

2018 Investment Outlook. Inflation and Rates Pivotal.

8 years of recovery

We have now had 8 years of economic growth since the financial crisis, with a little turbulence along the way, the European banking crisis 2011/2012, Taper Tantrum 2013, the China stock bubble in 2015. China has clearly matured and growth rates decelerated as one would expect from an economy of its size. The US has grown steadily albeit at a slower pace than in previous decades. 2017 witnessed a deepening and broadening of growth most notably in Europe and Japan. India's potential remains good but has been held back by some necessary policy adjustments. Generally, it has been 8 years of prosperity, punctuated by few moments of stress.

In the last 8 years, the major actors on the economic stage have been the central banks. When crisis struck they were quick to respond with liquidity infusions and rate cuts. As with all painkillers, QE and ZIRP are addictive and hard to wean off. Currently, the US Fed is the only major central bank which is raising rates and normalizing balance sheets. The People's Bank of China is trying to manage the credit transmission in the economy, not really tightening policy but putting an unruly system in order. The ECB remains accommodative at least up till September 2018. The Bank of Japan at last sees a growing economy and may be able to shift its QE program down a gear. One thing is clear, the need for extraordinary policy has passed and it is time to reset policy for when the next downturn hits us.

The global banking system, found wanting 10 years ago, has been put in order. US banks were recapitalized some years ago and now the European banks are also in good shape. Regulations and capital requirements raised in the years following the

crisis may even be relaxed. But though their period of expiation has passed banks face new challenges in the shape of Fintech and the shadow banking system. This evolution of financial intermediation poses challenges and opportunities. Regulators will have to change and expand their remits accordingly.

Tech has had a resurgence that has already well surpassed the heights of the Dot Com boom of 2000. Innovation has progressed by leaps and bounds, in hard as well as applied tech. The potential for the likes of Amazon, Tencent, Ali Baba, Facebook and Google appear limitless. But the high profile of the tech sector invites scrutiny and regulation, adding an additional dimension to tech investing. On top of that no investor should forget the limitless potential of Nokia, Ericsson, and the telcos in the late nineties.

To answer the question of whether equities can keep rising we need to understand the future of central bank policy and inflation. History tells us that central banks don't raise rates very far before the next problem arises. However, if the pace of rate hikes is sufficiently slow, and inflation muted, interest rates should not rise enough to threaten the expensive valuation of equities. This appears to be the broad consensus, however, it also assumes that there are no other factors which may cause them to accelerate their tightening. Inflation has been surprising low given the tightness in some labour markets and the pace of growth. One factor is the rise of innovation which increases productivity and efficiency. Another factor is inequality which leads to a surfeit of saving and demand deficiency. If central banks can maintain the glacial path of normalization, and inflation remains subdued, then equity markets are likely to continue their ascent. However, given recent performance, future performance is likely to be more subdued.

If inflation rises, and it may do so if commodities and energy prices rise, or if rising interest rates should reduce slack

in the economy, or if the Neo-Fisherian view (that real interest rates are slow to adjust and hiking nominal interest rates can lead to inflation) is right, then the outlook for equities could deteriorate. Valuations will be harder to support with higher interest rates and steeper yield curves.

Topical Areas:

China is no longer an emerging economy. With over 11 trillion USD nominal GDP, it is unsurprising that growth has slowed. The last 8 years have also presented China with several major challenges. One of them is how to deal with a more insular, protectionist world. China's response to this global trade (cold) war was to become more reliant on domestic demand, a continuing project. The reshaping of its economy, especially while trying to maintain stable growth has been capital intensive and has led to massive credit creation, through the banks and the shadow banking system from the bond market to more exotic financing structures such as LGFVs. Today, China is trying regulate and manage this complex credit intermediation system. Investors have watched developments with some concern but it is likely that the regulators have matters under control. The 19th National Party Congress has cemented President Xi's position which will give him more power to pursue his agenda of integrating China into the international community, building bridges while the US builds walls, and developing a Chinese hegemony. Simultaneously the Party is encouraging rule of law over rule of party, ironically, so it can extend its reach more effectively.

