

# Q1 2015 GAM Multi-Asset Class Solutions

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What has become increasingly apparent to us as asset allocators in the last few months is just how elusive pre-global financial crisis normality is proving to be. Equities have rallied since 2009 but the period has been characterised by weak developed world growth, cautious consumers and disappointing wage rises. This then is the profound dislocation at the heart of today's investment environment. The questions now are how long can it last and will stockmarkets eventually adjust to the economics or vice versa. Fundamentals certainly aren't encouraging in this regard and pessimists like to paint a picture of a world left anaesthetised after the bail-outs of 2008, with persistent spare capacity in the form of high unemployment and/or low incomes, few investment opportunities relative to excess liquidity thanks to quantitative easing (QE), low personal consumption and demand, a growing dependency ratio across the developed world and automation displacing both the skilled and unskilled faster than they can find new work. There is some truth to all of these assertions. Europe and the UK remain saddled with a legacy of bank debt while US consumers have failed to reprise the role they played a decade ago simply because the tailwind of credit is no longer there. And for Japan the demographic challenge is undeniable. There the age dependency ratio has grown 8% just in the three years from 2010 to 2013, with 100 working-age Japanese now supporting 62 dependents. It is therefore easy to become despondent. But markets continue to make progress regardless not just because of optimism about the future but also because of a global savings glut that pre-dated the global financial crisis and is set to continue thanks to it. Surplus countries including Germany, China and the Arab oil states, non-financial corporations with huge cash balances and QE in the US, Japan and now Europe have all contributed to a liquidity trend which is not going to go away anytime soon. The challenge for investors now is ascertaining whether an asset class is being driven up because its intrinsic prospects are good or because there is a wall of yield-seeking buyers bidding up prices.

## US

The first quarter of the year was relatively muted for the US. The S&P 500 made only marginal progress since investors had arguably already priced in a strong economic and corporate earnings recovery back in 2013 and 2014. But they may now have to wait for further improvements. The winter weather, less oil investment and a port dispute on the west coast meant that the annual GDP growth forecast for 2015

was revised down to an average 3% by analysts. The US economic surprise index – which tracks the difference between what analysts predict a given data release will reveal and what it actually reveals – also fell precipitously during the quarter. Corporate earnings for the S&P 500 meanwhile grew at less than 5% on the previous year by the end of the first quarter, well off the 8%+ growth rate seen at the end of the first quarter of 2014. Analysts see no improvement anytime soon, predicting earnings growth of 4.5% for the following 12 months. The overall employment picture was brighter, with jobs being added at a healthy annualised clip of over three and a half million. Both the market and the US Federal Reserve (Fed) got carried away with this and by mid-March had convinced themselves that interest rate rises were required, propelling the US dollar further up against the euro where the monetary policy divergence seemed the greatest. However, the FOMC meeting of 18 March reintroduced more cautious language about the economy's prospects which left investors in confusion about the timing of the first rate rise for over ten years. While we concede that the first three months of the year have been slow, we remain more optimistic on the prospects for the second half of the year. Wage growth may not be stellar at around 2% but add to that employment growth of about the same rate and nominal aggregate income is rising at a neat 4% clip. But the best part is that this gain translates entirely into consumers' broad purchasing power since headline inflation including energy and food was flat at the latest reading. The wealth effect should also feed through into housing as we enter the spring buying season. In particular, homebuilders should benefit from pent-up demand by younger 'millennials' keen to finally move out of the parental home but who have been waiting for better job security and pay. Stronger incomes, cheap oil and improvements in the housing market point to a mini-consumer boom later in the year, even if not on the scale seen in the run-up to 2008. This should help selected consumer stocks stand out from a wider market that is looking tired.



**Graham Wainer**



**Julian Howard**

Past performance is not indicative of future performance.

**GAM**

## **Europe**

Europe took the lion's share of headlines during the quarter for both good and bad reasons. Starting with the bad, Greece was the obvious concern given the recent election of a party eager to dispute the terms of austerity with the IMF, European Central Bank (ECB) and European Commission. However, Greece's economic situation, which had ironically been improving in the final quarter of last year, began to deteriorate. This left the government having to bargain from an increasingly weak position while finding little of the previously dependable support from traditional allies like Spain, Italy and Portugal. This may be because they now see the light at the end of the tunnel after years of difficult reform. Furthermore, the peripheral countries' bond markets were relatively free of the contagion of the 2011 eurozone crisis. Perhaps this had something to do with that wall of liquidity drowning out any re-pricing of political risk and keeping the bonds well supported. Either way, European equity markets chose to concentrate on a slew of more positive developments including the announcement and reality of the ECB's QE scheme, improvement in credit growth, lower oil prices, a competitive currency, falling unemployment, better corporate earnings and rising GDP growth forecasts. When expectations are at rock-bottom, as they were last year for Europe, any improvement in the economic situation can have a disproportionate effect on equity markets and this is what we have seen as a result. The eurozone economic surprise index corroborates this, with data releases positively surprising ever since October 2014. As long as Europe's economic news continues on the same trajectory, investors are likely to be pleasantly surprised for a good while longer given that the eurozone only emerged from recession in the second quarter of 2013. Of course at some point expectations will become sufficiently elevated that a period of softer economic news could disproportionately dampen the market mood. And then there is the longer term doubt over Europe's ability to transform its long term prospects given that we have yet to see the sustained rises in corporate capital expenditure and more meaningful economic harmonisation that would suggest success in this regard. All of that is for later though. For now, it makes sense to participate in what is currently in our view the most attractive of the major equity markets.

