January 2020

Outlook 2020

Priced to Perfection?

CAP

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Priced to Perfection?

- The fears of late-2018 did not materialize in 2019. The expected slowdown did set in, but US recession fears dissipated and market perceptions of a monetary policy overkill were contradicted by precautionary easing by both the Fed and the ECB.

- Similarly, even if the amount of noise was considerable, uncertainties over trade tensions eventually subsided, and Brexit concerns ended up taking a backseat.

- Positive expectations must now be fulfilled. The first part of the presentation therefore asks both *what must go right in 2020* and *what must not go wrong*.

- A relevant checklist is useful. Data processing is essential. In the second part of the presentation we outline the readings of our DREX models and our current cross-asset allocation.

- Our models point to a positive starting point for risk assets. But a dynamic approach to managing risks in 2020 looks as relevant as ever.

I. Fulfilling Expectations

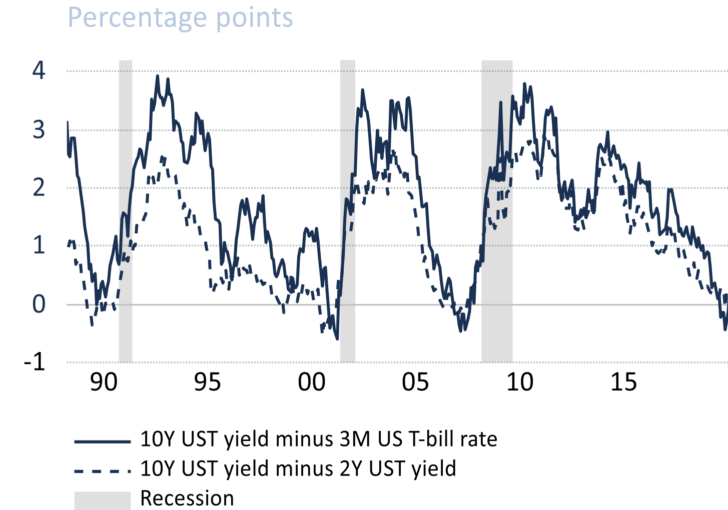
The US Yield Curve: has it lost its relevance?

There are reasonable doubts over the yield curve as a recession indicator:

- QE on its own may have flattened the curve and facilitated its subsequent inversion
- Negative yields on long-dated European gvt. bonds have prompted flows into the US market, possibly distorting the curve.

The main reason not to write it off altogether is that it has followed the usual late-cycle template, suggesting a higher probability of sub-par growth.

Clearly, this reading must be contrasted with other indicators.



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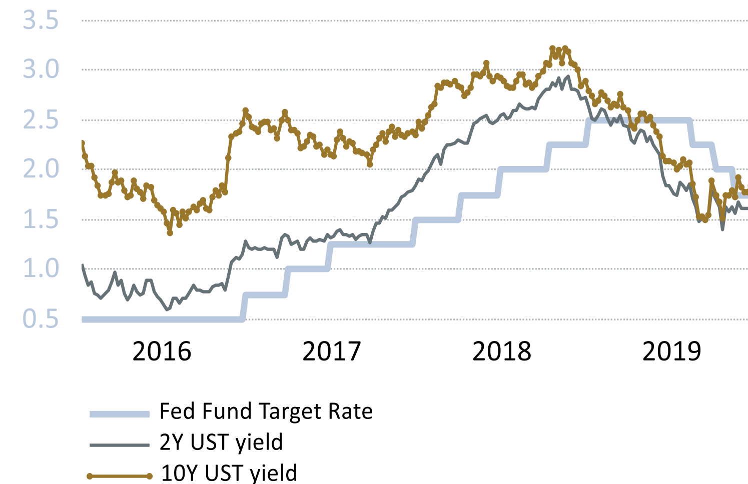

Source: Refinitiv Datastream, C.A.P

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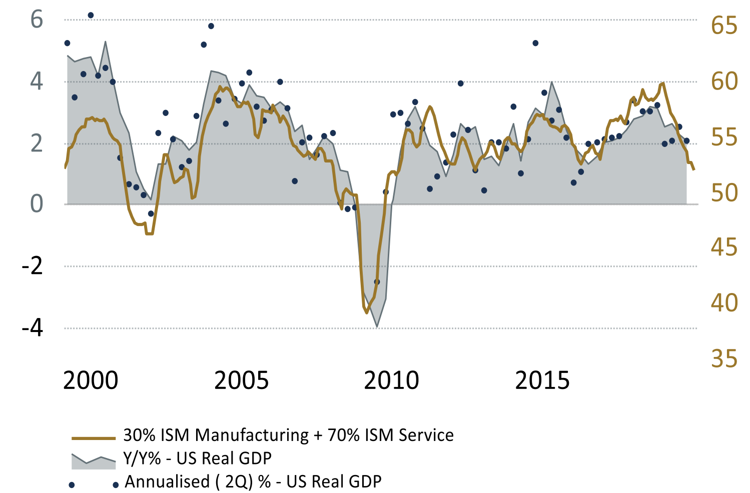
Manufacturing vs Services

- A composite of US ISM surveys for the manufacturing and non-manufacturing sectors is now suggesting annualized US GDP growth of 1.5%.
- Both the manufacturing and the services indices have been trending lower, but the gap between the two has widened begging the question of which one leads the other.
- Recent history suggests that the service sector has the upper hand. Soft patches in Q4 2012 and Q4 2015 saw a similarly wide gap narrowing mostly from a rebound in the manufacturing survey.



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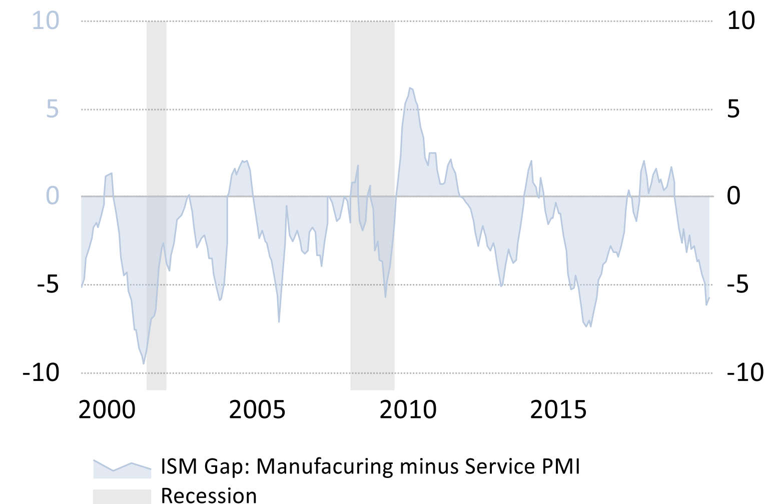

Source: Refinitiv Datastream, C.A.P

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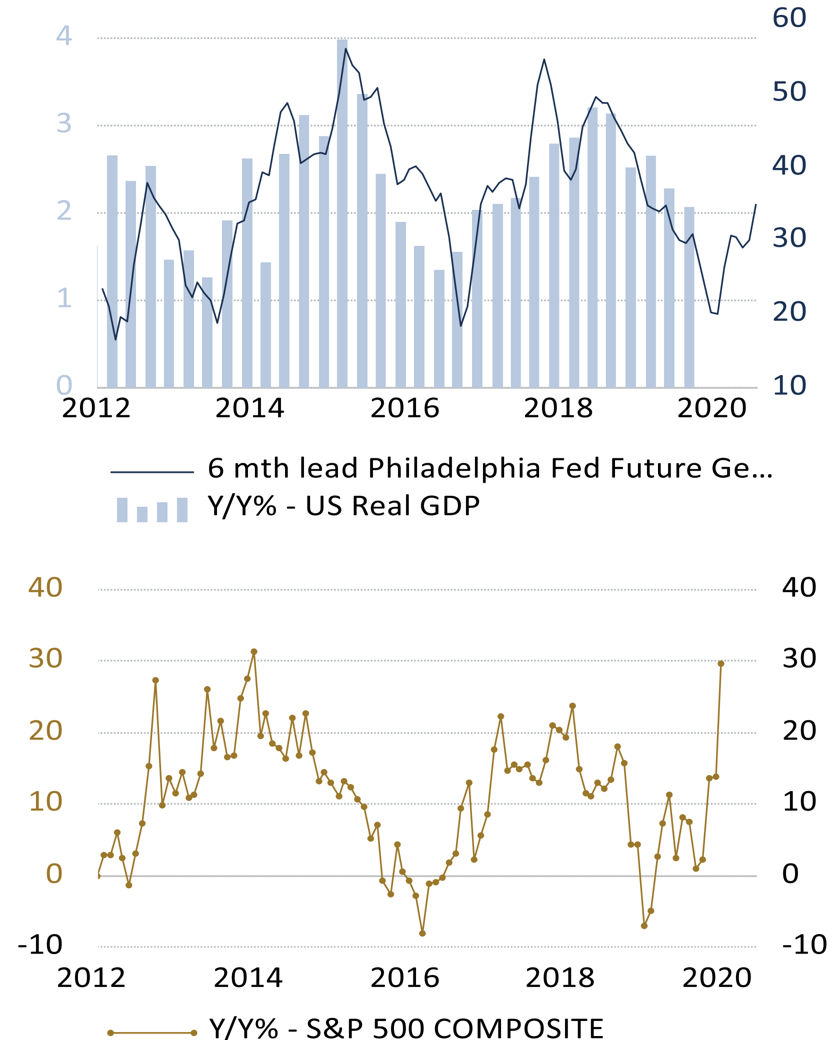
GDP Leads vs S&P500

- Lead data point in the same direction.
- Indicators like the Philadelphia Fed Future business suggest that Q4 was a short term growth trough and that Q1 2020 will see real GDP growth in the area above 2% y/y%.
- The relevance of this being fulfilled is clear enough.
- Wall Street has tracked leads closely, extending the liquidity driven market uptrend from H1 2019.



