Q2 2018 Letter

Marketing Material

July 2018

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Review

The second quarter of the year saw little progress in equities and bonds, as measured by the MSCI AC World Index USD and the Barclays US Aggregate Bond Index, though this masked significant underlying moves during the period. The equity market had staged a recovery after the correction of late January, only to see it unwind from mid-June as the trade dispute between the US and its major trading partners escalated. Bonds also see-sawed, with yields at first rising before falling away again as investors fled to the asset class amid a less certain economic and political outlook. Currency movements – specifically the rising US dollar - were more notable, profoundly impacting emerging market economies and related capital markets. With the first half of 2018 now complete, it is clear that the 'free ride' of 2017 in which equities rallied virtually uninterrupted is firmly over. Unlike during the China scare of 2016, a brief survey of the fundamentals suggests that negative sentiment may be more justified this time around. Across Europe, Japan, Emerging Markets and Asia, economic data has become more mixed even when taking into account seasonal factors, raising questions about how sustainable corporate profitability growth really is. Earnings in America for the first quarter grew by around 25% on the previous year, a phenomenal increase that will be hard to repeat. For markets to recover from the late January sell-off, let alone make further gains, fresh 'good news' will be required. However, the global context for such improvements is becoming less clear.

The current risks are three-fold: tightening US monetary policy, a rising US dollar and the possibility of a serious trade dispute. On monetary policy, Federal Reserve Chair Jerome Powell has made clear his desire to keep raising interest rates given the strength of the US economy but despite equivocal evidence of rising inflation. More technical, but no less concerning, will be the selling pressure on US Treasury bonds amid the Fed's post-QE balance sheet reduction and the Treasury's financing of the higher budget deficit in the wake of fiscal easing. This would have the effect of raising long term interest rates and sucking US dollars out of the financial system as they are used to pay for increased issuance. On the US dollar, the adverse consequences are already being felt in Turkey, Indonesia and Argentina since the greenback has become the global currency of choice both for debt-raising and trade invoicing. Finally, the worsening of the US trade dispute is stretching to the limit the theory that the administration's aim is merely to create noise in order to secure modest concessions from those it sees as taking unfair advantage. This may have been the intention at the outset but, with retaliation in full swing, it becomes harder for the parties to back down in a dignified manner, raising the risk of escalation and subsequent damage to the global economy. The US with its emphasis on domestic consumption is likely to better survive a prolonged trade dispute, though this will be of little comfort to manufacturers and producers struggling to make long term plans amid the heightened uncertainty.

Portfolio positioning*

Equity allocations across our portfolios had already been pared back in the last year and remain appropriate. Within the asset class we maintain a core position in US stocks generally and quality stocks in particular. The latter are characterised by high earnings consistency and this allows us to 'fund' structural allocations to the primary drivers of growth, primarily emerging markets and, to a lesser extent, technology. However, in the near term it is capital preservation assets that will play the most important role in a more uncertain environment, both in terms of limiting losses but also generating returns in the meantime. To this end, we continue to fine-tune the blend of diversified fixed income and alternative investments held across portfolios, focusing particularly on two key attributes: low correlation to traditional equities and bonds, and reliability of returns. The ideal capital preservation fund combines both features, but most emphasise one rather than both. As such, active allocation between different capital preservation styles will be crucial as the market environment evolves. Tactically, we are positioned for a rising dollar and higher US interest rates.

* 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.

GAM Investments

Conclusion

While our assessment of the outlook has darkened somewhat compared with last year or even last quarter, it is important to note that we do not forecast a worldwide depression akin to that which followed the last significant imposition of tariffs in the early 1930s. Crucially, we will be avoiding panic-sales out of the long term, secular growth drivers mentioned, even if this means maintaining allocations vulnerable to a potentially more uncertain market environment. This approach remains sensible when considering the alternative, which would be to attempt to market-time when policy on areas of concern like trade appears to be changing daily. Dampening portfolio volatility where possible will be important but our main message to investors is that they must extend their investment horizons.