India is one of the most interesting economies in Asia. The country has not seen a simple majority in the Lok Sabha since Rajiv Gandhi led Congress to victory in 1984. Current PM Narendra Modi's popularity is buying him a lot of patience to conduct a long overdue campaign of reform of the Indian economy. Demonetization in 2016 and GST in 2017 slowed

economic growth and imposed short term brakes on growth but the rebound is gaining momentum and the long term benefits of greater banking participation and a common market across Indian states should not be underestimated. A newly drafted insolvency law (2016) has been followed by regulators encouraging banks to deal with non-performing loans and most recently by a plan of recapitalization of the banking system. These measures will unblock credit intermediation which will boost investment. Indian equities are expensive, and inflation is a threat, but the long term prospects are positive. A young demographic, a population fast catching up to the size of China's and a nominal output only one fifth the size of the Chinese economy frames the opportunity. India is a long term play with great potential.

Japan's Topix flirts with the 1800 level, a major resistance which had been tested before unsuccessfully in 2007, 2000, and 1996 in Japan's lost two and a half decades. Economic growth has been steady and corporate profits growing. Various steps in reform such as easing of visa requirements, getting more women and retirees into the labour force, improving corporate governance have joined infrastructure investment, fiscal expansion and ultra-loose monetary policy in propelling the economy and the stock market. There is a palpable revival of animal spirits in Japan, the economy is not only growing but confidence has returned which will translate into an improved business investment cycle lifting the economy further. On a per capita basis, GDP growth is already competitive with the US. For investors, what Japan offers is a glimpse of the future, an ageing population, high national debt, low inflation and clues as to the sectors and businesses which thrive under these conditions.

While equities have done well these past years, on a risk adjusted basis, it is hard to compete with credit. Fixed income markets have performed remarkably well since the crisis, powered by falling interest rates as well as

tightening credit spreads. Today, bonds are more overvalued than equities. With central banks shifting towards normalization, (the Fed is already underway,) duration will be a headwind. As for credit spreads, the thirst for yield has led to a consistent tightening of spreads, more pronounced in investment grade but also in high yield. That economic fundamentals are healthy is not in question but there is a price too high and credit is near that. The duration factor can be addressed by trafficking in the floating rate sectors of the market but even these face tight spreads. Structured credit provided cheaper access to the market for more sophisticated investors but even some of these avenues are being exhausted. Mortgage bonds which were areas of value are becoming more expensive. The dearth of value in fixed income will encourage asset allocators to shift exposure over to equities further crowding the space.

Banks. 2017 marked a turning point in banking regulation. The Basel 4 framework has been agreed and will be implemented in the next few years. In the US, a new Fed Chair and a business friendly government will likely begin to soften banking regulation. European banks, some 2 years behind the US in the recapitalization cycle, are now adequately capitalized. New capital rules will require all banks to further strengthen balance sheets, but not by much more. Banks should become more profitable as CEOs will now focus on return on capital, not the raising of it. In China, regulators are perhaps half a cycle behind but are now busy reining in reckless credit practices and stabilizing the banking and financial system. They will likely succeed. In India, a newly inked (2016) insolvency law is being enthusiastic applied with some encouragement from the RBI, followed by a generous recapitalization package. A decade of banking sector underperformance from QE and increased regulation will soon be behind us.

Hedge funds and other alternatives. The era of QE and central

intervention saw correlation rise and volatility fall creating very challenging conditions for hedge funds to operate in. Hedge funds thrive on dispersion of returns among assets. High correlation makes it difficult to find winners and losers as assets rise and fall in unison. Low volatility also lowers returns requiring hedge funds to raise leverage but may either find investor resistance or reluctant prime brokers, (who have their own capital requirements to consider.) Indeed equity long short managers have lost market share to event driven and private credit managers as investors seek alternative sources of yield. This may soon change as central banks pull back from ultra-easy policy. Expect volatility to increase and correlation to fall implying easier operating conditions for hedge funds. This coincides with decreasing investor appetite for hedge funds and active managers in favour of passive and index following investing. As investors flock to passive investing, it can pay to move in the opposite direction.

