



Investment Letter – Q4 2017

“Don't confuse lack of volatility with stability” - Nassim Taleb, Author

If you were to view 2017 market levels at the start and then at the end, you could be forgiven for thinking the year had been uneventful, with global stocks recording their best performance since 2009. As is often the case, this performance masks the surprises and events that occurred through the course of the year.

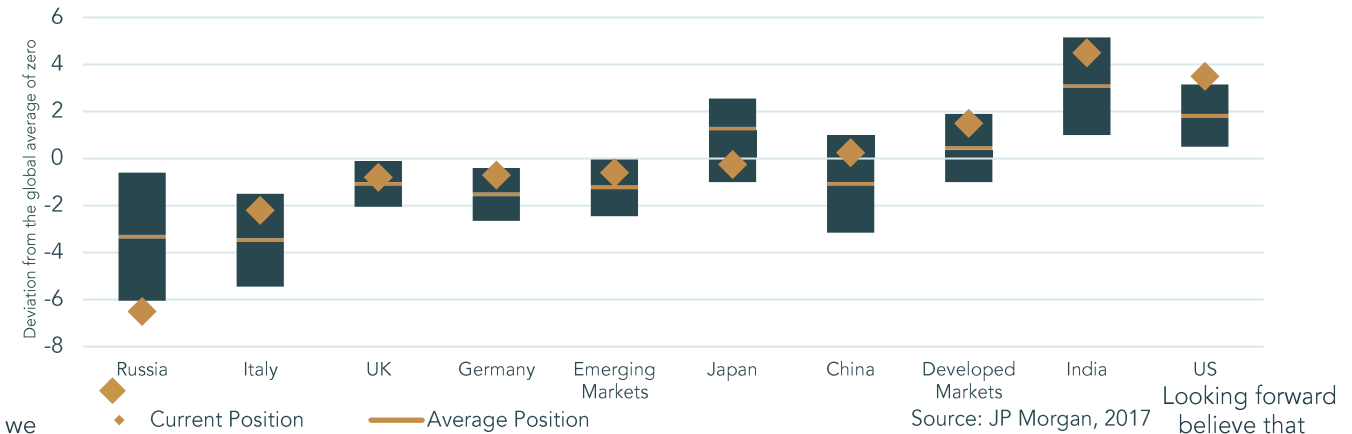
2017 was the first calendar year ever where the S&P 500 recorded a positive return in every month. Global equity markets were lifted on the back of business optimism following Trump's win in 2016, and since he was sworn in as President in January this optimism has continued. The expectation for tax reductions, which were finally voted through just before year end, and reduced red tape, continued to buoy markets throughout the year. With new all-time highs being reached regularly, valuations that looked to be stretched at the beginning of the year looked even more so by the end.

That said, while the FTSE 100 returned a decent 7.6%, it lagged global equities by the largest amount for 14 years. The year saw the UK trigger Article 50 to leave the European Union, hold a snap General Election which reduced, rather than bolstered, the Conservative government's position, and the Bank of England took a more hawkish tone. From an economic perspective inflation ticked up to 3.1%, largely due to previous sterling weakness, leading to an increase in the attraction of UK exports. GDP growth remained modestly positive at 1.5% with unemployment continuing to fall, and although consumer confidence remained reasonably robust, it has drifted down from the highs of 2015.

The Brexit negotiations made some progress over the year, but with conflicting reports coming from Brussels, exactly how much is unclear. With there being little guidance to date as to the ultimate shape and timing of any deal, we can only be sure of one thing; the coming year will again be dominated by negotiations and political upheaval.

When looking at some of our key portfolio positions in Asia, we must first reflect on China. October saw the 19th Party Congress; the meeting, which is held twice a decade, saw the Communist Party leadership affirmed. President Xi is seated firmly at its centre, with a vision of pushing forward China's global influence. In a world where developed markets, such as the US, are beginning to look inwards, the opportunity for China to elevate its position is clear. Also in October, Shinzo Abe succeeded in winning a snap election putting him on course to become Japan's longest serving political leader since the beginning of the current electoral system in the 1880s. The Nikkei 225 Index had a flat start to the year, returning 0.84% from January until September, but since then has returned 18%, making the year as a whole much more rewarding. Japan has long been one of our overweights and we see its strength continuing, as it enters 2018 with improving growth and stable inflation.

The stand out investment of 2017 was unquestionably Bitcoin. Whilst we don't have a view on whether it should trade at \$100 or \$100,000 we see the excitement continuing. This crypto-mania has, amongst other things, led to the creation of blockchain games such as CryptoKitties, where you can now use cryptocurrencies to purchase online cats, to breed, and then sell your e-kittens for crypto profits. Incredibly, \$12 million of sales have already occurred. The emergence of cryptocurrencies is a trend that will likely continue. Whether or not they will emerge as a conventional store of value is unclear, but the benefits of blockchain are real, with markets already looking at ways to utilise them.