## **UK**

Our stance on the UK has been unchanged for some time now and we feel that some kind of market epiphany is not far off. In particular, we are sceptical about the following: the

economy's ability to rebalance towards exports and away from consumption; its over-reliance on the housing sector given uncertainty over the future course of prices; growing credit card debt; generously low government borrowing rates relative to the sizeable twin deficit and of course the huge uncertainty of the general election in May. On the election in particular, markets may have become complacent after five years of successful coalition. This time around though, the actors likely to be in a position to prop up one of the two main parties are very different and will pay less heed to the 'national interest' than five years ago. All of which adds to the sense of complacency surrounding the state of the public finances. Balancing the books by 2015 was always unlikely given the eurozone crisis of 2011/12 and so today we have a twin fiscal and current account deficit of 11% which is barely less than the 2009/2010 peak but amazingly the government can still borrow at under 1.6% for ten years. While both the FTSE 100, trade-weighted sterling and gilts have fared well so far this year, this only heightens our feeling that UK assets are vulnerable to volatility in the coming weeks and months.

## **Japan**

Japan's experiment in economic resuscitation continues apace and, to look at the performance of Japanese equities during the quarter, investors increasingly feel that the efforts will pay off. One thing is certain and that is the commitment of the Japanese authorities. In a recent speech Prime Minister Abe mentioned the word 'reform' no fewer than 36 times, promising the most drastic changes to the country since the end of the second world war. Japan's QE programme is certainly one of the largest the world has seen in modern times. By February this year, the Bank of Japan's assets had swelled to a massive 65% of GDP, more than double the 25% of GDP the US Federal Reserve has achieved. On inflation, it is true that as a central policy goal flat core inflation adjusted for last year's consumption tax hike is somewhat short of the 2% target. But this is likely to be boosted by the upcoming 'shunto' wage round, whereby salaries are decided between management and unions representing nearly a fifth of Japan's workforce. In 2014, the increase was 2.2% but this spring up to 2.5% is predicted. Anything which can help distribute the proceeds of QE around all sectors of the economy – not just corporations – is welcome, since Japan's consumer has a key role to play in its broader recovery. We have mentioned how the stockmarket has registered its approval but what is most encouraging is that the Topix index has outpaced the US, UK and emerging markets without needing the yen to depreciate

against the US dollar and implicitly help exporters. The fact that forward earnings estimates have grown 20% versus last year's predictions hints at 'lift-off' for the Japanese corporate sector's profitability, while other market drivers include more buying from domestic institutions such as the government pension scheme, increased investor activism and improving governance standards.

### **Emerging markets**

Emerging markets are uniquely vulnerable to the strong US dollar, with the MSCI Emerging Markets index broadly inversely correlated to the greenback for over a decade. The Bank for International Settlements recently noted that emerging market debt denominated in US dollars had grown from \$2trn to \$4.5trn between 2009 and 2014. The trend itself is easy enough to understand, given that many emerging markets are only too pleased to be able to finance their current account deficits via willing US dollar creditors. But for those countries with high levels of US dollar debt and which generate much of their revenue in local or other non-dollar currencies, the situation is alarming since more revenue is required to keep up repayments. This frames the underperformance of markets such as Turkey's this quarter. Falling oil is another threat, albeit mainly for producing countries which have failed to diversify their economies, such as Russia and Venezuela. Brazil is in the unfortunate position of being both an oil producer and exposed to the US dollar via its outstanding debt. As ever, though, emerging market investing is about differentiation. Asia ex Japan, for example, is generally less exposed to oil production than Latin America and should do well on the back of cheaper commodity prices. In addition, a revival of the fortunes of the US consumer as outlined earlier should particularly benefit 'factory Asia'. China remains more contentious. For many, the benefits of falling oil and a potentially resurgent US consumer will not help a China struggling to avoid a widely anticipated 'hard landing' in which growth falls under the official 7% target. The Chinese economy's challenges are well documented, but are perhaps best articulated with a single statistic – total debt to GDP now stands at 282%. However, we are more sanguine than most, noting that Premier Li Keqiang and his officials are prepared to take action to boost confidence. Already, interest rates have already been lowered three times and so we are confident that the Chinese authorities, who have made a point of carefully studying the west's policy response during the 2008 crisis, will be able to steer through better than many assume.

