Q2 2015 GAM Multi-Asset Class Solutions

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July 2015

Are we on the cusp of normalisation? The question has become all the more pressing given the apparent growth signals sent out by this year's simultaneous rise of equity markets, government bond yields and energy prices. Little wonder then that market participants have obsessed over the timing of that crucial first interest rate rise by the US Federal Reserve (Fed). Regardless of when it happens, it is clear that the global economy will soon have to fend for itself. Certainly in the US, the omens are good. Consumers are not only much better off than they have been for years, they also appear to be spending again which should have positive implications globally. Two risks stand out in the form of the Fed tightening policy too much and the Greek situation. However, we believe that both are manageable and in some markets may even present an opportunity to pick up assets cheaply. Even so, there is likely to be volatility ahead. This is hardly a groundbreaking observation but as asset allocators we advise investors to extend their patience and time horizons wherever possible.

US

The US has tended to bounce back strongly from economic setbacks, a fact not lost on Warren Buffett who declared once that "It's never paid to bet against America. We come through things, but it's not always a smooth ride." Today, we see the US as the most likely source of global economic recovery. Unemployment is very low now, with 280,000 jobs added in May. Those in work are starting to see decent wage rises and petrol prices should remain supportive. While oil has rebounded a little this year, the longer term outlook suggests decline in the face of OPEC oversupply and a productivity revolution in US shale. This is feeding through to consumption. Americans have started buying cars again, a sign of real confidence in the economy's prospects, while retail sales have picked up.

The threat to these welcome developments is how the Fed responds to them. History illustrates the folly of a premature interest rate cycle, with 1994 being the most famous example of too soon, too much. Then, long term borrowing costs jumped higher, growth was hurt, Mexico was thrown into crisis and Orange County was bankrupted. What is most concerning today is how much consensus there is for a rate rise in September given that it was only really from May that US economic news began to positively surprise again. Thankfully Fed chair Janet Yellen looks set to tread cautiously, noting recently that improvements in the economy are "not yet definitive".

For equity investors, if rates do get raised sooner rather than later, markets should be able to handle it. Taking the last nine monetary policy tightening cycles, the S&P 500 has tended to make progress in the twelve months following the first rate rise. 1994 was no exception. Admittedly, valuations were not as rich back then as they are now but while price has moved ahead of earnings of late, we don't feel that the former is unreasonable given improving economic prospects. Furthermore, valuations are of little prognostic significance even though many column inches are devoted to the subject. Instead, we see a positive tailwind for US equities which should drive cyclical sectors of the market.

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Europe

If it were somehow possible to isolate Greece from the prognosis for the rest of Europe the latter's prospects look extremely positive in the short term. Spain in particular stands out - in the summer of 2013, economists predicted full year growth for 2015 would be 0.9%. Now it's predicted to be nearly 2.9%. In Germany, surveys suggest that parsimonious consumers are planning to spend more of their rising incomes. Corporate earnings are also picking up across Europe, validating the equity run-up so far and perhaps further progress too. All of this is underwritten by a supportive European Central Bank under Mario Draghi, who recently re-confirmed that the current quantitative easing (QE) programme would continue until September 2016.

But there are two issues which affect the short and long term outlooks. More immediately, there is Greece. Until recently, that the two sides involved would come to an arrangement seemed likely given that both the Greeks and the eurozone establishment want Greece to stay in the euro. Negotiations earlier in June apparently came within €2bn of agreement. But with the most recent referendum 'No' result, the situation has become more dangerous because the government's intransigence has received a fresh mandate. It is still not too late, but more detailed predictions are for political pundits given that the biggest stakeholders are now exclusively public institutions. If any 'good' can be drawn from all this it is the lesson that dire consequences await any radical European politician attempting to call the bluff of the rest of the eurozone instead of pursuing meaningful domestic reform. As for equities, they should continue to make progress in the short term although this will be less in amount and more in volatility than would otherwise have been the case.

The final, longer term consideration is that amid all the excitement about improving prospects, investors should remember that Europe will struggle to emulate the dynamism of the US and is some way off from a truly harmonised single market. Also concerning are the prospects for productivity - and ultimately economic growth - given technological and educational deficits versus key competitors. It is telling that the highest ranked southern European university in the world comes in at just 166th according to the 2015 QS World University Rankings. Investors therefore need to separate the excitement around the short term recovery from a much cooler assessment of longer term growth potential.

