GAM Multi-Asset Solutions

Q1 2018 Letter

Marketing Material for Professional/Institutional Investors Only

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Review

The first four weeks of 2018 saw global equities as measured by the MSCI AC World Index in local currency terms climb by 5.8%. This, coming after the 20% gain posted for 2017, suggested price action that was becoming unsustainable. Sure enough, the market went on to correct during the 'Wage Rage' episode of early February when US hourly pay was reported to have risen by 2.8% on the previous year. Investors took fright at the prospect of higher-than-expected inflation and the tighter interest rates that would surely follow. By late February, the 10-year US Treasury yield had risen to 2.95%, further contributing to the volatility in equities. But concern soon switched to the prospect of a trade war, as the US administration applied tariffs to steel and aluminium in an apparent effort to reduce the bilateral trade deficit with China.

By way of context, US wages eased off the following month and a more detailed analysis of the US inflation data revealed isolated inflation from a variety of unconnected sources such as truck leasing and hospital costs. In other words, no broad-based, wage-driven inflation shock. Bond yields gradually eased back as a result. On trade, the potential GDP impact of the tariffs announced so far by the US and China remains negligible. One theory posits that the noise and confusion was all a political ruse designed to 'sharpen minds' before negotiations focused on curtailing intellectual property theft and liberalising Chinese markets to foreign imports. This remains to be seen but it is undeniable that economic fundamentals have remained encouraging. While some indicators showed signs of softening – such as European manufacturing and US consumption – most measures of global economic health were positive. The Bloomberg consensus forecast for US GDP growth at 2.8% is just shy of the administration's 3% target. Outside the US, the IMF upgraded its forecast for Emerging Market economies' growth while the JPMorgan Global Composite Purchasing Managers Index was firmly in positive territory for February.

None of this is to sound complacent though. The reality is that global equity markets have not recovered from the steep correction of late January and early February while the bond markets – traditional equity diversifiers – appear vulnerable to the merest hint of inflationary pressure. Market volatility has stayed elevated and the prevailing narrative, while flitting from inflation to interest rates to trade to unregulated tech stocks before reverting back to trade, remains downbeat. The danger is that the market's largely unwarranted gloom could become self-fulfilling. The longer it fails to regain its poise, the more likely it is that shorter term investors will run out of patience and capitulate altogether.

Portfolio positioning*

Across portfolios we remain engaged in equities but with generally lower exposures than a year ago, reflecting our policy of paring back risk as the market rally extended. Amid the latest bout of volatility, strategic allocations are broadly unchanged and the regional focus is on emerging markets while in the US we hold a thematic preference for quality stocks demonstrating consistent earnings. Where held, we have used our tactical asset allocation sleeve to modestly increase equity exposure when volatility has appeared to be unjustified. Away from equities, capital preservation assets in the form of fixed income & credit and alternative investments performed a vital function in defending portfolios from the worst of the market drawdowns during the quarter. While this first test since the allocation was fine-tuned last year went well, it is only after more sustained periods of market turbulence that such low-correlation strategies can be accurately assessed.

Conclusion

In what was surely a sign of market complacency last year, one commentator remarked that S&P 500 index trackers had become 'money market funds' into which investors could deposit confident that their capital would be intact when the time came to make a withdrawal. Today, heightened volatility has changed that dynamic. Global equities are in negative territory just one quarter into 2018. While we believe that gains from the market are still very possible this year, particularly in the specific themes mentioned above, progress is very unlikely to match that of 2017 either in magnitude or linearity. Instead, increased volatility will emphasise the roles of investment horizon and capital preservation in the months to come. If neither sound particularly exciting, it should be remembered that they serve a critical investment function, namely to maintain investor engagement in what remains a fundamentally well-supported market.

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

GAM Investments

* 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.

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