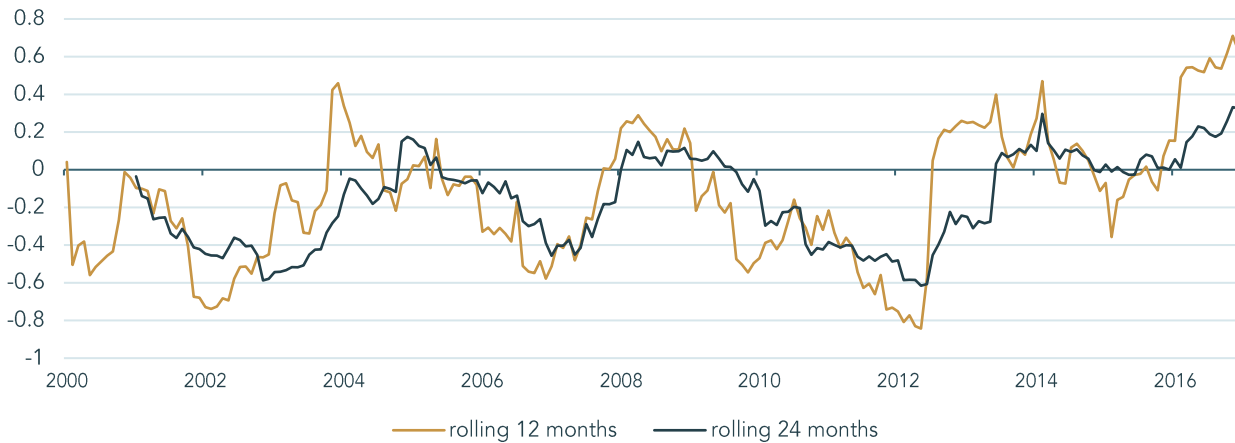


Looking forward we believe that there are some key themes that will require close attention through 2018. Firstly, volatility has been very subdued and this has helped stretch pricing ever higher across the majority of markets as investors face their 'fear of missing out' after such long rallies. The chart above looks at valuations across a number of countries, both relative to each other and also relative to their own historic averages. The blue bars show the range of valuations seen over the last 14 years, with the diamond representing its current valuation relative to its average. It is clear from this that valuations across the majority of developed markets, and even some emerging markets, are currently high on an historic basis. From a pure valuation perspective there are few markets offering value, with Japan and Russia being the main outliers.

Acknowledgment of expensive markets leads us to be more cautious in our developed equity allocation and look further afield for more interesting opportunities. One of those is in Emerging Europe where there has been a 'lost decade' of performance since the financial crisis, resulting in systemic underperformance relative to developed markets. They now offer high dividend yields with a likely recovery in earnings. Markets such as Russia and Turkey are particularly unloved and increasingly poorly covered by global equity investors. As a result of this and cheap valuations, they offer the opportunity for outperformance; Emerging Europe's forward Price Earnings (P/E) ratio is half that of MSCI World and a third cheaper than MSCI Emerging Markets. Not only do these areas have extremely low correlation to other global regions, they also have low correlations with each other.

2018 will also see a shifting monetary policy stance by the major central banks. The last ten years have been characterised by extremely low interest rates and a global push into unorthodox measures, such as quantitative easing (QE). With the Federal Reserve leading the way, policymakers are now focusing their attention on the withdrawal of this stimulus through the slow reversal of QE and cautious increases in interest rates. The Fed plans to reduce its balance sheet by \$10bn a month, and then increase this amount at 3 month intervals, until it reaches \$50bn a month in Q4. With cumulative global QE set to fall to zero in Q4 2018, and further interest rates rises expected from the Fed and the Bank of England, there is an increased likelihood of a policy error, which would be damaging for both equity and fixed income markets.

The thematic risks are not limited to equity and fixed income markets, but also the currency markets. In the aftermath of the Brexit vote in 2016 sterling saw a large depreciation, many of the effects of which we are only now facing as it feeds through into higher inflation readings. In 2017 sterling became the 6th most volatile currency, behaving more like an emerging market currency. This now puts sterling in a curious position. On the one hand it is extremely cheap by historical standards and so there is an inherent expectation of it strengthening from here – particularly on the back of any positive news around Brexit negotiations. On the other hand, the potential for either domestic or European political upheaval leaves open the possibility for further volatility.



The historic rule of portfolio diversification has been to have a mixture of fixed income and equities because they tend to move against each other, particularly in times of market stress. The chart above looks at the correlation between UK equities and UK fixed income. When the lines are below 0, it shows that fixed income prices rallied as equity markets fell, and importantly vice versa. In those periods when the graph is above 0, the opposite is true, and this correlation is now more positive than at any time in the last 18 years. This means that the traditional equity and fixed income model does not offer the same protection as it has done historically. As a result, absolute return strategies have become increasingly necessary for portfolio diversification, and to offer capital protection when risks are particularly high.

As we look forward to 2018, we are confident that portfolios are well positioned for the current environment. In equities we maintain caution to developed markets, whilst looking for the remaining pockets of value, and we continue to favour Asian and emerging economies. Traditional fixed income looks difficult to own given the expectation for rising interest rates, and we therefore continue to prefer a more alternative approach. We go into the year fully prepared for the potential challenges ahead, but optimistic about the opportunities that currently exist and those that will inevitably present themselves.

Fred Hervey
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