Risk appetite and aversion. Investors have been accused of complacency as the market has risen. Evidence is found in the weak VIX, in high PE multiples and in tight credit spreads. The reality is more balanced. It is true that absolute PE multiples are high on a historical basis but this is less acute once one considers the low treasury yields. The equity yield gap still suggests that equity valuations are not at an extreme. They are expensive but not exorbitant. Then we have credit spreads and here the high valuations are less defensible since they are already expressed as a spread over treasuries. Credit markets are indeed expensive, at least where senior unsecured bonds are concerned. The leveraged loan market is tight, but this is explained by demand from investors seeking floating rate exposure. With the underlying economy in good health, the arguments against loans may be more technical than fundamental in nature. As for the VIX as a complacency indicator, it shows but half the picture. A closer look at the options market reveals that skews have been elevated in the last 8 years, indicative of investor caution.

This healthy caution has, however, recently been eroded as the market continues to inch higher.

Generally, FX is sufficiently flow and sentiment driven to confound the best of fundamentally based forecasts and 2017 was no different. In late 2016, a strong consensus developed for a strong USD. The Trump Presidency and the promise of more protectionism and tax breaks coupled with an already stable and growing economy propelled the USD to a high on Jan 2 from which it spent the whole of 2017 falling (the DXY losing 10%.) The improving European economy and the signals that the ECB might begin to normalize policy boosted the EUR more than hard data would have suggested. The long term picture for the USD remains good, however; the economy is stable and growing, the Fed has already turned the corner, and fiscal policy is finally turning the President's way. The ECB may well end accommodation in October this year and the BoJ might even signal some moderation of its QE, but rate differentials are still substantial and the inflation prospects also still favour the US. The protectionists tendencies will also boost USD prospects over the longer term. While we have long held a bullish USD view based on fundamentals, we see significant interference from flows and sentiment that we had not taken significant currency views in 2017. The long USD trade is one which we think will pay off but which also requires patience and pain tolerance and it is one which we avoid in our more conservative portfolios.

Strategy:

Our asset allocation is advised by the relative valuations between equities and fixed income. While we expect equity returns to slow in 2018 from 2017 levels, we expect the deceleration to be even more pronounced in fixed income. In the past we have always managed to find niche markets within fixed income to provide us with a superior risk return than

either equities or traditional bonds. These opportunities are becoming more difficult to find.

We have a disciplined risk allocation process which takes into consideration the potential returns and the risks of each investment we make. Generally speaking, we will be increasing equity exposure slightly while de-risking our fixed income portfolio. On a net basis, this should maintain the overall risk level since equities are riskier than bonds. We will be deploying more risk to hedge funds given our optimistic outlook.

In equities, we will focus more on Asia given the opportunities we see in the region. Our position in Asia also gives us an edge and greater insight into the markets in the region. We expect to allocate more actively to India, Japan and China. In the rest of Asia, we are cautious as the giants pursue their national agendas, potentially to the detriment of the smaller countries in the region. Globally, we have an optimistic view on developed market banks, especially in Europe. Asian banks are probably a year or two lagging developed markets and we will monitor the situation with a view to capturing the catch up when it occurs.

In fixed income, we are understandably cautious on duration. The USD curve has flattened significantly over the year and we do not see much further scope for flattening. The economy is too strong to warrant an inverted curve. That said, the 2 year will continue to reflect Fed rates policy and continue to climb. This implies that the long end should sell off. We will focus our exposure in floating rate paper and may opportunistically hedge USD duration at longer maturities. We maintain the same level of caution on EUR rates which may move in sympathy with the USD curve. In terms of credit, we see more value in high yield than in investment grade corporates but generally regard corporates as expensive. The leveraged loan market is not cheap either but rising rates will bring us some yield. Investment grade CLOs are relatively attractive on

a loss adjusted basis and we will dedicate capital to this segment. Generally we are witnessing corporate issuers increasing leverage, in some cases to pay dividends, and see the sector as expensive on a loss adjusted basis. We find better fundamentals in the US MBS market where households' leverage remains moderate. We also find value in subordinated financials and contingent capital as part of a wider banking theme where we expect the reversal of QE and regulation to be positive for both bank equities and credits.