Allocation insight

7.6.2018

Dollar driving investment returns

The fairly good market development in May was overshadowed by political instability in Italy and Spain. The social problems related to the countries' debt are largely the same as those that triggered a deeper political crisis a few years ago. Investors once again fear the worst-case scenario, i.e. the countries' uncontrolled exit from the euro zone, even though it does not seem likely. From investors' perspective, central bank policies and foreign exchange rates on both sides of the Atlantic play a more central role than politics. During the past few months, the currency markets have experienced a material change that may give the equity and corporate bond market development a positive boost.

Currency strengthened by solid economic growth

The narrowing of the market rate differential between the euro zone and the US in the early part of the year (Fig. 1) was the single most important driver for the appreciation of the euro and the depreciation of the dollar. The euro zone was still recovering from the deflationary shock caused by the drop in oil prices in 2015–2016. Subdued inflation pushed European market rates below zero and the valuation of bank shares to a level of bankruptcy pricing. The recovery process initiated in autumn 2016 continued last year, accelerating economic growth in the euro zone and raising inflation expectations and market rates. As the US is practically self-sufficient in terms of oil supply, the US economy suffered less from the declining oil prices. Economic recovery in the US last year was also nothing like that experienced in Europe and, as a result, market rates remained almost unchanged. The euro appreciated, the dollar depreciated.

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This year, the situation has been quite the opposite. Trump's administration's stimulating financial policy, coupled with the existing good economic momentum, has led to a higher economic growth rate in the US than in the euro zone. The upward movement of market rates has been strong and the side effects have been felt in all investment markets. In the euro zone, on the other hand, similar financial political stimulus has not been seen. At the same time, the strong euro has reduced the competitiveness of the export sector in the euro zone. Economic activity in the euro zone has become more moderate over the course of the spring. Reflecting the situation, the interest rate level in the euro zone is more or less at the turn-of-the-year level and the difference compared to the US market rate level has increased. The euro has depreciated while the dollar has appreciated.

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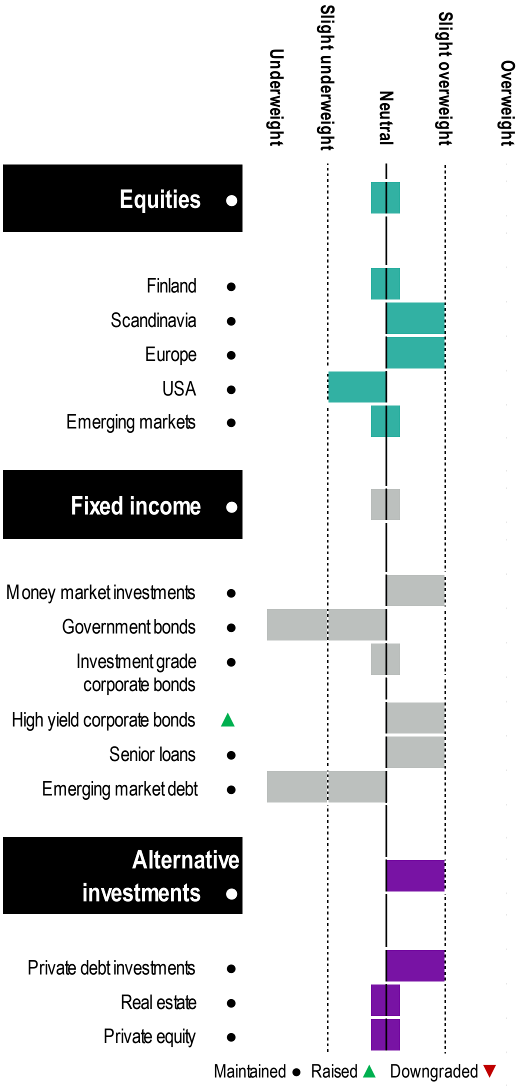