Source: Refinitiv Datastream

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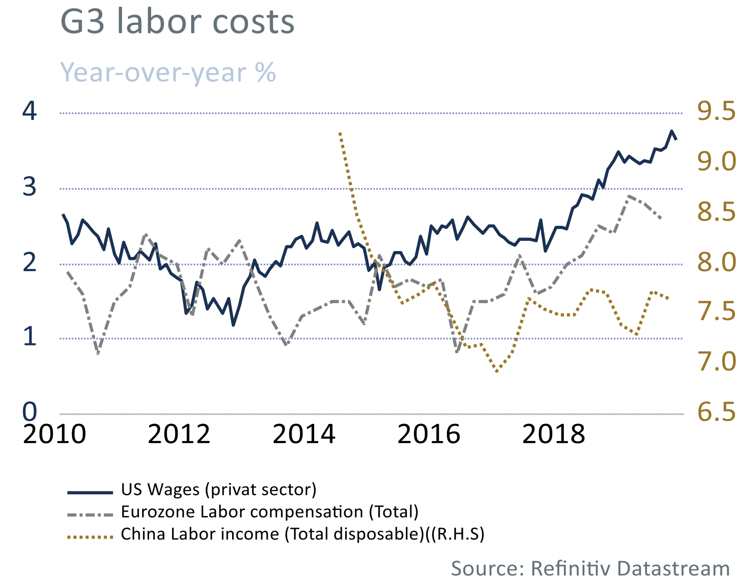
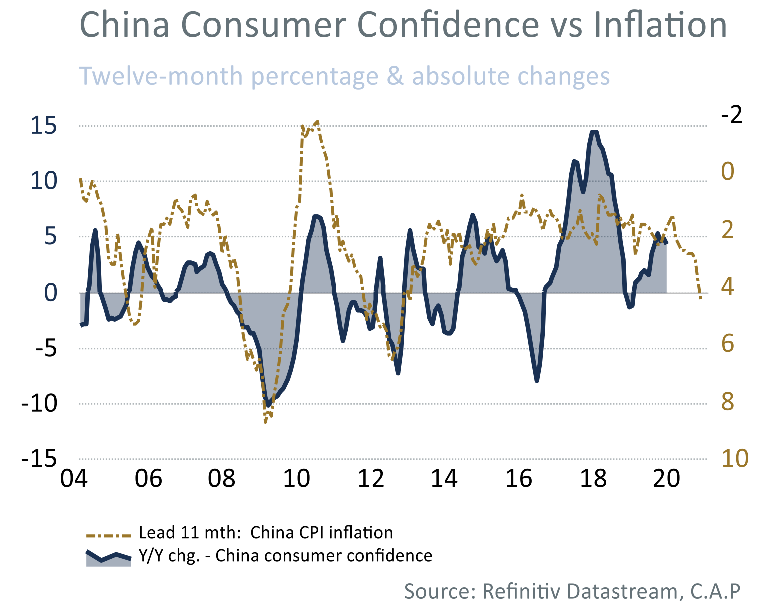
Price and Cost Inflation

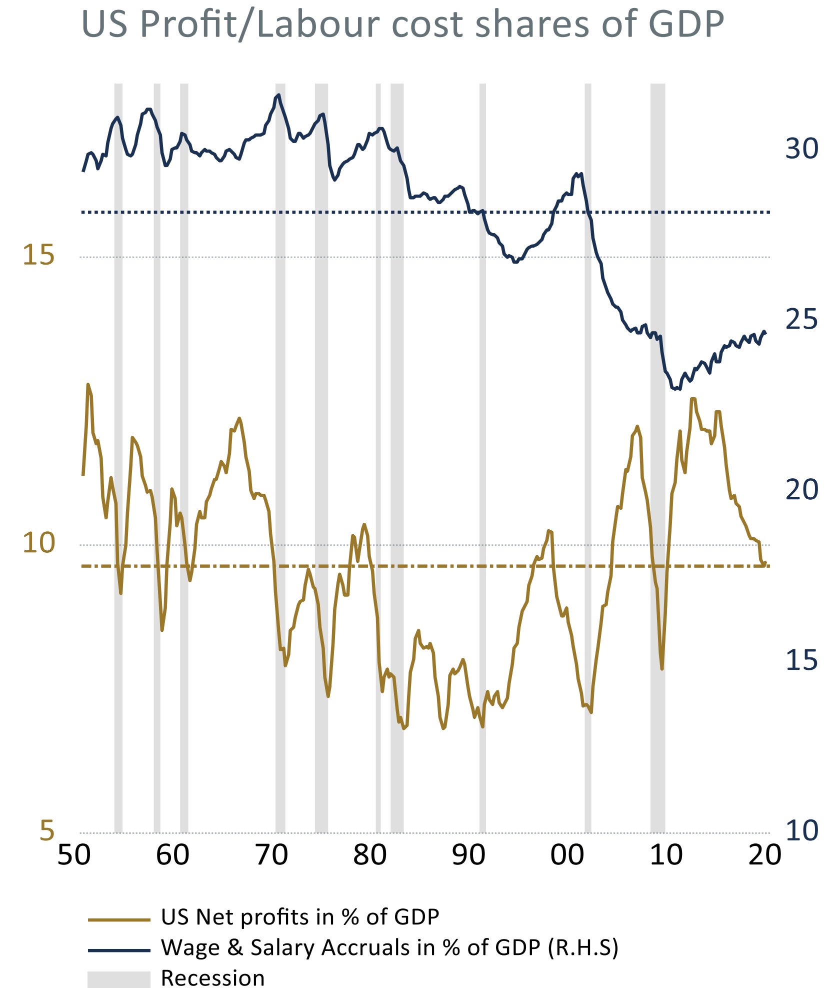
- Subdued inflation in both the US and the EU is evident in both consumer and producer prices.
- By contrast, labor costs are rising at a higher pace than at any time since the financial crisis, witnessing diminishing slack in labor markets.
- Limited pricing power in the western economies suggests more of the same. The main risk deriving from this is arguably to job growth.
- China presents a special case. Consumer inflation is currently soaring due to the pigs disease crisis. If unresolved, the loss to disposable incomes suggests serious headwinds for private consumption going forward.





Corporate Earnings

- Growth in US corporate earnings was generally expected to flatten in 2019, due to the base effects of the 2018 tax cuts.
- The decline in profit margins, however, is not driven by similar dynamics and is closer connected with the increase in labor costs outstripping the increase in final prices, mentioned before.
- To meet market expectations, an earnings recovery must materialize in 2020, strong enough to overpower the headwinds from narrowing profit margins.



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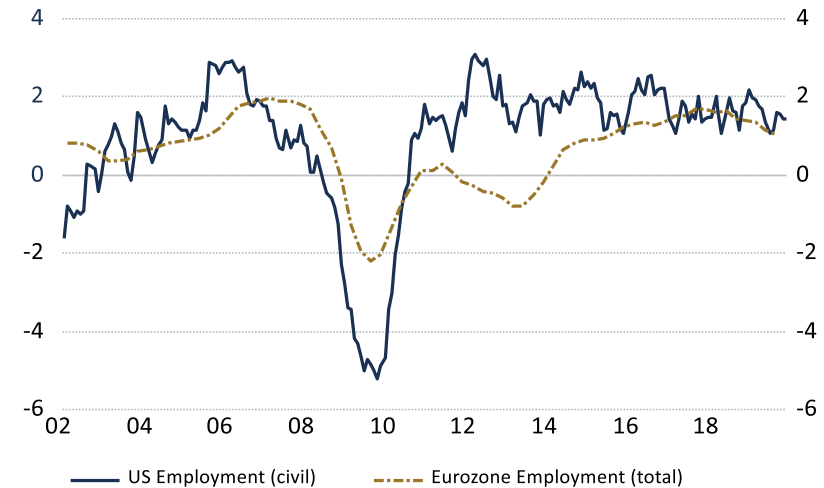
Employment Growth

Private consumption has been well underpinned by growth in personal incomes and employment.

