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Becoming more defensive

The continued stock market rally has been a welcome surprise for most investors. After the dismal fourth quarter of 2018, the rising markets have enabled investors to more than recover from the harsh decline at the end last year.

The most significant positive influence on markets has been a shift among central banks in the US, Europe and China to a more accommodative stance. It was a major u-turn in policy. Once again, monetary stimulus in the form of lower interest rates and bond buying programmes are back in vogue. In this environment, gold prices have also risen, reaching ABN AMRO's end-of-year forecast price earlier than expected. The ABN AMRO Investment Committee is taking advantage of the positive turn in markets by deciding to reduce stocks and sell gold.

Adjustments in asset allocation

The overall asset allocation has been adjusted. Stocks are now less in favour (moving from neutral to underweight); and commodities revert to neutral with the sale of the gold position. Some sector changes within the equities portfolio have also been made, with the intention to make the portfolio more defensive, i.e. less reliant on economic growth. No changes have been made to the regional allocation, which continues to favour the US. Bonds continue to be out of favour. Within the bond portfolio, the position in corporate credits has been strengthened, using the proceeds from a reduction in inflation-linked Italian and Spanish government bonds. European corporate bonds will be supported by the expected bond-buying programme of the European Central Bank (ECB).

Decision to take money off the table in stocks

There are a number of pros and cons affecting the overall investment climate. The decision to reduce the position in stocks is the result of evaluating a number of factors and their expected impact over the following three to nine months. In general, the Investment Committee believes that the possibility of a downturn outweighs the potential for further improvement, while the chance of recession remains low.

More headwinds than tailwinds for now

On the one hand, the Fed's willingness to reduce rates is clearly positive for investors. Lower interest rates will encourage investments and will lead to higher profits.

The ABN AMRO Private Banking Global Investment Committee (GIC) has regular discussions to review key macroeconomic drivers, risk factors and market prospects in relation to the tactical asset allocation of client risk profiles. For more information, contact your Investment Advisor.

However, a large part of this benefit is already priced-in to current prices. Further upside is therefore limited. On the other hand, business sentiment has weakened significantly, due to the trade war reescalation. This will weigh heavily on earnings. Earnings revisions over the past weeks have already indicated that there is a serious chance of earnings disappointment. And while a sort of trade war 'truce' emerged after the G20 meeting, real progress is hard to see. Already, Trump is tweeting that China is not buying the large quantities of agricultural goods that he said was promised.

With stocks now at the upper side of the expected trading range, the Committee believes it is time to reduce risk and move to an underweight versus the benchmark. The proceeds from the sale are suggested to be invested in cash.

Using sectors to position more defensively

In recognition of an environment of slower economic growth, changes have been implemented in the sector allocation. The health care sector is now more in favour (moving from neutral to overweight), while the industrials sector is viewed more negatively (moving from neutral to underweight).

The preference for the health care sector is due to the earnings growth of health care companies being less dependent on the economic cycle. There have also been improvements in the pipeline of new medicines, which is also expected to increase the resilience of health care companies in an environment of lower growth. Based on these factors, the health care sector is expected to be able to perform better than the overall market during an economic slowdown.

The industrials sector is out of favour based on weaker economic and earnings fundamentals, particularly in Europe. Moreover, the possibility of escalating trade war tensions could hurt the sector and its supply chain. See Figure 1 for an overview of our sector stance.

Figure 1: ABN AMRO sector view

Sector	View
Communications Services	Overweight
Consumer discretionary	Neutral
Consumer staples	Underweight
Energy	Neutral
Financials	Underweight
Health care	Overweight
Industrials	Underweight
Information Technology	Overweight
Materials	Neutral
Real estate	Neutral
Utilities	Neutral

Source: ABN AMRO Private Banking

Bond markets in the middle

The bond market is balancing the impact of more supportive central banks with the possible effects of rising threats to the global economy. Strong declines in ten-year yields have moved Bunds deep into negative territory and kept the US yield curve clearly inverted. (An inverted yield curve is widely seen as a precursor to a recession.) The yields on these safe-haven bonds reveal that bond investors are expecting more action from central bankers.

Spreads on more risky bonds, from investment-grade corporates to high-yield bonds to emerging-markets debt, had been widening in May, following the renewed tensions in the trade war. Since early June, however, spreads have fully reversed course. The current environment remains conducive for credit spreads, especially as we expect the ECB to resume buying corporate bonds.

Inflation-linked bonds continued to struggle and remained volatile and vulnerable in a period where markets are anticipating 'Japanification,' that is a prolonged period where low-growth expansion is accompanied by low levels of inflation. In an environment where interest rates are expected to be lower for longer and inflation in the eurozone remains stubbornly muted, the decision was made to reduce Italian and Spanish inflation-linked government bonds and to invest the proceeds in corporate bonds. We continue to recommend that investors have a longer duration position than normal in their bond portfolio or in comparison with their benchmark. Long-duration (safe-haven) bonds can provide diversification from equity and credit risks in times of market turbulence.

Commodities: take profits in gold

The decision to invest in gold in mid-March was based on the forecast of ABN AMRO's precious metals specialist that gold prices would rise over the year, with an estimated year-end price of USD 1,400 per ounce. This year-end forecasted gold price has been realised early. We therefore suggest using this opportunity to take profits in the position. By acting now, any future decline in gold markets is avoided. There would, for instance, be a brutal decline if the large number of speculators holding extreme long positions would decide to sell. Such a wave would push gold prices toward significantly lower levels.

Conclusion

Multiple tailwinds and headwinds are whipping the investment landscape. Economic growth has clearly slowed and

central bankers are introducing measures to thwart the slowdown. The trade war between the US and China has hurt business confidence and capital investment. And in the midst of this, stock markets are rallying, but seem to be increasingly unrooted from fundamentals.

By reducing stocks, selling gold and investing in cash, we reduce risk in the portfolio, based on an investment horizon of three to nine months. We also preserve the gains made after a rollercoaster ride in equity markets, benefiting from the positive development of the central banks' reversal in monetary policy. Changes to the equity sector positioning also make investor portfolios more resilient in an economic downturn. An expanded cash position can also be used to act opportunistically in the future, such as to re-enter the market after a correction.

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