Q4 2017 Letter

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FOR PROFESSIONAL INVESTORS ONLY

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Review

2017 saw strong gains across global equities, with the MSCI AC World Index up just over 20% in local currency terms. While most of the major markets fared well during the year, there was also considerable regional diversification in evidence. For example, the FTSE returned just under 12% but the MSCI Emerging Markets Index piled on a cool 31%. For many investors, these positive returns were surprising given perceived political risks and also the sheer age of the equity market rally, which it could be argued began back in March 2009. However, the political factor can be discounted with some confidence. The well-established Policy Uncertainty Index was in fact not especially heightened versus its 20-year average despite the newsflow out of North Korea. Without wishing to sound complacent, it should also be remembered that the media is driven by the mantra "if it bleeds it leads" and the North Korea story was always going to dominate given the two larger-than-life personalities involved. From a broader perspective too it is worth noting that we have in fact been living in an era of relative calm since the end of what Eric Hobsbawm once described as "the short 20th century". Today, there are no grand political ideas violently battling it out for supremacy.

This still does not fully explain why investors ignored the political upheavals of the last year, even if they were not of the same scale as the past. Here we would observe that direct household ownership of stocks in the US at 14% is now about half that of cat ownership, leaving institutions and high net worth individuals with longer investment horizons to dominate the equity scene. Undemocratic this may be, but we believe that a changing ownership profile has helped account for the calmness observed across equity markets in 2017. As for the Trump phenomenon itself, while many such as George Soros predicted economic catastrophe from the new administration, the reality is that the new Presidency brought with it a new-found confidence amongst consumers, corporate boards and investors. Coal barges once again steaming down the Ohio River, rightly or wrongly, gave many Americans a renewed hope in the future and this was reflected in strong consumer spending. Furthermore, the recently signed-off tax reform package will be a net positive on top of an already strong earnings recovery for listed corporations this year. Whether firms then go on to invest, increase wages or buy back stocks will be a high quality problem for CFOs to tackle in 2018.

Beyond the US, growth was observed across most of the major economies. No OECD members were in recession in 2017, while high-frequency growth indicators like steel, the Baltic Dry shipping index and even luminosity measured by satellites over China all suggested a genuine, broad-based growth story which underpinned progress in equities. The huge gains in emerging markets deserve special mention. Recent underperformance against US equities, improved budget balances, better counter-cyclical policies, a stable China and the shift from commodities to technology as reflected in the MSCI Emerging Market index all combined in 2017 to generate significant returns. Other regions benefited correspondingly, notably Europe and Japan. Europe in particular also saw domestic reflation, with unemployment falling and GDP growth rates catching up with those of the US. This translated into the region's outperformance of global equities until it faded in the second half of the year amid a strengthening euro. The UK saw more lacklustre equity performance. While it is tempting to put this down to Brexit, the FTSE 100 stockmarket ceased to follow the UK leading economic indicator a while ago. Instead, gains which sterling made against the US dollar during the year had the effect of dampening down UK-listed corporate earnings from overseas when translated back into the pound. Overall, however, 2017 was a year in which global market fundamentals were both sound and broad-based.

GAM Investments

Portfolio positioning*

Despite the supportive picture of 2017 painted above, 2018 will not be without its risks. Chief amongst these is the fact that China is starting to apply the brakes to credit creation and the US Federal Reserve appears too eager to raise interest rates given low inflation. Less immediate but no less relevant, the 'iron law of valuation' dictates that the more an investor pays for a stock, the lower the expected total return will be over time. Most equity valuation measures today suggest that the high compound rates enjoyed since the end of the global financial crisis will not be repeated in the next few years. This need not signal a market collapse, but simply more subdued returns. As asset allocators, we pay particular attention to the fact that the earnings and dividend yields which global equities offer today are far superior to the yield of developed market government bonds. Equities therefore continue to merit a meaningful place in a diversified portfolio. Within said equity allocations we retain a core in the US, a highly liquid market which offers relative stability in the event of volatility in the months to come. In particular, we favour quality stocks which offer steady earnings accrual. Interestingly, technology is well-represented in the quality style, a sign of that sector's relative maturity in contrast to the speculative nature of the TMT boom years of the late 1990s. Complementing this US and quality allocation, we emphasise Europe but particularly Emerging Markets/Asia. For the latter, the near term policy mix is encouraging as stated earlier but crucially, the long term secular growth story is irrefutable. For those investors with the time horizon and flexibility, this is where we would place particular emphasis. We also maintain a meaningful allocation to Japan, with our lower conviction in the UK allowing us to 'fund' our firm belief in the European and Emerging Markets story.

Away from equities, we continue to highlight the challenge of selecting the right investments within the capital preservation sphere. Corporate bonds offer coupon but, with spreads over risk-free bonds tight, there is little room for error in the event of a sell-off in broader risk assets. Junior European financial credit and low duration US high yield have their place but must be appropriately sized. We complement these with the more independent return stream offered by total return approaches, US MBS bonds and insurance-linked ('catastrophe') paper, cognisant of course that none are truly risk-free. In alternative investments, performance was generally encouraging in 2017 but volatility in macro funds towards the end of the year reminds us that gains can easily fade. For this reason, we will be emphasising diversified sources of alternative return, including carefully risk-managed merger arbitrage and market neutral long/short equity styles. Finally, our tactical asset allocation sleeve affords us the opportunity to engage or dis-engage from equity markets in the event of a significant departure from the fundamentals. Absent such an opportunity, and 2017 was notable for its lack of entry points into the equity market, we deploy coupon-bearing bonds to generate steady return as well as opportunistic relative value themes such as long technology / short physical retail stocks where a strong secular trend is in evidence.

Conclusion

The investment environment remains supportive overall, with global growth and corporate earnings in good shape going into the New Year. However, this needs to be weighed against exceptionally strong recent market returns and the possibility of investor euphoria breaking out. Historically, overconfidence has tended to be the final phase before a meaningful market adjustment. The other balance that investors must achieve is the short term with the long term. It is easy to discuss investing in compelling multi-year themes such as emerging markets and technology during a bull market. But when portfolio valuation statements come to be scrutinised amid a more volatile backdrop, investor psychology will naturally be tested. It is worth noting that for an entire cohort of younger investors and their professional fund managers, the 2008 global financial crisis preceded their time as decision makers. This will make any return to a more volatile era all the more challenging. For now, our approach is best described as 'late cycle expediency', characterised by a recognition that strong equity gains well in excess of the so-called Siegel Constant of 6.6% are probably unsustainable but that equally there are no immediate imbalances brewing that might unseat confidence in the markets and bring about a sizeable correction. For this reason, a genuinely diversified approach makes compelling sense, combining a structural allocation to equities with capital preservation assets that have evolved over time to emphasise consistency and independence of return generation. While we believe that 2018 will see the continuation of many of last year's themes, we also recognise that flexibility will be vital if markets depart from our central scenario.

* 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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