The risk to continued employment growth derives from both supply and demand factors:

- Labor supply is limited by the level of unemployment unless the level of labor market participation rises more notably.
- Demand for labor is limited by the narrowing profit margins, driven by higher labor costs.

Any upside to labor market participation? It cannot be ruled out, even if the decline has been driven mostly by structural factors. Such a scenario would help to extend the expansion.



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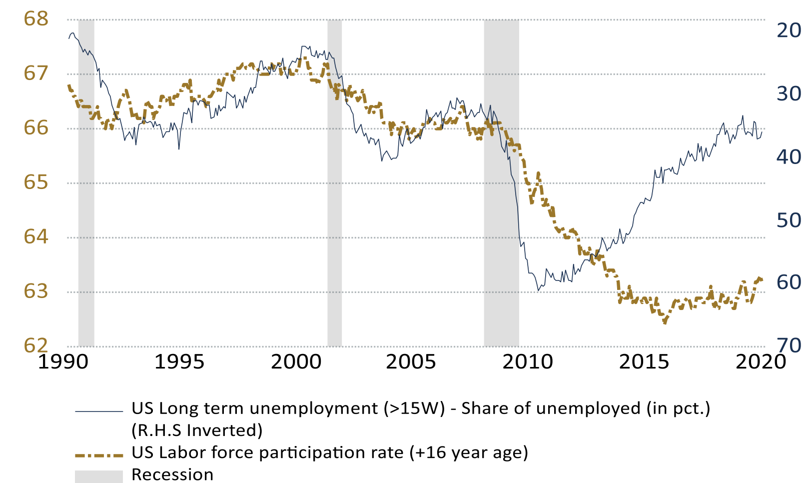

Source: Refinitiv Datastream, C.A.P

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Default Rates and Liquidity

- Strong liquidity and credit conditions are key factors behind the long maturity of the current expansion phase for the global economy and high risk markets.

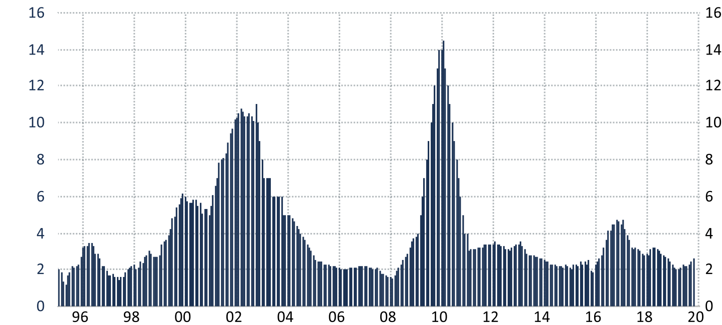
- Central banks ability and willingness to manage global liquidity exceeded investor expectations in 2015 and again in 2018. Our Illiquidity Indicator suggests that central bank intervention kept illiquidity from moving to positive in both years.

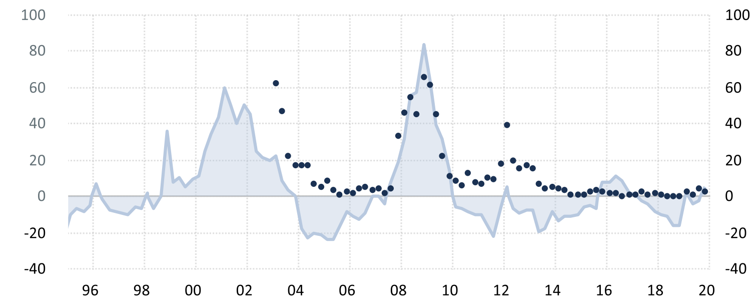
- Although nothing suggests central bank tightening in 2020, two condition look crucial for liquidity to continue to support markets:

  - Bank lending conditions remain favorable
  - Default rates continue subdued

Default rates, Illiquidity & Credit conditions

Global, US & Eurozone





Source: Refinitiv Datastream, C.A.P

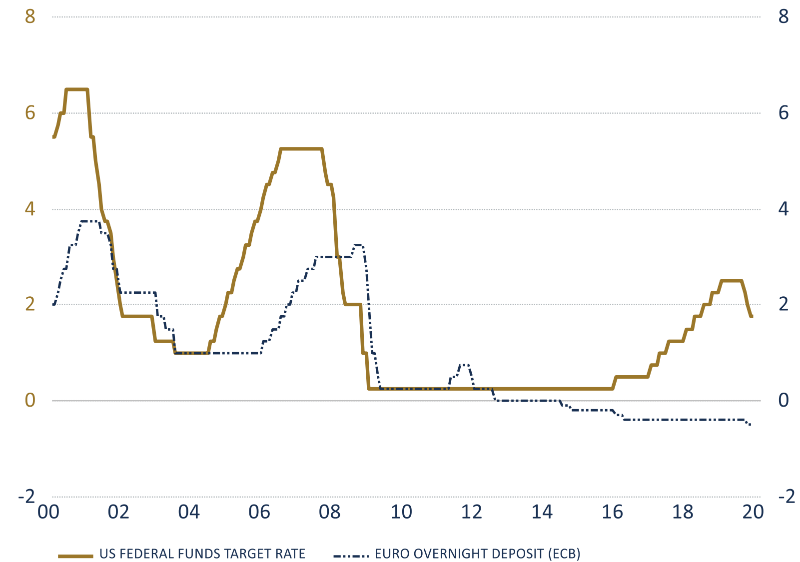
Central Banks:

Easing moves by the Fed and the ECB in 2019 were justified from an 'insurance' point of view.

Dovishness clearly dominates but the bar for further easing may have moved higher:

- Fed opposition to negative rates would eventually put the onus on increased QE.
- Internal opposition in the ECB to further easing is growing.

Further easing in 2020 might require a more pronounced setback and its signaling effect could be less certain than in 2019.



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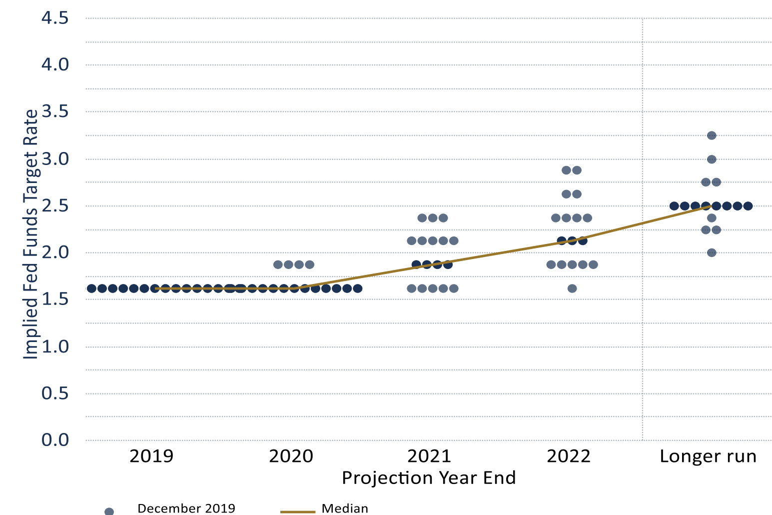
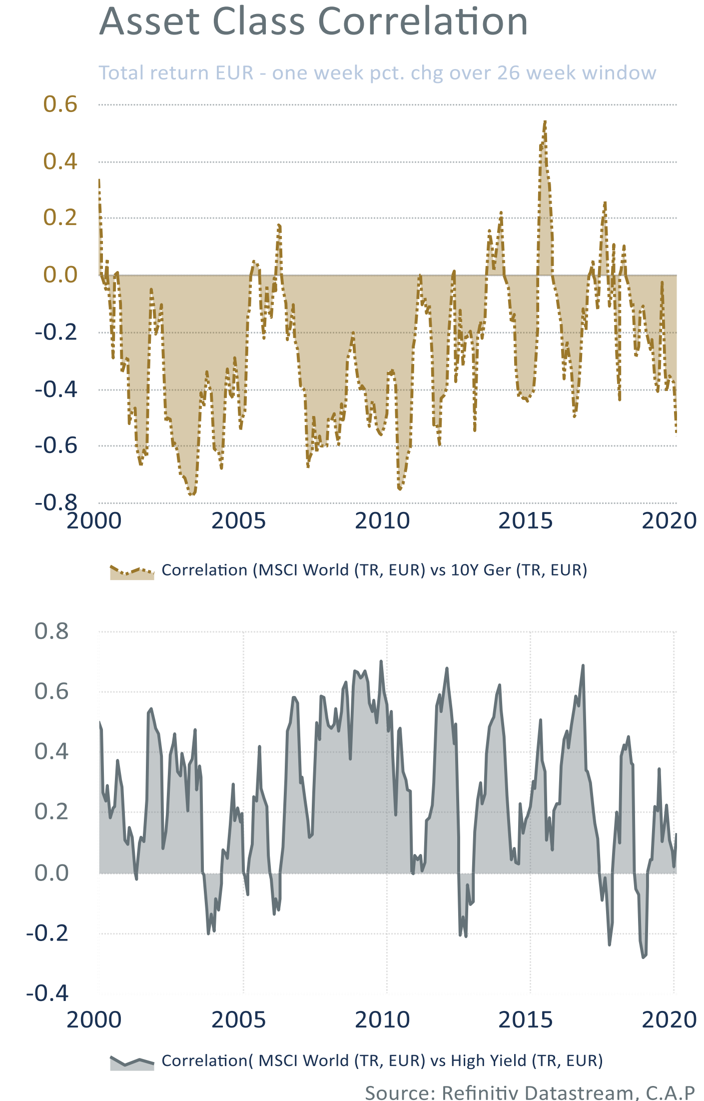


Source: Refinitiv Datastream, C.A.P

Asset Class Correlations

- Diversification between Low- and High-Risk assets has continued to work well.
- Since the risk-off scenario in Q4 2018, the correlation between EU High quality bonds and global equities has become increasingly negative.
- During the same period, the correlation between Credits and Equities has stayed relatively low, in sharp contrast to the period around the financial crisis.
- The key risk to this picture would be a (significant) increase in inflation, a scenario with little backing from data.