[1] www.gavekal.com

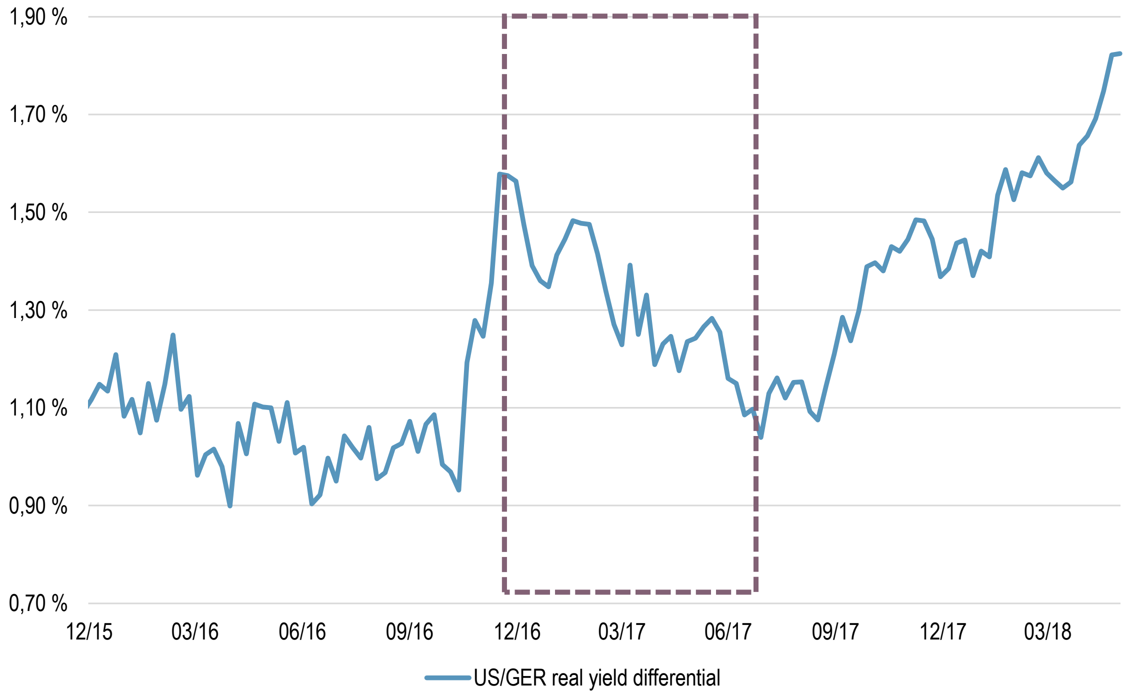

Figure 1. Differential between the US and German 10-year government bond interest rates 30 Dec 2015–1 Jun 2018. Source: Bloomberg.

Currency movements have significant impact on investment returns

In 2017, the main excess return driver for the global investment portfolio was the overweighting of euro-denominated investments at the expense of dollar-denominated ones. This year, dollar-denominated investments have yielded excess returns for investors as the dollar has appreciated against the euro. The development has been contrary to the market participants' consensus expectations. In our allocation solutions within fixed income, we have successfully overweighted dollar-denominated fixed income investments in the early part of the year. The role of currency allocation is all the more important in the current situation, with fixed income investments offering very few sources of return.

Strong dollar eases pressure to raise interest rates

Foreign exchange rate fluctuations will have a material impact on investment returns also during the remainder of the year. The appreciation of the dollar reduces inflation pressure and thus the Fed's pressure to raise interest rates in the US. Nevertheless, the Fed is expected to continue on the interest rate hike path but at a slower pace than before. The markets expect the Fed to raise its key interest rate one to three times this year. Dispersion in the various players' forecasts has recently increased.

In Europe, the ECB has announced that it will continue its stimulus programme at least until September. However, it is likely that the ECB will postpone its announcement of a possible unwinding of the stimulus programme at least until after its June meeting, as political uncertainty has increased and recent economic data in the euro zone has been weaker than expected.

A looser-than-expected monetary policy during the rest of the year would improve the predictability of companies' future quarterly earnings and reduce uncertainty in the fixed income markets. Thanks to a stronger dollar, this quite positive scenario seems more and more likely.

Equity market vibe still positive

Economic growth and companies' earnings growth are still giving the equity markets a positive vibe. However, valuation levels are higher than historical averages, albeit at a lower level than early in the year. In addition to earnings growth, the relatively attractive return expectation, particularly compared to fixed income investments, speaks in favour of making equity investments.

During the month, we rebalanced the equity investments in our portfolios back to neutral weight, as the equity weight had risen above our target level following the share price rise in April–May.

In fixed income investments, we favour corporate bonds

At the end of May, we subscribed for the ML Euro High Yield investment basket which invests selectively in euro-denominated senior loans and high yield loans. The investment strategy of the investment basket was revamped in the beginning of June. According to the new strategy, investments can also me made in senior loans, which allows the Group's investment approach to be implemented even better than before. The subscription was financed by reducing the ML Fixed Income Portfolio's share of the investments.

The appreciation of the dollar was the main reason for a return exceeding the market index in May. The weight of dollar-denominated investments of fixed income investments is approximately 21 per cent. As the dollar has appreciated, we have gradually increased the dollar risk hedging ratio, as a result of which the hedging ratio was 90 per cent for dollar-denominated investments and just two per cent of fixed income investments were exposed to open dollar risk.

In our allocation solutions within fixed income, we have successfully overweighted dollar-denominated fixed income investments.

Alternative investments on track

In May, we made investment commitments in the Cheyne Strategic Value Credit fund which invests selectively and opportunistically in European corporate bonds, and in EQT's Mid-Market Credit II fund which makes direct debt investments in companies mainly in Northern Europe.

With the portfolio still under construction, roughly 40 per cent of the assets are in money market investments. The degree of investment will rise as the existing investment commitments are called in.

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