UK

We have been circumspect on the prospects for the UK for some time now but a more nuanced picture is emerging. Starting with the areas of concern, house price growth is slowing according to the ONS and economic growth on the previous year has fallen from its heady 3% reading at the end of 2014 to 2.4% in the first quarter. Analysts predict it will stay at around that level for 2015 as a whole. Not bad by global standards though further challenges include persistent trade and fiscal deficits and the elusive manufacturing revolution.

But now there are grounds for optimism. The UK today boasts a technology industry that could scarcely have been imagined ten years ago. In London alone, the number of firms in the sector has grown 46% since 2010, with 200,000 people employed nationally. The tech story is also pleasingly balanced, with clusters growing from Belfast to Cambridge. The positive impact on the economy is probably underestimated in the official UK economic statistics, suggesting that UK productivity is perhaps not as bad as previously thought. Meanwhile the improvement in the UK's labour market is undeniable, with unemployment now at just 5.6%. Wages have hit a robust 2.7% growth rate and are broad-based, with construction and financial services leading the way.

Finally, the politics is less ominous than before. The May election should herald broadly pro-business policies and although we now have the spectre of an EU referendum it seems unlikely that the electorate will vote for an exit. In terms of equities, mid-cap stocks are likely to be more reflective of the above technology and consumption themes than their large cap equivalents. The latter face their own challenges given the associated energy exposures. UK mid-cap stocks for their part tend to be more tied to the domestic economy and therefore appear to be the more interesting angle.

Japan

Japan's corporate prospects remain compelling in the near term. Judging by April's performance, the stockmarket now appears able to make progress without the assistance of a cheaper currency. Other supportive themes include institutional asset re-allocation and the governance revolution that has accompanied it. A renewed focus on the rights of the shareholder and return on equity are to be warmly welcomed, as is increasing evidence of the adoption of a more western-style management in corporate life. All of this is encouraging for Japanese equities but the outlook for the real economy looks rather different.

Abenomics has characterised economic policy since 2013 and yet the economy is forecast to grow just 0.9% in 2015. There is little to suggest that growth potential may fundamentally change given how undiminished Japan's structural challenges are. In the 1950s and 1960s, the economy was growing at around 10% a year while the working population grew at around 1%. The difference represented a productivity miracle as Japan led the transistor and miniaturisation revolutions. Now, the working age population is shrinking by 1% a year while growth is barely positive, revealing a productivity crisis. Compounding the problem is Japan's social security burden, with debt to GDP already at nearly 230%. We are therefore more cautious over a longer term investment horizon.

Emerging markets

Much has been made of how emerging markets (EMs) have learnt the lessons of past crises to reform their economies. But today they appear vulnerable to developments in China, commodities markets, US interest rates and the dollar. A slowing China and falling demand for commodities has exposed the vulnerability of many EM growth models. Meanwhile EM corporate borrowers have been tapping international bond markets since the 2000s and increasing their US dollar risk even as governments sought to reduce theirs. EM economies now have $3.3tn of USD-denominated borrowing to service. Higher US interest rates and a strengthening dollar are making themselves felt and it is no surprise that the equity markets of the 'Fragile Five' (Brazil, India, Indonesia, South Africa and Turkey) have together been moving inversely to US bond market volatility. EMs are unlikely to make meaningful progress while uncertainty over US interest rates persists.

But it's not all bad news. Once the initial hurdle of the first US rate rise is cleared, EM assets could stabilise and offer a buying opportunity. Turning to China, the stockmarket appears to have decoupled from the slowing economy. While equity valuations on the ChiNext and SME boards are probably excessive, large cap stocks like financials are much less stretched. A genuine equity culture is being promoted by the Chinese leadership as a way to divert saving away from the housing sector. As the market matures - and this will likely require a good correction or two along the way - it should play a key role in efficiently allocating resources to viable businesses. Back in the real economy, we note that the Chinese authorities have plenty of options open to them in terms of stimulus. A debt swap scheme has just been announced and QE remains possible. Having observed closely the west's financial crisis, China is well-placed to manage its economic transition in a sustainable manner.