II. Asset Class Weightings:

Consulting our *DREX* models

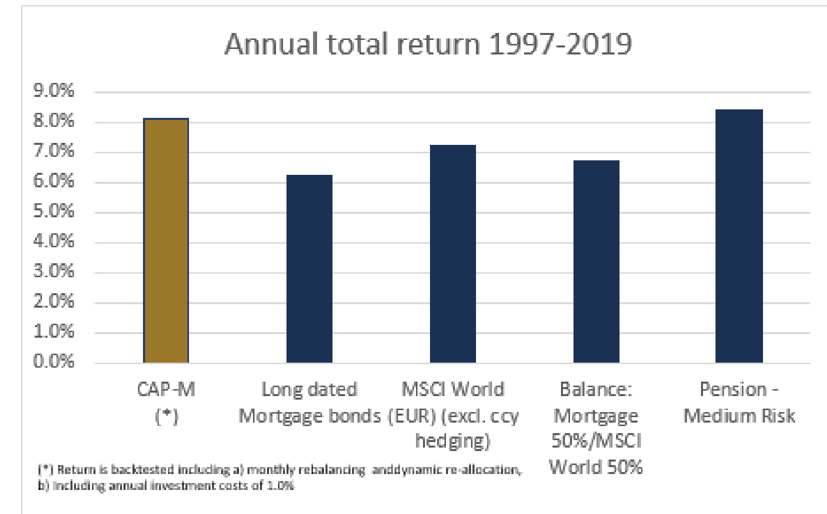
Why DREX?

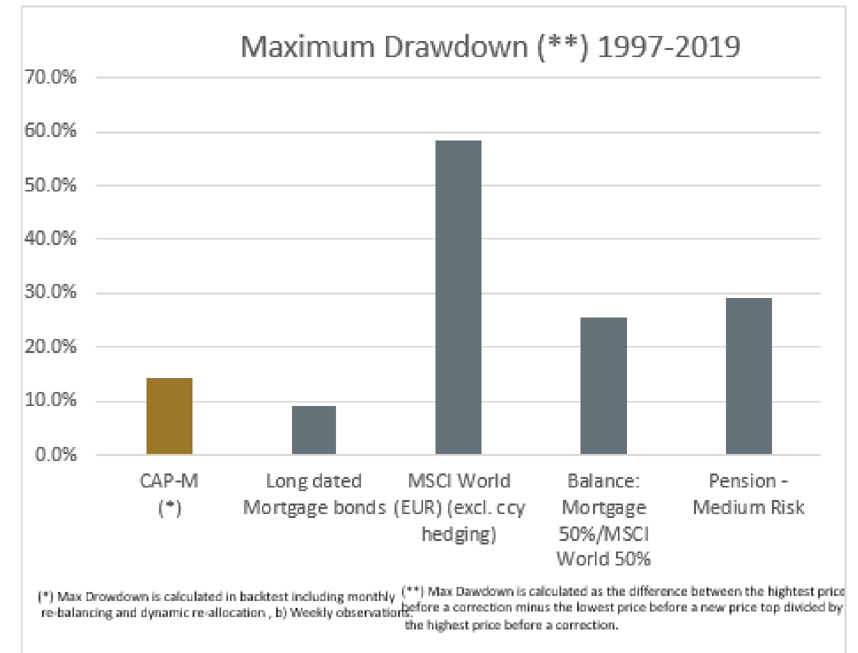
- By introducing a set of 1-6 months return expectations **(DREX)**, we have been able to achieve robust performance without excessive risk-taking.

- Once a month, we systematically gather, process, and invest according to the dynamic shifts in return expectations for individual asset classes as well as for assets grouped in different risk categories.

- Our data-driven investment process implies that we invest solely based on data already released. In other words, we use a *nowcasting* approach and are not relying on our ability to predict future asset class returns

- The back-tested results for our CAP Model portfolio (CAP-M) demonstrate lower Drawdown risk in bad times and competitive performance in good times, compared to portfolios *without* dynamic allocation shifts.





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Start 2020 CAP Model-Portfolio (CAP-M)

- Already in November, we raised our Overweight in global equities, as our dynamic indicators suggest a new leg of expansion for the global economy. The length and strength of this recovery is still a big unknown.

- This overweight is concentrated in European and US equities – and both in Large and Small Cap stocks.

- We keep High Risk credit bonds in a double Underweight positions. In Europe, we hold Investment Grade bonds in neutral, while introducing a double Underweight in Euro-linked long Core gov. bonds.

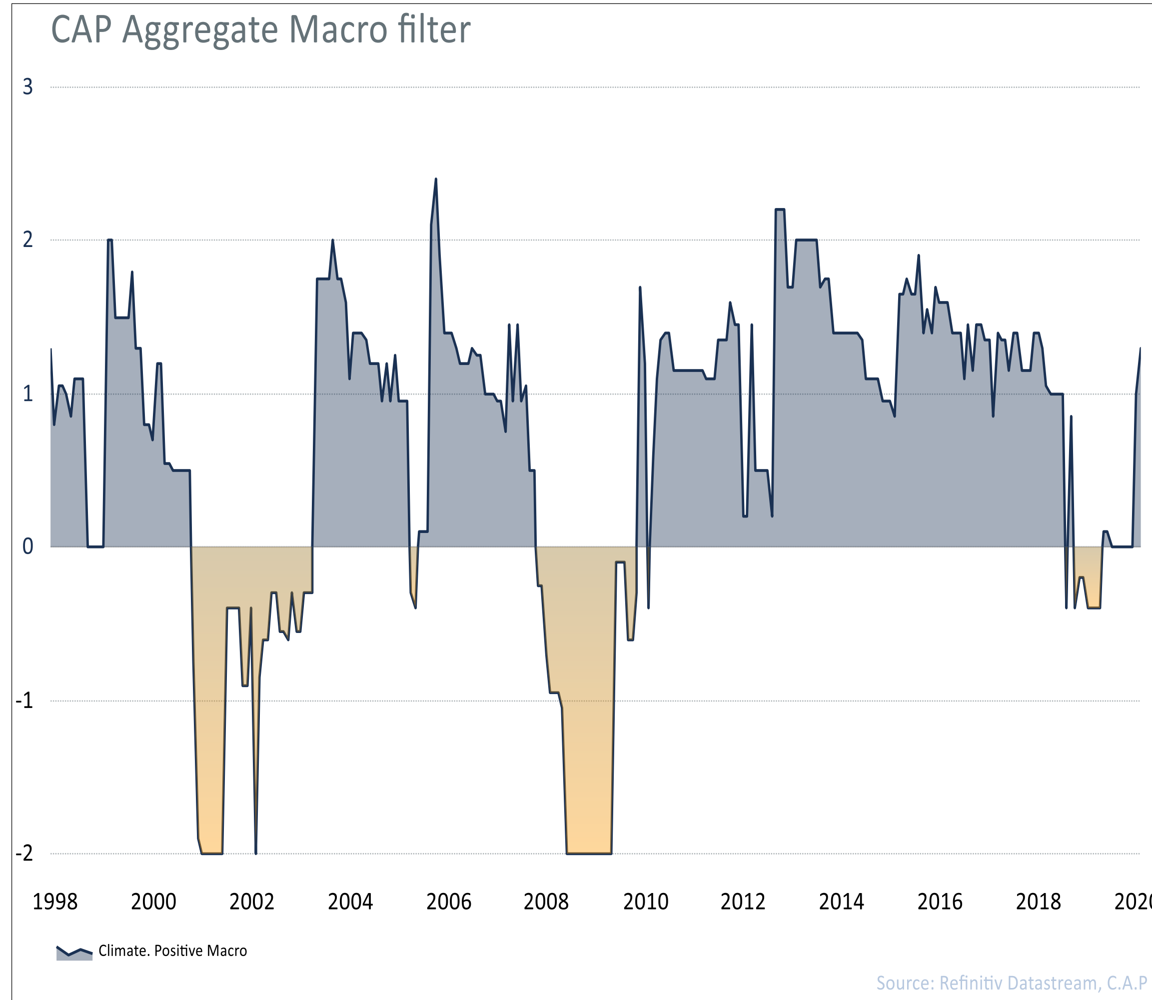
- We are adding exposure to our Risk-On portfolio, and reducing the size of our Risk-Off portfolio, keeping Gold as our only Risk-Off portfolio play.

