



Investment Letter – Q2 2017

“Before long, we will all begin to find out the extent to which Brexit is a gentle stroll along a smooth path to a land of cake and consumption”. Mark Carney, 2017

The quarter has been dominated by the power of politics and populism yet again, however we believe other factors have been the driving force behind markets. The various elections that we have seen over the past year have reminded us all to expect the unexpected. The influence of social media, its increased use in campaigns, and a sense of a need for change have increased the engagement of younger voters and seen a resurgence in personality politics. In spite of political turbulence remaining high, markets have learnt how to respond to these major political events and surprise results with apparent nonchalance.

Following the EU referendum vote, where the bookmakers favoured a ‘remain’ outcome, sterling fell 10% overnight and the FTSE 100 fell 8%. It took 3 days for equity markets to recover. After Trump's victory to become US president, US stock futures fell aggressively initially, although this lasted only a matter of hours. The French election in May saw President Macron beat polling expectations and France take a step against populism. This win for independent centrist Macron over the far-right Le Pen saw a reduction in political risk in the region and a boost in business confidence, however the market did not so much as blink. Most recently in the UK, with the probability of a Conservative majority at 78%, a hung parliament result was undoubtedly a surprise. But not as surprising as the reaction of the market where sterling fell a mere 2% overnight and the FTSE 100 was up 1% following confirmation of the result, with the market quickly extrapolating that a hung parliament had increased the probability of a ‘soft’ Brexit.

Investors are now focused on whether this relatively calm market backdrop can continue to move asset prices higher. We believe that the narrative changed during the last couple of weeks of the quarter. That change was central bank monetary policy. In the US, the Federal Reserve announced another cautious step towards policy normalisation with a 0.25% increase in interest rates, but crucially highlighted that later this year they intend to begin to reduce the size of their balance sheet. This was followed by the Bank of England leaving rates unchanged, but unexpectedly the vote was split 5-3 with 3 members of the Monetary Policy Committee voting for a rate increase. Later we heard Mark Carney hint that some of the stimulus package could be withdrawn if UK wages pick up and business investment strengthens – this came only a week after he stated it was ‘not yet the time’. Finally, Mario Draghi, President of the European Central Bank, caused further confusion by stating ‘deflationary forces have been replaced by reflationary ones’ which markets felt indicated possible reduction of stimulus coming closer – a stance that was somewhat reversed later. Over the course of 2 weeks, we had what appeared to be coordinated rhetoric from key policymakers at the Fed, ECB and BoE, all indicating an intention to remove some monetary stimulus and a desire to normalise policy. Without any significant upward trend in inflation, perhaps central banks instead have their eyes focused on overheated and expensive asset prices. We believe that this is key for investors to watch as policymakers could easily make an error while being too focused on returning interest rates to ‘normal’ levels.

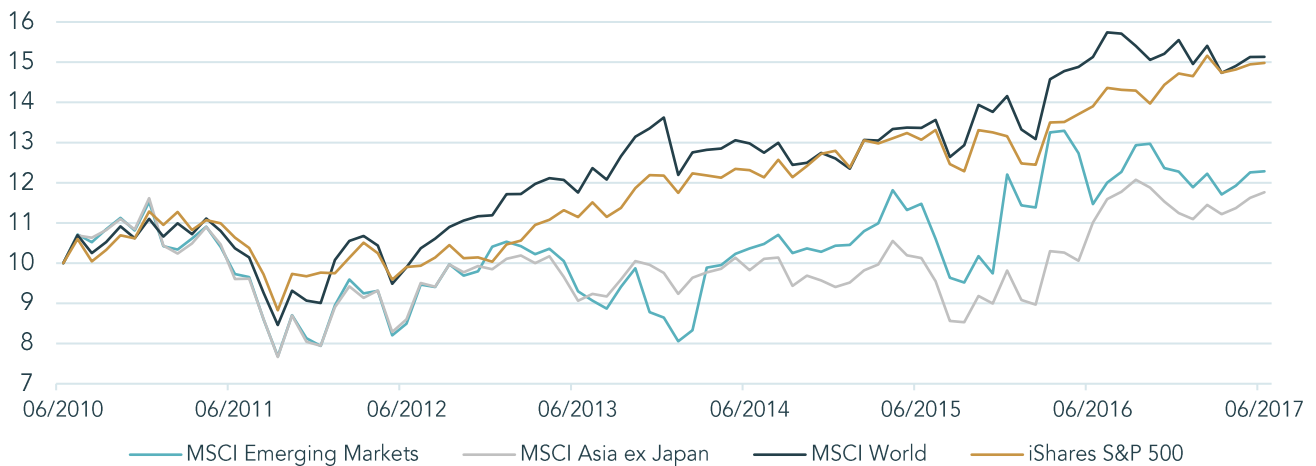
Despite our broader caution across most developed markets, we remain more confident about Emerging and Asian equity markets. In the past it has been considered higher risk to have exposure to these markets when US interest rates are rising. This however no longer seems to be the case and while we remain mindful to the risks, we believe that the potential returns outweigh those risks. As emerging economies grow and reduce their dependence on foreign debt, in particular US dollar debt, our belief is that a decoupling is taking place as they are no longer so sensitive to the strength of the dollar. We view 2016 as having been a pivotal year where correlations between developed and emerging markets have fallen and the associated opportunities of returns in emerging markets has increased.

Alongside the relatively subdued performance of developed equity markets this quarter, there has been limited volatility. The VIX index is the most watched index of market implied volatility (based on the US S&P 500 equity options market) and is commonly known as the fear index. Year-to-date the index has remained calm and even managed to hit a 23 year low, implying that investors expect quiet market conditions, whereas we expect volatility to return. Often spikes seen in the VIX index originate from issues in developed markets, but result in a broad based equity sell off. Emerging markets therefore tend to be sold even when there have been no changes to the underlying fundamentals. If this occurs we would see it as an opportunity to further increase exposure to these markets.



Emerging and Asian equity markets also look attractive on a relative value basis. The graph below shows the price/earnings ratios of MSCI Emerging Markets and MSCI Asian Markets versus the S&P 500 and MSCI World indices. It is clear that Emerging and Asian markets are currently offering a lot more value than that seen in the developed world. From a structural perspective the demographic story still remains the biggest long term opportunity, particularly with emerging markets home to 85% of the world's population. Alongside the growing wealth of these nations, the changes in middle class numbers means a huge boost to consumer spending. From 1990 to 2009, Asia's middle class grew by 38%, causing surging demand for consumer goods in these countries. In 2009 the global middle class was 1.8 billion people and it is estimated to grow to 4.9 billion by 2030, with Asia making up two thirds of that. Today 525 million people in Asia are considered middle class, which is more than the entire population of the EU.

Price/Earnings ratio: Emerging Markets vs Developed Markets



In the current uncertain environment it has been crucial to continue to diversify portfolio strategies on a global basis and ensure that risk remains controlled and appropriate. With potential headwinds for the US and UK equity markets we remain defensive, and will look for opportunities on the back of any weakness. Whilst it is unclear whether the road to Brexit will indeed be a "gentle stroll along a smooth path to a land of cake and consumption", our suspicions are that it won't be. In another quarter we may be none the wiser to the outcome, but we believe we will have the opportunity to capitalise on what the uncertainty will bring. As we look ahead, we will see developed market policymakers beginning a process of monetary tightening, but without the solid economic backdrop that would normally justify this. We remain convinced that a non-conventional approach to fixed income and an active management style within equities is the most appropriate solution to benefit from the unwinding of monetary stimulus.

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