### **Fixed Income and Credit**

The Great Moderation is the term applied to the era of falling inflation and government bond yields that began in the early 1980s and persists today. One of the biggest calls any investor in bonds has to make is when yields will lift off from their low levels and return to 'normality', whatever that may be. In a logical world this should start to happen as recovery gathers pace, future inflationary expectations rise and interest rates begin their tightening cycle. However, the key player here, the US Fed, is worried on the first two counts and therefore appears reluctant to engage in the third. In the short term at least, their assessment appears sensible given recent weakness of the US economy. However, as described above, we see a strengthening of the US recovery later in the year. Frustratingly, this may not be felt much in US Treasury yields, not because of some inherent long term malaise in the US economy as some commentators argue, but because surplus global liquidity will continue to need a home. The effect of this is a smothering of fundamentals whereby many bond markets remain well bid regardless of what happens in the domestic economy. Net foreign buying of long-term US securities in particular has been strong and is likely to receive a boost from Japanese institutional investors whose own domestic government bond market is being rapidly hoovered up by the Bank of Japan's QE programme. High levels of global liquidity have also found their way to the UK, perhaps explaining why UK gilt yields remain so low despite the deficit. In continental Europe this, as well as the ECB's own QE, has served to keep European peripheral bonds surprisingly stable despite the Greek situation. The downside is appalling investment returns for liability-driven investors such as pension funds. If you invested in German bunds at today's yield of 0.18%, it would take a theoretical 380 years to double your money. Despite such extremes, we see little catalyst for this situation to change meaningfully and therefore remain cautious on government bonds. Corporate and high yield bonds are in part beneficiaries of the same trend. In late 2014, US high yield spreads over Treasuries moved significantly wider as concerns mounted over falling energy prices and what this would mean for all those energy-related firms with high yield debt. However, the first quarter then saw high yield spreads tighten once again even though oil continued to fall. It may well have been the case that wider spreads at the end of last year simply offered a buying opportunity for investors keen to pick up yield. Again, caution is required as the traditional fixed income and credit markets remain poised between questionable fundamentals and unquestioning buyers.

### **Portfolio positioning\***

All our investments aim to reflect as closely as possible our carefully considered thoughts on markets. In equities therefore, we are strategically cautious on the UK and Latin America as described while more neutral in the US and Asia. We prefer Europe, Japan and effective global income approaches in this asset class. In fixed income and credit, we are sensibly avoiding any top-down decisions on the future direction of the major government or corporate bond markets as discussed but are happy to maintain exposures to dedicated total return bond managers who will often have stronger views both on the long and short side. Otherwise, we continue aiming to harvest returns from the insurance-linked, mortgage-backed security and carefully selected financial debt areas. In alternative investments, we are neither depressed nor excited about the prospects for long/short managers and so portfolio allocations tend to be modest. We do think the outlook for macro traders is brighter but maintain that for communication and transparency purposes in-house managers have a key role to play. Tactically, we are becoming increasingly active as discussed last quarter. We are short via

optionality in expensive US technology stocks while partially hedged against US small cap stocks which we feel are vulnerable in the short term. We do, however, like homebuilders and associated stocks while optionality in Chinese equities should allow us to benefit if the economy gets the help it needs from the authorities. We are even more disposed to European equities as a whole, with additional satellite holdings in Spanish and Italian stocks. Exposure to Japan completes our tactical equity plays. In currencies, we are short sterling against both the US dollar and euro in anticipation of market realisation of the UK's fragility as the general election approaches. We also have modest positions in which we are short the Japanese yen and euro versus the US dollar. This makes sense given the monetary policy divergence that is likely to persist for some time even if the US holds off interest rate increases for now. The themes and positioning described reflect the fact that today's asset allocator must combine the 'old' skill of assessing long term fundamental prospects with the 'new' skill of identifying near term opportunities that might suck in yield-hungry capital. Expediency and flexibility will be key to enhancing returns.

\* We caveat this with a 'where relevant', since not all our clients are invested in the same strategies. Nonetheless, common themes do run across asset classes and tactical asset allocations, so we trust that an overall flavour of our positioning will be helpful.

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Source: GAM unless otherwise stated. (Unless otherwise noted, where shown, performance is shown net of fees, on a NAV to NAV basis).

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