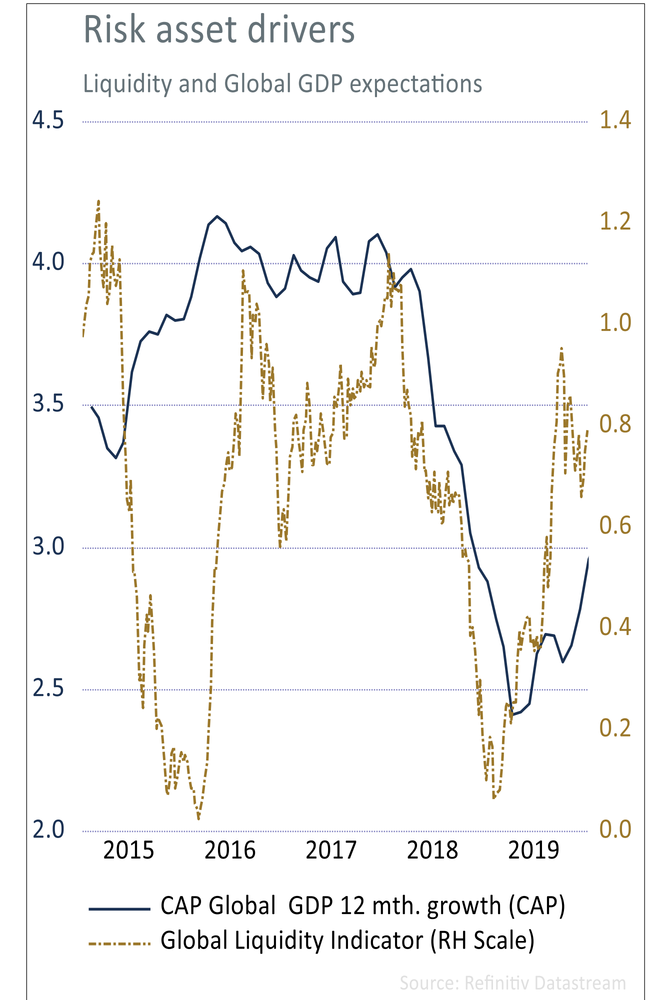
- For more details on our live model portfolio, CAP-M, please see pages 23-24.

Low Risk Portfolio	**Underweight**
- Long Gov.bonds (DKK)	Underweight -
- Mortgage Bonds (DKK)	Overweight +
- Eurozone Core Long Gov bonds	Underweight -
- IG Corporate Rate Risk	Neutral
Risk -Off Portfolio	**Underweight -**
- US Long High Quality bonds	Underweight -
- Japanese Short bond	Underweight -
- Swiss Short bonds	Underweight -
- Gold	Neutral
High Risk	**Weighting**
High Risk Portfolio	**Neutral**
- High Yield Bonds	Underweight -
- Emerging Debt	Underweight -
- Local Equities	Neutral
- Global Equities	Overweight
+ US Equities - Large cap	Overweight
+ European Equities - Large cap	Overweight +
+ EM Equities	Neutral
+ JP Equities	Neutral
Risk-on Portfolio	**Overweight +**
- US Growth stocks	Overweight +
- US Small Caps	Overweight +
- EU Small Caps	Overweight +

Investment Climate - January 2020

- The Top-down investment climate has shifted to gradually more positive since October 2019.
- A liquidity boost stabilized High-Risk markets in H1 2019. In Q4 2019, growth optimism took over from Liquidity as the primary driver of risk assets.
- Noticeably, Liquidity has remained positive and has not (yet) reverted.





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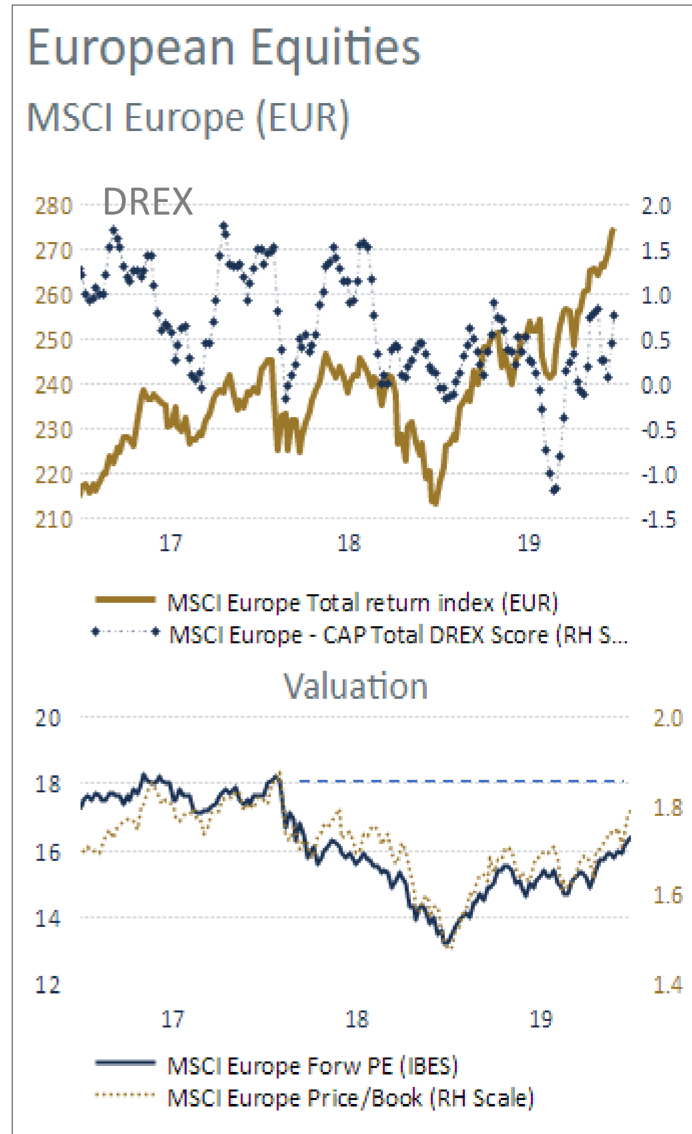
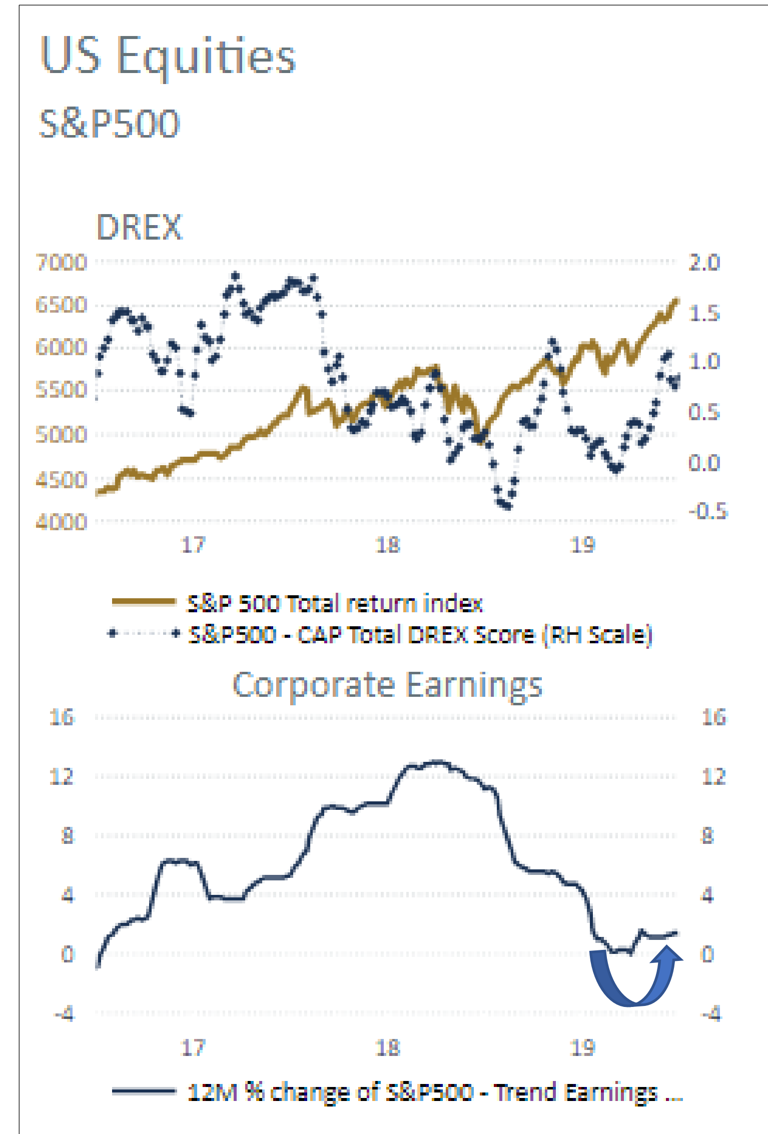
Higher Equity market return expectations.

