Q4 2014 Investment Advisory Board Meeting Summary

January 2015

HIGHLIGHTS

- Falling oil should eventually help the US and world economies but markets will start 2015 choppy
- Politics remains a major cause for concern in the eurozone, and to a lesser degree the UK
- Japan enjoys strong prospects for political stability and reform
- Contrarian ideas in fixed income and credit worthy of consideration
- In currencies, the euro should stabilise but the US dollar, Japanese yen may continue 2014 trends

The falling oil price was the key trend dominating the final quarter of the year. The Board felt that the sharp decline should eventually prove positive for global growth and provide a strong tailwind for consumer sentiment, particularly in the US. However, market analysts appeared less sure due to a lack of clarity regarding the trigger for the downward price spiral in the commodity. Debate rages as to whether supply-side factors alone were the cause or whether weakening global demand also had a part to play. Regardless, equities remained well-supported by central bank liquidity and reassurances of monetary looseness even as longer-dated G4 government bond yields continued on their downward trajectory. Looking ahead, the Board agreed that in the short term market volatility was set to rise and that the first half of 2015 would be a test of skill for active, unconstrained managers.

US equities

The Board was broadly positive on the prospects for the US economy, and remained confident in its **overweight US equity recommendation.** Being several years into a run of macroeconomic expansion going back to early 2009, some members highlighted the possibility of growth disappointing expectations and the market correcting, although the overall mood of the Board was positive.

Weakness in the oil price first began to manifest during the third quarter, so it was by no means a new phenomenon in the final months of 2014, nor a surprise factor for 2015. US consumers were the early beneficiaries of the price adjustment and almost instantly increased spending on groceries and autos rather than adding to their savings. The upbeat mood was supported by job openings coming in above pre-housing crisis levels during the final quarter of the year. The Board also noted that more productive areas of the economy were leading the way, driven by a rise in technological innovation and investment. Nevertheless, these positive indicators were not enough to overshadow the fact that the US equity market and indeed the global economy remained dependent on support from policymakers and for now were still being fuelled by expectations of future recovery and 'normalisation'. Elevated volatility may be an indication that patience for hard results is starting to run out and that in choppy markets it is up to skilled active managers to generate gains for investors. ETF flows are set to distort market movements further.

UK equities

The Board was **mixed on the UK equity market,** with some members noting the imbalances in the UK economy, while others flagged strength in fundamentals and technological adoption. There was extensive discussion regarding which businesses would be beneficiaries in the UK in the coming months. Auto-related firms and those embracing technological innovation were popular options. One member flagged his **aversion to large-cap stocks in favour of domestically focused companies** on the back of falling energy prices.

While the UK economy enjoys some bright spots, the bigger-picture view continues to remain unconvincing. Manufacturing activity is still in decline, housing sentiment is rolling over and policy towards the public finances is inconsistent. In particular, there is no clear consensus as to how the national books will be balanced or indeed whether debt could even be increased for infrastructure and scientific innovation. The political situation has also become highly uncertain, and the Board agreed that another coalition government is the most likely outcome following the next general election.

European equities

Politics remains the dominant factor at play within Europe, leaving the Board reluctant to express a firm view on the region beyond **a neutral stance.** While eurozone growth accelerated during the third quarter and employment numbers remained stable, the political risks are high enough to threaten this modest progress.

Board members also highlighted the divergence between what is being observed at the consumer level and the way the market is moving. Consumer sentiment is strong, as reflected by upbeat retail sales figures, but sentiment around the region's long term prospects remains sceptical among investors. Until some convincing solutions to the various political issues materialise, a prolonged period of secular decline is likely for the eurozone.

Looking at Greece specifically, some Board members believed the likelihood of the country 'hard defaulting' on its International Monetary Fund debt repayments was possible. While a default would create high levels of market volatility in the short term, it could prove to be of longer-term benefit for the region. However, Argentina's default of 2001 led to a decade of economic underperformance and the Greek population would likely face similar hardship in the event of non-payment of debts. It was noted that in the meantime the Greek economy continues to create jobs and foster its business culture.

