



## Investment Letter – Q3 2018

“Interest rates are the mother and father of all evil”. President Erdogan, on Turkey’s unorthodox approach to protecting its depreciating currency.

In a conventional diversified portfolio, it has been a tough year to make money. As interest rates have risen, fixed income assets, the traditional bedrock of portfolios, have fallen in value. US Equities have been an outlier in markets, with strong performance seen throughout the year, whereas elsewhere fears around trade wars and their effect on global growth continue to stall markets.

The disparity between the US market and the rest of the world is evident when studying the performance of the MSCI World Index (an index of developed market equities), which moves from a positive return of 4% year to date, to negative 4% when US Equities are excluded. The chart below highlights the point at which the recent divergence in the markets began. Since the high correlation from the start of the year broke down in May, the US has outperformed the rest of the world by an extraordinary 12%, leading us to question how much wider these jaws can stretch.

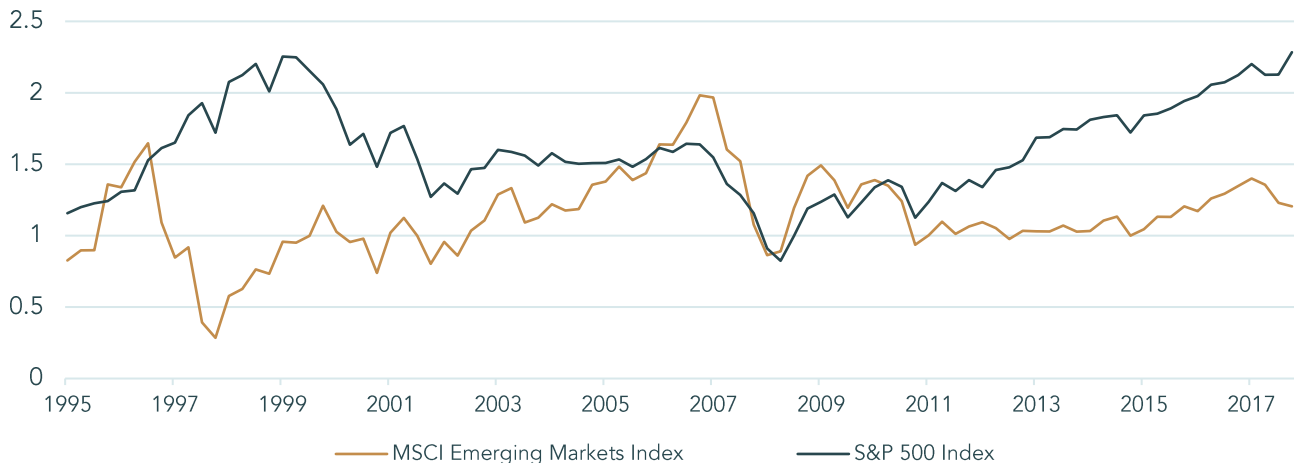


The outperformance of the US has been aided by tax cuts, which have encouraged American companies to repatriate Dollars and subsequently buy more of their own stock. It is estimated that during 2018 US companies will have bought back more than \$1 trillion of their own equity, up 66% from 2017. The second largest buyer of US equities has been ETFs (Exchange Traded Funds). These index tracker funds have continued to see strong demand; the result of which is that ETFs are likely to have bought c\$400 billion of stock by the end of this year. To put the size of these purchases in context, active fund managers are expected to buy just \$25 billion in 2018.

We spend a lot of time looking at various valuation methodologies of different markets. The Price to Sales ratio is arguably the most simple and effective way of identifying valuation variations across regions. Sales are the revenue a company makes, which means that this measure is difficult to manipulate and is a good reflection of how a business is performing. On this basis, the US has now overtaken the highs of the dot-com bubble, suggesting valuations are particularly stretched. This is not to say that we think it will not get more expensive in the short term, but on a comparative basis we would prefer to be invested in markets where the risk/return characteristics are more attractive. For example, using this Price to Sales ratio, Emerging Market Equities in 2010 were trading on a premium to US Equities. That was followed by a sustained period of underperformance of the asset class in both absolute and relative terms. With Emerging Markets currently trading at a 47% discount to the US, we believe that in the medium and long-term they offer the potential for much greater upside. To illustrate this, the chart below looks at the Price to Sales ratio of the S&P 500 versus the MSCI Emerging Markets Index.



### Emerging Market Equities versus US Equities - Price to Sales Ratio



Even with strong fundamentals in some Asian and Emerging Market countries, their currencies are vulnerable to a strengthening US Dollar and the daily news surrounding trade wars. This vulnerability reared its head this quarter when a number of countries found their currencies under significant pressure. August saw economic turmoil hit Turkey when sanctions were imposed by America, and what was already a fragile economy saw its currency fall by 25% versus the Dollar. The Turkish Lira has now depreciated 40% in 2018 and inflation recently hit an alarming 18%, both severely damaging the economy. Other countries had to react quickly to try and defend their currencies. In Argentina, the central bank raised interest rates to an eye watering 60%; this sadly has had little impact with weakness returning to their currency late in September. A more unconventional method was reported in Indonesia, where there is a strong movement by the population to try and defend their country's currency. There, a fried chicken chain gave out free meals in September to any customer who could prove they had sold US Dollars in favour of the Indonesian Rupiah.

The short-term impact of the trade war newsflow does not materially influence the fundamentals we are seeing in these countries. Their growth rates remain more attractive than that of the developed world and that looks set to continue. An example of the potential for growth in these territories may be evidenced by the fact that last year alone 8 million students graduated from Chinese universities, which is twice as many as the US. Most notable perhaps is that the growth in the number of engineering students has been explosive as part of the government's push for innovation. Our Emerging Market exposure remains extremely diversified, and whilst the uncertainty around trade and tariffs will continue to create volatility, we are positioned to make the most of the opportunities we see and look forward to benefitting when Emerging Markets recover, which we firmly believe they will.

Outside US Equities this quarter, there were few bright spots in markets. Japanese Equities were one of the exceptions, with the Topix returning 6% in the last 3 months. Our portfolios also benefited by being out of conventional debt, but in a sideways trending market it has been hard to make positive returns.

The final quarter of the year is set to be an eventful one for UK and US politics. A Brexit deal could be offered sometime in October, but whether any deal can get through Parliament is another matter. US midterm elections in November look set to cause at least a minor upset to President Trump's agenda, with the House of Representatives appearing likely to swing to the Democrats. There is an outside chance the Senate could switch as well, which could unleash real change, albeit we see the likelihood as slim currently. We continue to try and position the portfolios as positively as possible, but with stretched valuations in some areas and political risk in the forefront of our minds, our inclination has been to continue to gradually reduce risk and take a more alternative stance.

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Chief Investment Officer