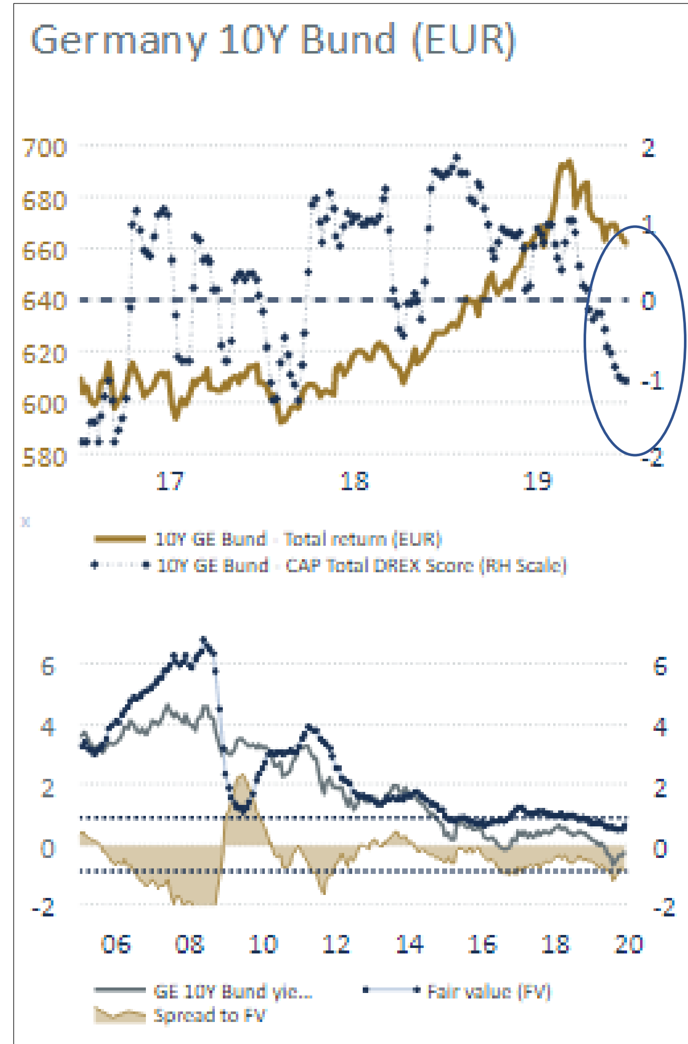
- DREX scores for both European and US equity markets have picked-up
- In Europe, both Macro, Earnings and, not least, Valuations are underpinning the equity market.
- In US equities, Earnings (recovery) and Macro support are dominating factors.

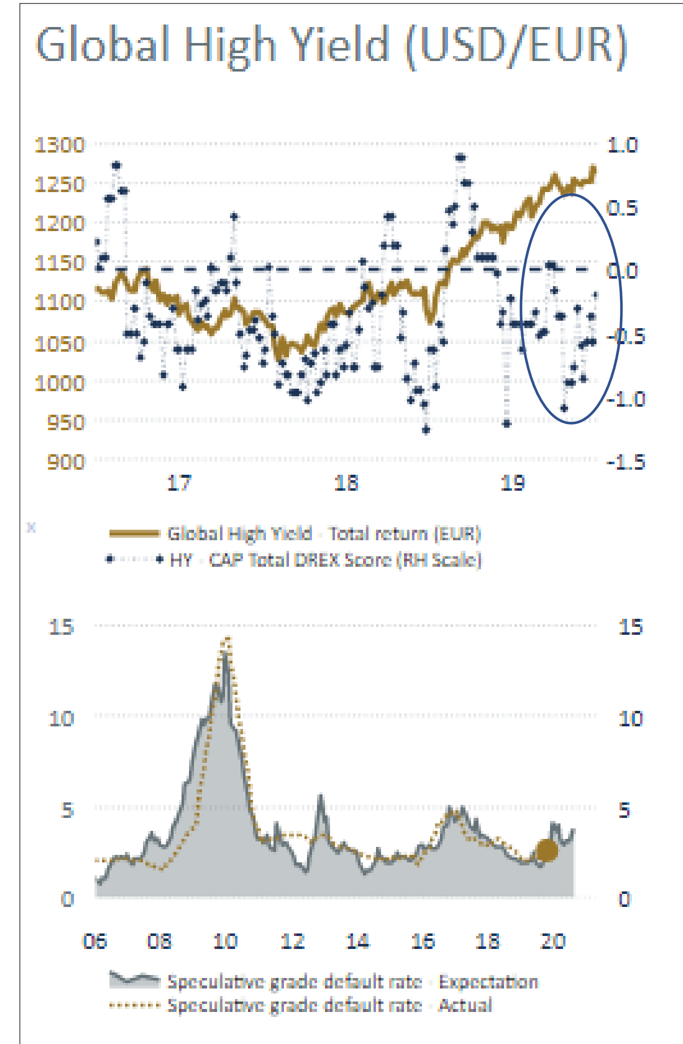




Weak DREX for both high and low quality bonds

- DREX scores for key fixed income asset classes have all moved into negative territory.
- In Europe, Long Core government bonds started to underperform when Growth took over from Liquidity as main market driver.
- Low qQality bond markets have not yet experienced negative performance, but eroding fundamental support reduces DREX scores compared to e.g. equity markets.





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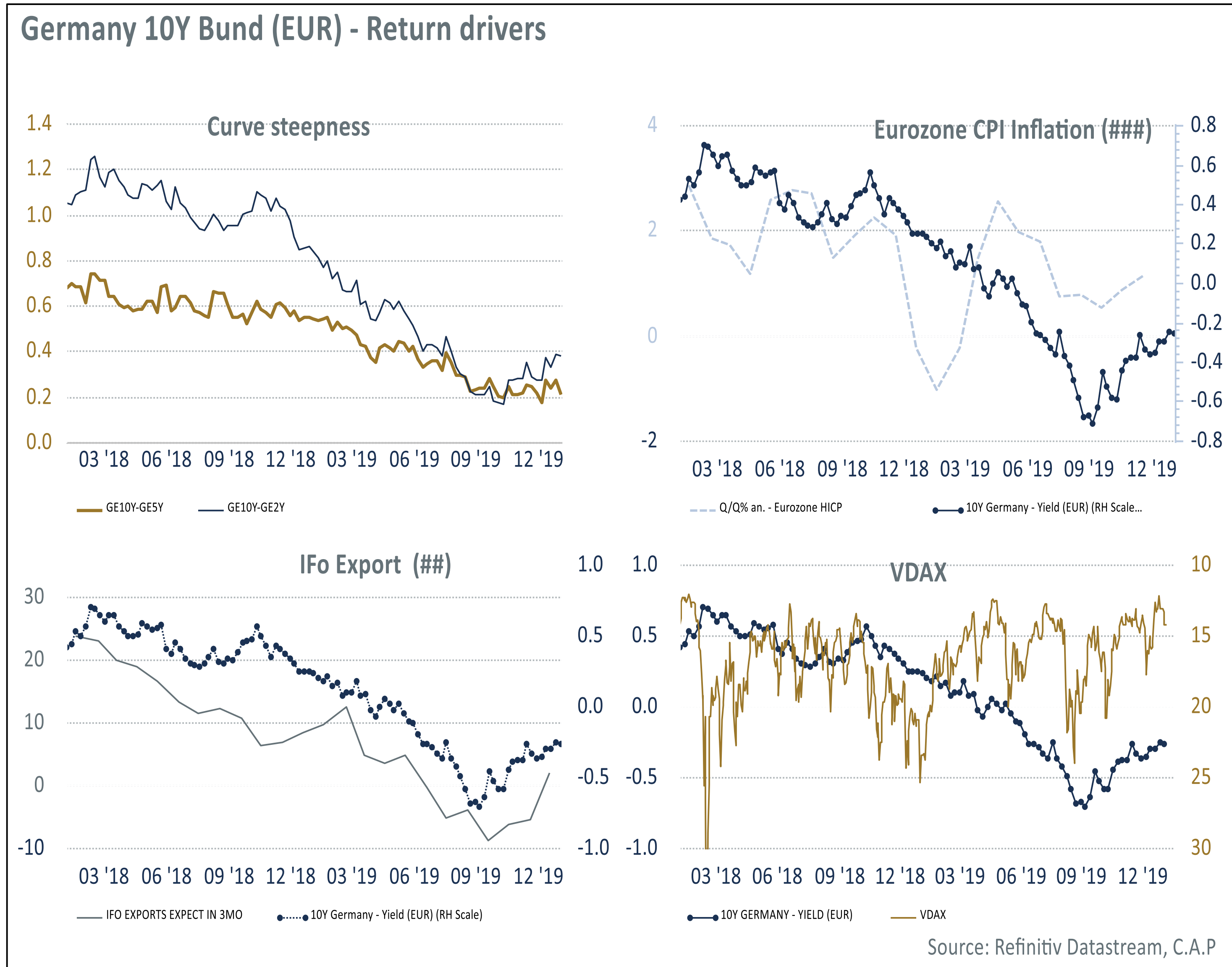
Factors behind the weak DREX support for German Bunds

- Carry-roll, Inflation, and Low Risk asset volatility are all factors behind the weak DREX support for Long Core Government bonds (EUR).

