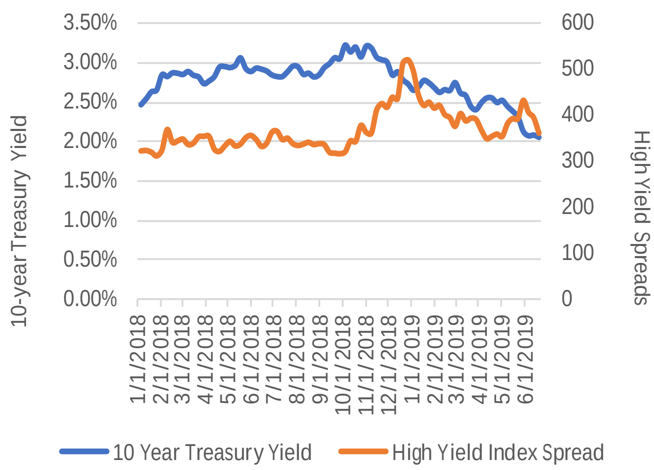
Global Market Positioning

July 2019

Real-time insight on how DuPont Capital has positioned its portfolios as a function of key factors driving the markets.

Key Market Factors (as of July 2019)

Changes in Yield and Spreads

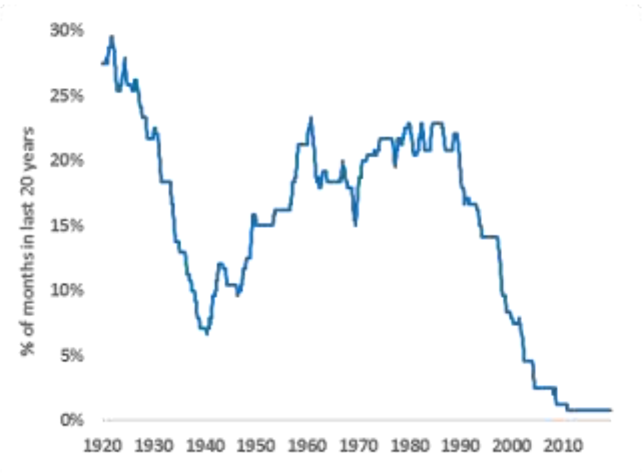


Source: Bloomberg, JP Morgan
As of June 21, 2019

Are Fixed Income Markets Forecasting a Recession?

- Both stock and bond prices have been rising in 2019. Because of this, we have seen people asking if the two markets are predicting different economic outcomes with fixed income markets predicting a recession.
- U.S interest rates have declined significantly since the 4th quarter of 2018, with the ten-year falling by over 100 bps. However, high yield spreads have tightened by over 100 bps with yields down by over 200. Currently, high yield spreads are below both five and ten-year averages. Investment grade spreads have also tightened significantly in 2019.
- So, credit markets are not forecasting a recession. Instead, they are pricing in a "Goldilocks" scenario of moderate growth, low inflation, and accommodative monetary policy.
- With the Federal Reserve poised to lower rates if needed, this scenario may continue over the next several months.
- Caution is warranted, as Treasury yields may be pricing in the Fed to lower rates more than will be needed and rates could rise later this year.

Frequency of Low Volatility Equity Corrections



Source: Bernstein

Volatility—Feast or Famine?

- Recent macro and central bank dynamics have many investors primed for a recurrence of a low volatility, "melt up" equity environment. However, lest anyone forget the fourth quarter of 2018, May's sell-off provided yet another reminder of how quickly risk aversion can spike.
- Over the last couple of lengthy economic upcycles, orderly or benign corrections (>10% in magnitude without volatility breaching 15%) have become virtually extinct. Historically, such ebb tide episodes accounted for anywhere between 10%-20% of market fluctuations.
- Monetary policies, abundant liquidity, and the rise of passive or risk-targeted products appear to have played causal roles in amplifying the bifurcation of volatility. The compositional change – longer periods of below-average calm punctuated by more acute outbreaks of turmoil – is unlikely to fully reverse unless the underlying structural drivers do as well
- As patient investors, a long-term investment approach is predicated on capturing the alpha opportunities that arise from shorter-term market inefficiencies and over-extrapolation. If these windows of opportunity become narrower but more frequent in nature, investment process and preparation will be key to differentiating such patience from passivity.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CURRENT POSITIONING (as of July 2019)

GLOBAL EQUITY

- With a return of more dovish Central Bank policy/guidance, the liquidity impetus for equities is once again a consideration. Our prior positioning piece alluded to widespread market optimism that a non-inflationary path of soft but recession-defying growth, similar to 2016, could resume, at least in the US.
- Such a scenario is plausible but arguably reflects wishful thinking for a return of low volatility and steady returns. However, many cyclical sectors are now more late-cycle than in 2016 and global macroeconomic drivers are less favorable. The Eurozone Manufacturing index decline has leveled off but remains divergent from its Services counterpart. Equivalent leading indicators in China and across Asia are similarly subdued and global supply chains remain vulnerable to further political flux.
- Focusing on the "volatility of volatility" and its compositional changes through time provides a useful framework for long-term, bottom-up portfolios to invest across structural tail risks or binary top-down factors. Extended periods of benign "risk on" volatility contrasted with increasingly episodic phases of indiscriminate and technically-driven sell-offs can offer more frequent valuation opportunities and market disconnects to buy companies where we have fundamental, through-cycle conviction.
- We continue to advocate and follow a quality and relative growth profile within the twin-track US market. High quality names tend to trade at a premium internationally given deeper underlying economic sensitivities, so relative valuation scrutiny is required. In higher beta assets classes, such as Emerging Markets and US Small Cap, we pursue a value-centric approach to capturing alpha. Healthy M&A deal activity, particularly in the US, offers a broad opportunity set for Merger Arbitrage portfolios.

FIXED INCOME

- Global economic growth has slowed and the Federal reserve is ready to reduce rates if needed. US interest rates have declined significantly this year and may have moved lower than is warranted by the fundamentals. The duration of our portfolios is shorter than the benchmark to protect against rates rising from current levels.
- Emerging Markets Debt (EMD) rebounded this year after a poor 2018, with hard currency outperforming local currency. Although slower global growth, country specific issues, and on-going trade frictions may cause a short-term pull-back, we believe valuations are still more attractive than in other fixed income sectors. We added several positions and reduced cash in our portfolios in the second half of 2018, but have been less active this quarter due to the rally. In US Dollar sovereigns, we are overweight Ukraine, Mexico, Brazil, and Argentina. In local currency, our main exposures are to Brazil, Mexico, Poland, and Russia.
- Investment grade corporate spreads tightened significantly this year and are now close to long-term averages. Although corporate bonds are not cheap, they are the best valued segment within investment grade fixed income. Accordingly, we have a small overweight to corporates in our Core and Core Plus portfolios. We favor the basic industry, insurance, and consumer cyclical sectors, but are underweight longer duration bonds to reduce interest rate risk and spread duration.
- High yield spreads have also tightened significantly. Spreads may tighten further, but the market is expensive with yields below 6%. We are monitoring the market and looking for opportunities in select restructuring situations as well as in more liquid investments that we believe have an attractive long-term risk-reward profile.

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