Japanese equities

The Board was **broadly constructive on the Japanese equity market,** citing PM Abe's reform agenda as enlightened and crediting him with being one of the more visionary leaders of the developed world given his preference for encouraging growth before beginning the process of fiscal consolidation. The second sales tax hike, which had loomed as a significant market risk, was delayed, allowing the government to be more pragmatic when structuring fiscal policy.

The political situation in Japan is also stable following the renewal of Abe's mandate. He now has the luxury of a clear four-year run of power, in which meaningful change can be implemented without undue political pressure.

The Board's Japan specialist further noted that corporate profits are at all-time highs, spending has rebounded after a modest decline, the labour market is robust and corporate earnings are set to outperform on a global basis in 2015.

Fixed income and credit

With the continuation of the 'hunt for yield' mind-set among investors, much of the Board's fixed income discussion focused on the corporate high yield market. This area holds some promise after a recent sell-off affecting the whole market appeared disproportionate to the troubles related exclusively to energy issuers. **The potential buying opportunity is both for said issuers and the market as a whole.** Several members also noted their interest in niche credits as a return source, such as **US student loans. Convertible bonds were considered an interesting way** to target equity market volatility, although eurozone convertibles could disappoint and should be approached with caution on an issue-by-issue basis.

With many speculators positioned short of long-dated US Treasuries, the Board discussed **going long the same bonds** as a contrarian bet, with **the sweet spot being the ultra-long end of the curve in 30-year plus territory.** Longer-dated US Treasuries could be supported by on-going risk aversion in markets.

Currencies

The **US dollar was among the higher conviction currency** suggestions of the meeting. The main risk associated with the idea though is that the greenback may get pushed disproportionately high as a result of eurozone weakness, which could then prove a drag on the S&P 500 index with its relatively high overseas earnings profile.

Most members held a **neutral view on the euro** at this stage, with some commenting that it had become oversold. The possibility of further quantitative easing has been largely priced in, but as with the European equity market, the region's political turmoil cannot be overlooked. The euro is also unlikely to see any significant benefits from the oil price decline.

The Board was **broadly agreed on future yen weakness,** noting the shift in sales activity to international markets, which should aid the economy. One member note that yen weakness occurred with each new wave of the Bank of Japan's QE programme.

Strategic and tactical views – Investment Advisory Board
Q4 2014 meeting

	Low Conviction	Cautious	Neutral	Positive	High Conviction
Equities Positive			UK *[unbalanced, politics]* Europe *[politics]*	Japan *[enlightened reform agenda]*	US *[recovery, dynamism]*
Fixed Income & Credit Neutral				Convertible bonds *[equity volatility]* US student loans	
Alternatives Cautious					
Tactical Asset Allocation (TAA)		FTSE 100 v. 250 *[domestic revival, energy]*		HY (energy issuers) *[sell-off entry opportunity]*	30-year US Treasury *[contrarian play]*
TAA - FX		Yen *[moves lower with each new QE programme]*	Euro *[arguably oversold]*	US dollar *[economic strength, monetary policy direction]*	

Source: GAM

The views are those of the manager at the time of publication and are subject to change.

The Investment Advisory Board (IAB) is a dedicated group of highly skilled, senior investment specialists with expertise across all the major asset classes as well as an in-depth understanding of macroeconomic and monetary policy. Chaired by Graham Wainer, its objective is to advise on general investment strategy, including strategic and tactical asset allocation for global equities, fixed income and credit, alternative investments and currencies. The agenda is set by the Investment Team with the objective of extracting views relevant to the management of a broad range of client portfolios.

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Graham Wainer
Global Head of Investments,
GAM Managed Portfolios

Tim Haywood
Investment Director,
GAM

Graham Turner
Founder and Chief Economist,
GFC Economics

James Aitken
Founder,
Aitken Advisors LLP

Anthony Lawler
Head of Portfolio Management,
GAM Alternative Investment Solutions

Contributors

Ben Williams
Investment Director

Tim Love
Investment Director

Alexander Friedman
Group CEO

GAM MP Investment Team

S&G AM MACS team

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