- What is missing to further erode support for the asset class is a Eurozone activity recovery. But this could be in the cards.



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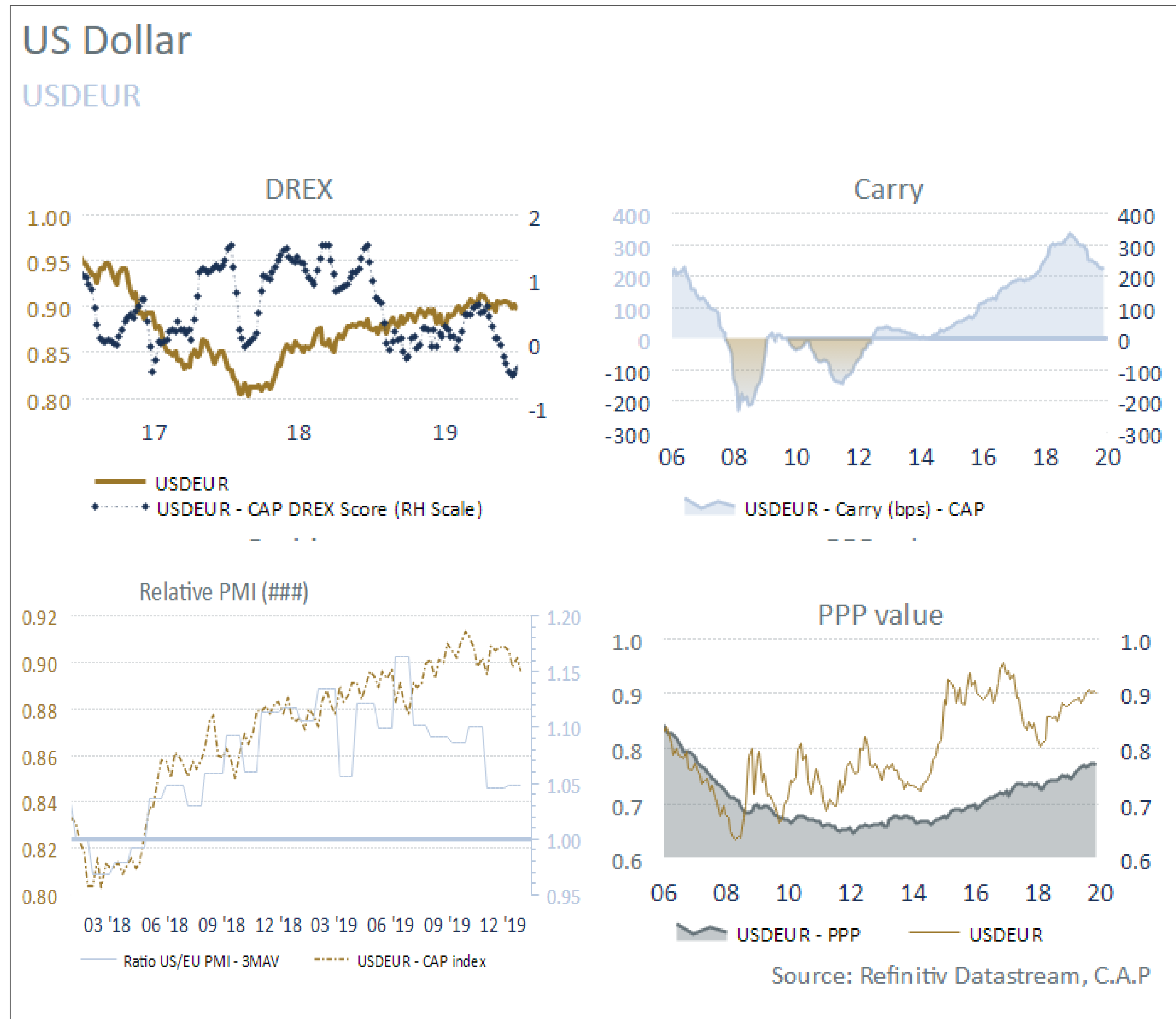
Weaker USD DREX support

- We are further reducing our exposure to USD.
- FED's rate cuts have narrowed the relative Carry position between the USD-zone and Eurozone.
- US Business cycle indicators have weakened relative to European indicators.
- Valuation has for long pointed to weaker USD vs EUR.
- Higher commodities prices 'give room' for weaker USD.



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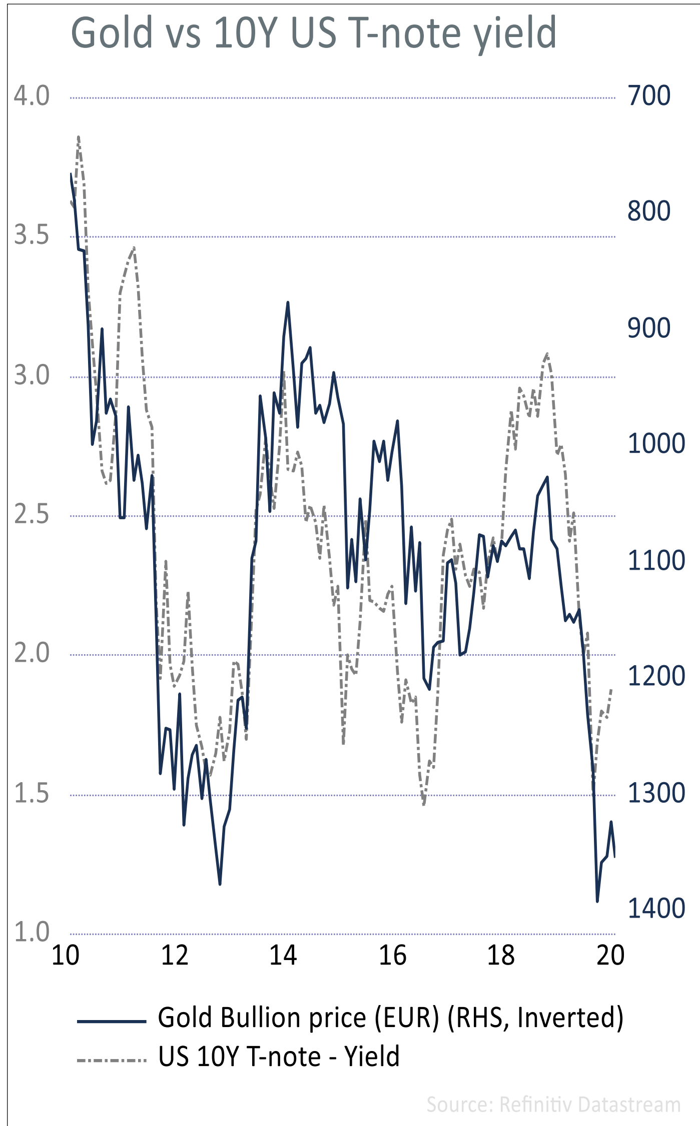
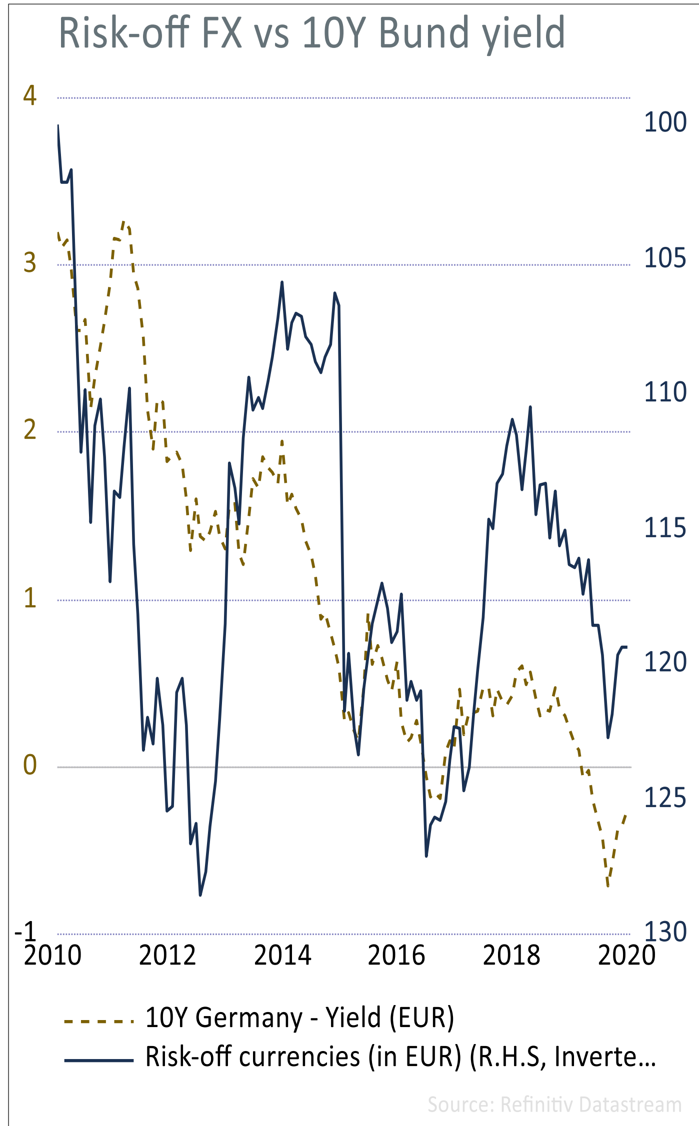
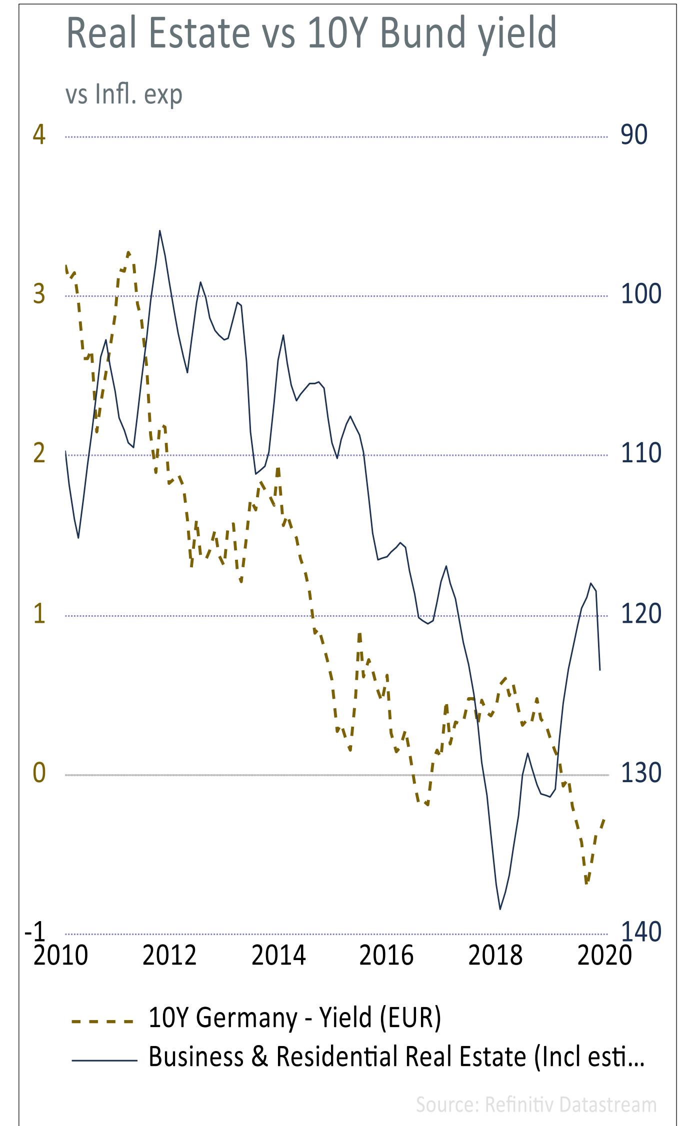
Our Low-Risk puzzle: Can you diversify from bond risk?







