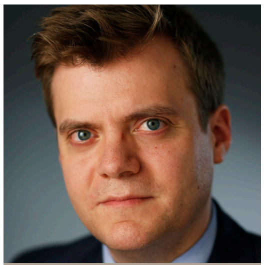
Q3 2018 Letter



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Review

The third quarter of the year saw global equity markets as measured by the MSCI AC World index rise nearly 5% in local currency terms, while the S&P 500 climbed nearly 8%. The review period was marked by a divergence between the US economy, currency and equity market on the one hand, and those of many other regions on the other. Early in the quarter, capital flowed into the US amid encouraging economic news, stronger corporate profitability and rising interest rates. The contrast with the other major economies was often stark. The Brexit cloud and its attendant uncertainties continued to hang over the UK, while in Continental Europe the Italian elections proved to be too unsettling for international capital to withstand and its equities underperformed. Once again, European politics turned investors away from a region which had promised so much but continued to disappoint and exasperate in equal measure.

But far more volatility characterised the emerging markets, particularly Brazil, Argentina, South Africa and Turkey. Trade disputes did not help but the slide in these economies' respective currencies against the US dollar was dramatic, and for good reason. The 'dollarization' trend has left many emerging markets vulnerable to a strong US currency. The Bank for International Settlements recently estimated that there is US$3.4 trillion of debt owing by non-bank borrowers in emerging markets. Global trade invoices are also increasingly denominated in US dollars, affecting countries like Argentina in particular. This poses a unique challenge when the dollar is as strong as it has been, with interest payments needing to be stumped up in US dollars amid falling local currencies. Towards the end of the quarter, there were some signs of stabilisation as Turkey and Argentina belatedly raised interest rates and speculative short-selling of currencies simply became too painful.

The question for investors now is whether to expect a rotation out of US assets back into more beaten-up areas such as emerging markets. On the US side, the case against its equity market is slowly starting to build. Stimulus in the US – whether in the form of low interest rates or tax cuts – is now in the rear view mirror and corporate profitability will be hard pressed to keep setting new records without it. Emerging market equities meanwhile continue to be one of the best ways to capture the superior long term growth from the developing economies and are now effectively 'on sale', trading at far cheaper valuations than this time a year ago. Analysis of past data shows that at current pricing, emerging market equities have tended to go on to deliver a compound rate of return of around 10% over the next five-year period. Clearly, valuation is no market timing tool, and more things could go wrong for emerging markets before they go right again. A quietly rising oil price hurts the many emerging economies that consume rather than produce oil, while the US dollar may continue to rise amid the Federal Reserve's determination to keep tightening monetary policy; Fed Chair Powell's recent comment that the central bank was still a "long way" from a so-called neutral interest rate is especially noteworthy.

Portfolio positioning*

Portfolios remain cautiously engaged in global equities, in recognition of the fact that the world economy, while showing some signs of softening, does not appear to be heading for recession or depression. Within the equity allocations, the emphasis remains on a core-satellite approach, dominated by a core of US stocks in the form of the Quality and, to a lesser extent, the Value styles. Quality stocks enjoy favourable skewness characteristics, participating in rising markets but also defending well on the downside. Value stocks represent a particularly compelling opportunity given their underperformance against US bond

Past performance is not an indicator of future performance and current or future trends.

* Where relevant, since not all our clients are invested in the same strategies. Nonetheless, common themes run across our allocations, so we trust that an overall flavour of our positioning will be informative.

yields over the last couple of years.

The US allocation is complemented by high conviction satellites in emerging markets and Japan. Emerging markets have been discussed above, while Japan continues to see improved governance and signs of economic revival in key areas. The UK and Europe are still represented but retained at relatively lower allocations. Turning to capital preservation assets, the dismal returns of the HFR Global Hedge Fund peer group index so far this year highlight the need for low correlation to capital markets and high reliability of return in equal measure. As such, our favoured areas include MBS bonds, insurance-linked bonds, short maturity US high yield bonds, long/short equity and merger arbitrage strategies. Tactically, we hold cash both for its rising US yield but also in order to be able to act opportunistically in the event of any market volatility not matched by a corresponding deterioration in long term fundamentals.

Conclusion

The investment environment arguably offers more scope for selective opportunity than it did last year. If 2017 was the ‘everything rally’, 2018 has seen more regional equity dispersion, with areas such as emerging markets and US value stocks opening up compelling opportunities for investors away from the dominant S&P 500 index. The course of the US dollar will be a major determinant of what happens next. Mere stabilisation of the US currency would probably be enough for emerging market equities and bonds to regain their footing. But a continued ascent in the greenback, driven by relentlessly higher US interest rates, would ultimately be bad for equities around the world, not just emerging markets. Our feeling is that inflationary pressures in the US are not so strong as to justify a limitless tightening of US monetary policy and that maintaining and even building on positions in emerging markets makes sense. In the meantime, investors need to keep focusing on getting Capital Preservation right. Evidence from alternative investment peer group indices suggest that this remains a work in progress while US government bonds - those traditional diversifiers which investors continue to rely on - have been selling off as yields start to normalise. While we don’t believe that equities are about to enter a sustained bear market, the longer the rally continues the more important the non-equity component of investment portfolios will become.

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