Fixed Income and Credit
The second quarter saw developed government bond yields rise. The question is whether this is 'The One', i.e. the reversal of declining yields observed since the early 1980s. For this to be so, we would need to see higher levels of future growth and inflation. On inflation, bond markets in the US, Europe and the UK suggest higher prices to come and wages - the largest component of inflation - are starting to lift off too. The other key element of the bond yield is growth and this is certainly improving in the US and Europe. But the final piece of the puzzle resides in the German bund market. Some profit-taking after the first few months of the European QE rally, along with a risk premium due to the Greek situation surely played a part. In the US therefore, it is possible that yields have got a little ahead of the (very real) recovery. They also remain vulnerable to downward pressure from savings excesses in the global financial system.

In credit, we believe high yield bonds offer an attractive pickup versus investment grade and government bonds. They are well placed to resist rising interest rates and market enthusiasm for the asset class was demonstrated by how well energy issuers recovered after last year's oil sell-off. The main risk in this segment is assumed to be the declining liquidity of credit markets since 2008, so if everyone sells at once the market may not be able to cope. However, recent research by JPMorgan and Deutsche Bank suggests that the last three years have in fact seen an improvement in the market depth for corporate bonds. It is traditional government bond markets that may have more questionable liquidity - witness the 'flash crash' in US Treasuries of last autumn. We feel that the main risk to credit markets has always been an economic slowdown which affects the ability of issuers to fulfil their repayment obligations. However, this seems unlikely today.

Portfolio positioning*
As expected, all our investments reflect as closely as possible our thoughts on markets. We are well engaged in equities where, in the US at least, prospective corporate earnings yields are higher than government bond yields. We invest through managers in different regions focused on styles such as contrarian, income and quality. Passive exposures are deployed where appropriate. Our primary regional focus is in the US. In Europe, a more neutral stance is warranted while exposure is achieved via an experienced active manager. In the UK, we are marginally positive about the economy's longer term prospects while in Japan we agnostic over the long term outlook and in this case a passive allocation is preferred. As for the rest of the Asian region and other EMs, we remain cautious even if Chinese equities have potential. However, a dedicated EM equity manager may still benefit portfolios through a discerning approach.

In fixed income and credit, our allocations are mainly to managers who we feel can deliver returns regardless of what happens to government bonds. We combine absolute return managers with mortgage-backed securities, carefully researched emerging market debt and insurance-linked bonds. We will be reviewing the latter given the huge amount of capital pouring into the market relative to issuance levels. Our exposure to the junior debt of financial companies remains in place - the sizeable exposure to floating rate notes here should provide some resistance to rising interest rates. Finally, we have added a high yield manager focused on more short-dated, higher quality bonds. This should allow us to pick up higher yields in a risk-controlled manner.

In alternatives, the market environment appears more conducive to opportunities for macro managers given the yawning gap between the monetary policy trajectory of the US and the UK on the one hand and Europe, Japan and many other economies on the other. In terms of exposure, we have concentrated recently on GAM managers given the need for transparency in this sphere. But as the UCITS market has matured, we are sufficiently confident to be adding a new, carefully screened external macro manager to our existing allocation.

We also capitalise on significant global themes via a dedicated tactical asset allocation exposure. Here, we are engaged in the US, European and Japanese equity markets. We nuance our US allocation with a holding in homebuilding stocks while in Europe we emphasise Spain. In currencies, we are short the Korean won versus the US dollar in anticipation of a response by the Korean monetary authorities to Japanese yen depreciation. In fixed income, we hold a 'curve flattener' to reflect the view that expectations for higher short term US interest rates will get ahead of the medium term growth and inflation realities.

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

Conclusion
The global economy may be facing challenging growth, demographics and productivity but we are more convinced than ever of the potency of the US. We are now seeing the start of what we believe will be a genuine consumer-led recovery there which should drive domestic corporate earnings in the first instance and overseas growth thereafter. The US economy is also well-placed to deal with the kinds of roadblocks others will struggle with. High levels of technological innovation can help address productivity and demographic challenges while the 2016 Presidential race could pave the way to rebalancing what would otherwise become an ageing and less productive society through immigration. Equities are likely to be the main articulation of improving US growth as they always have been but it should be remembered that recoveries are rarely linear affairs. For some investors, this is enough to avoid the asset class altogether. But for those able to adopt a more long term, considered view we feel there is no more compelling investment opportunity today.

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JN6451 – July 2015