III. CAP-M details

Model Portfolio CAP-M – Details - 1 -

Update: 27/12/2019

Cross Asset Portfolio Models						CAP-M Today	- 3mth	SAA
Low Risk	**Weighting**	**Performance (EUR)**				**Portfolio Weight**		
		- 1m%	- 3m%	- 12m%	YTD %	100%	100%	100%
Cash		-0.1%	-0.4%	-0.6%	-0.6%	0%	0%	0%
Low Risk Portfolio	**Underweight**	**-0.2%**	**-1.6%**	**5.5%**	**5.5%**	**31%**	35%	**35.0%**
- Long Gov.bonds (DKK)	Underweight -	-1.0%	-3.7%	6.1%	6.1%	2.6%	7%	**7.0%**
- Mortgage Bonds	Overweight +	0.0%	-0.7%	1.5%	1.5%	11.1%	6%	**7.0%**
- Eurozone Core Long Gov bond	Underweight -	-0.9%	-3.6%	5.0%	5.0%	2.7%	7%	**7.0%**
- IG Corporate Rate Risk	Neutral	0.0%	-0.9%	5.6%	5.5%	14.2%	12%	**14.0%**
- US Short High Quality bonds	Neutral	-1.1%	-2.4%	5.6%	5.6%	0%	2%	**0.0%**
Risk -Off Portfolio	**Underweight -**	**1.2%**	**0.0%**	**12.6%**	**12.6%**	**3%**	10%	**10.0%**
- US Long High Quality bonds	Underweight -	-1.7%	-4.1%	10.6%	10.6%	0.0%	4%	**3.0%**
- Japanese Short bond	Underweight -	-1.1%	-3.8%	2.5%	2.5%	0.0%	1%	**2.0%**
- Swiss Short bonds	Underweight -	1.0%	-0.4%	2.7%	2.7%	0%	2%	**2.0%**
- Gold	Neutral	2.4%	-0.3%	20.8%	20.8%	3%	3%	**3.0%**
High Risk	**Weighting**	**Performance**				**Portfolio Weight**		
		- 1m%	- 3m%	- 12m%	YTD %			
High Risk Portfolio	**Neutral**	**2.2%**	**5.7%**	**24.2%**	**25.4%**	**53.9%**	55.0%	**55.0%**
- High Yield Bonds	Underweight -	0.9%	0.3%	17.6%	17.6%	5.2%	7.0%	**8.3%**
- Emerging Debt	Underweight -	-1.1%	0.1%	15.7%	15.7%	5.5%	7.6%	**8.3%**
- Local Equities	Neutral	3.9%	10.7%	26.7%	26.7%	10.0%	10.8%	**11.0%**
- Global Equities	Overweight	2.3%	6.8%	30.8%	30.8%	33.2%	29.6%	**27.5%**
+ US Equities - Large cap	Overweight	2.5%	7.4%	33.9%	33.9%	12.2%	11.8%	**11.0%**
+ European Equities - Large cap	Overweight +	3.7%	7.2%	26.9%	26.9%	10.8%	7.8%	**8.25%**
+ EM Equities	Neutral	6.0%	9.1%	21.0%	21.1%	9.0%	10.0%	**8.3%**
+ JP Equities	Overweight	-0.4%	3.8%	21.4%	21.4%	1.2%	0.0%	**0.0%**
Risk-on Portfolio [4)]	**Overweight +**	**3.7%**	**10.2%**	**34.0%**	**35.6%**	**12.5%**	0.0%	**0.0%**
- US Growth stocks	Overweight +	3.9%	11.1%	43.1%	43.1%	4.2%	0.0%	**0.0%**
- US Small Caps	Overweight +	2.5%	9.1%	27.8%	27.8%	4.3%	0.0%	**0.0%**
- EU Small Caps	Overweight +	4.8%	10.4%	31.2%	31.2%	4.0%	0.0%	**0.0%**

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Model Portfolio CAP-M – Details - 2 -

Update: 27/12/2019

Portfolio Performance & Risk

	Risk profile				Performance				Portfolio Risk					
	Fixed In. Risk %	Equity Risk %	Liquidity Risk [1] %	FX Risk [2]	-1m%	-3m%	-12m%	YTD %	Std. Dev. (LT)	Max DrawD (LT)	Pension Risk score [3]	Max DrawD (LT)	Pension Risk scor	TE Risk [4] %
CAP-M 'LIVE' [5]	**37.9%**	62.1%	15%	45%	0.6%	2.9%	17.4%	17.4%	6.2%	14.6%	4.5	14.6%	4.3	2.1%
50/50 [6]	46.3%	53.8%	13%	38%	1.5%	3.1%	18.5%	18.5%	8.8%	26.2%	5.9	26.2%	6.2	-

(1) Liquidity Risk (inspired by 'Asset Management', Andrew Ang),

(2) Total ccy exposure outside EUR/DKK, (3) Calculated in accordance to guidelines from 'Forsikring og Pension', (4) TE is 5Y Tracking Error to Bei

Source: C.A.P

(5) CAP-M 'Live' performance based on listed +25 ISIN, (6) 50% MSCI World (EUR) + 50% Eurozone IG (EUR)

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Copenhagen Allocation Partner
Bredgade 30, DK-1260 Kbh K.

www.c-a-p.dk
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