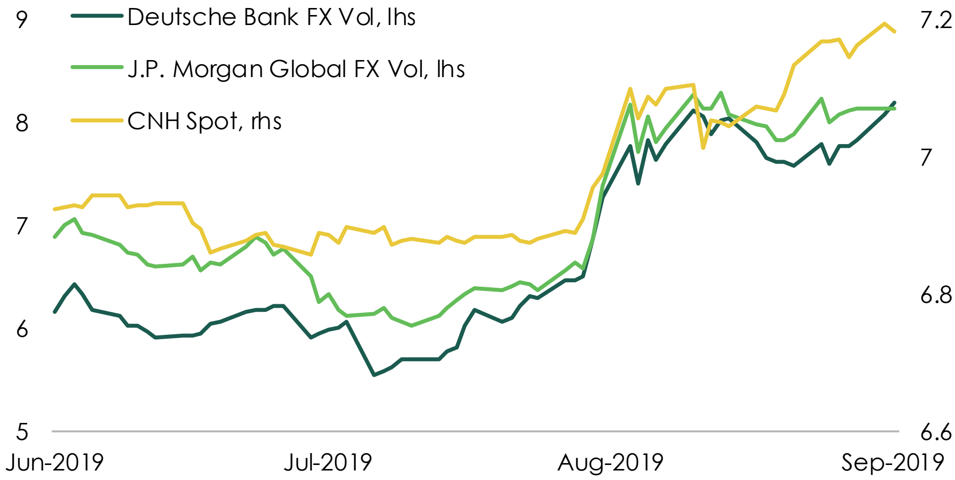
Source: Macrobond as at 03/09/2019.



SHOCK AND AWE SEEMS DISTANT

In short, we see little reason to change current tactics and given the recent slump in emerging market FX (vs the dollar) we are emboldened as this remains a strong indicator of the dollar's dominance. However, at these low levels of global yields and the Fed slowly being dragged into satisfying the market to maintain the cycle, some caution is warranted. The shock and awe required from the Fed still seems distant and so recent trends aren't likely to change. Something breaking on the US side (undercutting US equity resilience) might be needed to deliver this necessary step. The dollar ripping higher or falling oil prices could do this. It's worth noting that we see no reason for the fall in the Chinese renminbi (CNY) to stop given China's growth pain and reluctance to indulge in another investment lead credit stimulus. Foreign exchange intervention to combat the strong dollar hurts China via monetary tightening, and China needs just the opposite. China needs weaker policy rates to encourage consumer borrowing in its most unlevered sector and this will propagate further CNY declines.

A STRONGER CNH HAD BEEN ACTING AS A SHOCK ABSORBER FOR GLOBAL FX



Source: Macrobond as at 03/09/2019.

Headline inflation and inflation expectations have also been trending lower despite the low unemployment rate – there has been very little feed through from wages to prices. Disinflationary pressures are structural, and the Fed will be worried that inflation has dropped despite a strong economy. Fed members have repeatedly said that they don't want to get caught at the zero-bound in the same way that Europe and Japan have, and will move pre-emptively to avoid that fate.

STAY LIQUID

Given all the above, we believe being liquid here is key. We sold out of emerging markets prior to Trump's re-escalation and Argentina shock blow-up, as the basis for Q2's carry trade looked very flaky in our view. Quite simply, either the dollar falls or risk does. The same problems exist but price levels don't look as appealing, while the correct policy response doesn't seem imminent–so we've reduced risk until either our thesis or valuations change.

In addition to the top down view, we've been looking to add alpha via more idiosyncratic positions.

POSITIVE ON GREEK, ITALIAN SPREADS

We have been long-term advocates of owning Greek and Italian sovereign bonds as they moved away from political crisis and converged towards other European sovereigns. Throughout the whole European crisis, when spreads widened we'd look for the same things to see whether the bonds could eventually stop trading like a credit asset and resume trading as an European duration asset. There are two key criteria for a European sovereign to trade as a duration asset in our view

- Low redenomination risk
- Willingness to play by the rules (or at least break them within the agreed political process)

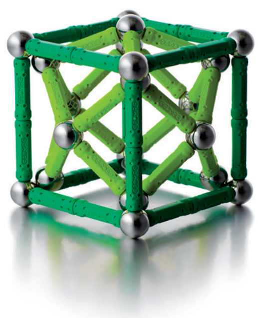
Using this framework we think it is clear why Italian and Greek sovereign bonds have rallied so impressively this year. Under former Prime Minister Tsipras, Greece mostly played by the institutions' rules and implemented reforms, while there is a very strong majority in its parliament for euro membership. The new prime minister, Kyriakos Mitsotakis, despite his promise to cut taxes, has been formalising his policy in discussion with Greece's European creditors. Lifting capital controls by consulting all stakeholders is a good omen.

In Italy, talk of mini-BOTS has fallen away–in a nation of high private savings it doesn't win votes– while it looks increasingly likely that the policy's instigators are to be removed from power. With Five Star and the PD forming a government we'd expect the 2020 budget to broadly fall within the European Commission's parameters–President Mattarella probably insisted on this when giving them the mandate.

On this basis, along with the likely renewal of QE operations and the yield grab underway (hedged European yields offer good pickup in a low-yield world) by the ECB, we remain positive on Italian and Greek spread trades and we expect further convergence to bunds as well as other peripheral countries. The biggest risk to our view is continued low growth fuelling anti-establishment parties in both creditor and debtor nations, which could change this political dynamic, or a dramatic change in ECB policy. We don't see this risk as imminent but remain watchful.

QE IS OVERCOMING THE POLITICAL RISK IN ITALY

Source: Macrobond as at 03/09/2019.



THE MODEL PORTFOLIO

ALPHA FACTOR	CONVICTION WEIGHTS (PER SECTOR)	DIRECTION	Exposure (weighted duration or %)	Risk Cont. (TE,bps)	Risk Cont. (%)
CREDIT		NET SHORT	-0.55yrs	17	8.3
US / EUR Coco bonds	25%	LONG	0.20yrs	2	1.0
Buy USD CDX HY	40%	SHORT	-0.45yrs	10	4.9
Buy EUR Itraxx XOVER	35%	SHORT	-0.30yrs	5	2.4
Developed Market Rates		NET LONG	0.95yrs	149	72.7
US	25%	LONG	1.55yrs	45	22.0
UK	5%	SHORT	-0.45yrs	-4	-2.0
Germany	15%	SHORT	-1.75yrs	14	6.8
France	5%	SHORT	-0.70yrs	9	4.4
Spain	5%	LONG	0.20yrs	5	2.4
Italy	20%	LONG	0.80yrs	34	16.6
Greece	15%	LONG	0.60yrs	29	14.1
Canada	10%	LONG	0.70yrs	17	8.3
FX (vs. USD)		NET LONG	4.50%	28	13.7
British Pound	10%	LONG	2.00%	3	1.5
Euro	25%	LONG	4.50%	8	3.9
Japanese Yen	25%	LONG	4.50%	8	3.9
Korean Won	10%	SHORT	-2.50%	1	0.5
Mexican Peso	15%	SHORT	-2.00%	4	2.0
South African Rand	15%	SHORT	-2.00%	4	2.0
Inflation		NET LONG	2.50yrs	11	5.4
European Inflation	50%	LONG	0.80yrs	14	6.8
US Inflation	40%	LONG	1.10yrs	-4	-2.0
Japanese Inflation	10%	LONG	0.60yrs	1	0.5
			Total	205	100

Source: Merian Global Investors, as at 04/09/2019.

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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