Q1 2019 GAM Multi-Asset Solutions Letter

Marketing Material

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Review

After the market volatility of the final quarter of 2018 came a strong recovery. The S&P 500 lurched from the worst December in 30 years to the best January in 30 years and was up by double digits on the year to the end of March. The MSCI AC World Index in local currency terms posted similar performance. For both investors and interested observers, the sheer magnitude of the turnaround was curious, even adjusting for the excessive gloom in evidence by the end of last year. After all, the laundry list of concerns valid in late 2018 had barely changed in 2019, namely the slowing Chinese and European economies, the fading tailwind of US corporate tax cuts, chaotic European politics including Brexit, and an on-going trade dispute between the world's two largest economies. The driving force behind the recovery in our view lies in a profound and largely unexpected change in global policy stance this year. The US Federal Reserve formally switched off the autopilot of regularly tightening monetary policy that had been in place since 2014 and conceded that there was little inflationary pressure expected in the US despite very low unemployment and gradually rising wages. In Europe, where long term interest rates went negative in March, the ECB recognised the deteriorating economic situation by lowering its growth and inflation forecasts, re-launching direct lending facilities to corporates and underlining the fact that while its QE programme was no longer expanding, existing bonds would be reinvested upon maturity. In Japan, the BoJ stood ready to expand purchases as necessary while the Bank of England announced that it would be "prudent not passive" in the event of an economic shock to the UK. In China, authorities deployed a typically agricultural analogy when they described their stimulus efforts as "irrigation not flooding" but the initial signs were of strong efficacy. Industrial metals and property prices, manufacturing indicators and the stockmarket all flickered back to life in a sign of market confidence in China's ability to engineer the fabled soft landing, i.e. rein in its historical credit expansion without compromising the economic growth the Party draws its legitimacy from. Taken together, this gave market participants the confidence to remain engaged and climb the 'wall of worry'.

Portfolio positioning*

The decision not to make any wholesale cuts to the equity allocations was prudent given the suddenness of the recovery. While equity markets have not fully regained the ground lost in late 2018, they were well on their way by the end of the quarter. The underperforming Europe, Emerging Markets and Japan equity managers also started recovering performance versus their respective indices. While regionally emphasising Japan at the expense of the UK and Europe was not immediately fruitful, the US allocation with its focus on Quality stocks fared well. Value stocks had a better January but we are becoming increasingly sceptical of this style becoming a redoubt for sunset industries such as financials, industrials and autos. As such, we are in the process of opportunistically reducing exposure.

*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.

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

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The other important theme in the equity books remains as a structural feature, namely the exposure to emerging markets and Asia. While 60% of the world economy is classed as 'Developing' by the IMF, these economies' stocks represent less than 20% of the MSCI AC World Index. The next few years will see a huge regional re-allocation within global equity benchmarks, with the recent inclusion of China A-Shares into the MSCI indices proof that the process has already begun. Away from equities, our back-to-basics approach to capital preservation manifests primarily in cash-equivalent funds and 'alt-bonds' including MBS, insurance-linked and thematic high yield. In alternative investments, highly selected equity long/short funds share space with merger arbitrage. Tactically we have emphasised defensive, short-dated US government bills where yields are now in excess of 2% while positioning for higher long term interest rates in Germany. Taken together, we believe this particular combination of non-equity assets can both generate a modest return and resist the worst of any drawdowns in the equity market, smoothing out the return stream across our multi-asset portfolios.

Conclusion

We remain optimistic that 2019 as a whole can generate a meaningful, positive return in equity markets despite the challenges described. While jitters remain around binary events such as Brexit and the US-China trade dispute, and bond markets remain pessimistic about future growth, a survey of world economic soundness reveals soundness. The US is experiencing full employment and rising wages, suggesting a benign outlook for all-important consumption which accounts for most of the world's largest economy's output. It is harder to be so sanguine about Europe but controlled stabilisation in China should limit the damage to Europe's export-dependent model. As for the binary events mentioned, the fallout from a 'hard Brexit' will be largely contained to the UK, Ireland, the Netherlands, Denmark and the German auto industry. For sterling clients, mitigating this risk may require no action since the globally-invested portfolios we manage should provide an effective hedge against a falling pound. As for the US-China trade dispute, its importance may have been exaggerated. A quick analysis of global manufacturing data shows a decline in 2015-16 remarkably similar to the current one. The cause in both cases? Not a trade dispute but a deliberately engineered slowdown of credit creation in order to curb excesses. Therefore, while we remain confident of modest market progress, volatility should be expected as this process runs its course. At such times the importance of adhering to a suitable asset allocation via regular rebalancing cannot be overemphasised. Incrementally buying beaten-down assets and selling over-extended ones has always been a key factor in generating performance over time: 2019 should provide plenty of such opportunities.

For more information, please visit GAM.com

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