GAM Multi-Asset Class Solutions

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Risk assets in the form of global equities, US high yield bonds and commodities ended the quarter not far from where they started after a violent sell-off gave way to a sharp correction from the middle of February. This raises the question of whether the prospects for the global economy actually worsened and then improved in the space of three months or whether investors had simply become too pessimistic before suffering a fit of circumspection. The former seems unlikely given the steady deterioration in the global growth outlook as reported by analysts and supranational bodies like the OECD. But the latter is not entirely satisfactory either. Instead, a weakening in the US dollar and pick-up in crude oil prices served to provide some genuine respite for beleaguered emerging markets and energy producers. Having come full circle, investors are right to ask: what next? On the positive side, the US employment picture looks healthy and recession there seems unlikely. The Federal Reserve's easier rate tightening path, China's renewed credit and fiscal stimulus and the ECB's fresh package of supportive measures are all suggestive of market support in the short term. But any longer term optimism around central bank policy response could be misplaced as its efficacy has started to dwindle. The announcement of negative interest rates in Japan boosted the Nikkei index for barely four days; the ECB's deepening and extension of quantitative easing saw outright euro strengthening while the Fed's unexpected dovishness was at odds with the emerging inflation picture, raising the spectre of uncomfortable monetary tightening further down the line. In China, the top planning official attending the National People's Congress (NPC) declared failure to meet the new GDP target of 6.5-7% would be "impossible", with the corresponding policy announcements provoking consternation among many observers. After all, China's current excess capacity problem is largely the result of similar measures pursued in 2009.

Looking ahead to the rest of the year, a cooler assessment of the fundamentals suggests limited gains for equity markets from this point. In the US, the first quarter's corporate earnings ex energy are expected to fall versus the previous year. In emerging markets, despite undeniable progress the earnings outlook has barely improved. China's structural challenges have been made worse with slower underlying growth inevitable but markets still express disappointment with each round of currency depreciation. At the global level, productivity and capex growth remain puzzlingly weak.

While equity markets are driven by sentiment in the short term, valuation remains a key driver of longer term returns. As such, taking the end of 2012 as a reference point, the re-rating in developed market equities remains exactly that, a re-rating largely unvindicated either by GDP or earnings growth. Equities are not cheap because investors are still owed for their continued patience. Finally, political risk goes largely ignored even though it is currently elevated and established measures of policy uncertainty exhibit reasonably strong correlations with market returns. The circus that is the US election campaign, the UK vote on European Union membership, Europe's migration challenge, the tightening grip on power by the Chinese leadership, the death throes of *La Revolucion* across Latin America and the on-going threat from terrorism all loom large. The restoration of pre-global financial crisis levels of trend growth and end demand would require co-ordinated fiscal and structural reform, the unlocking of global excess savings, the opportunistic use of low interest rates to upgrade dilapidated infrastructure and probably further unconventional central bank measures. However, such action remains as elusive as ever. Instead, a scenario of broadly directionless markets, punctuated by unpredictable bursts of euphoria and despondency seems more plausible.

* Where relevant, since not all our clients are invested in the same strategies. Nonetheless, common themes run across our allocations, so we trust that an overall flavour of our positioning is still informative.

Investment implications* – Equities

In multi-asset portfolios, the above assessment suggests more limited allocations to equities, with the focus within the market on those areas most able to generate returns regardless of the wider economy. So-called quality stocks exhibiting high levels of free cash flow and repeatability of earnings make sense in the US, a region which has traditionally fared well relative to others in challenging environments. Europe continues to offer 'ground up' opportunities for domestically focused stocks and the region also enjoys significant upside potential. Engagement here remains sensible. In Japan, the prospects for the overall index have dimmed given the domination of the large-cap behemoths dependent on an increasingly discredited policy of currency devaluation. However, intriguing themes exist within Japanese mid-cap stocks which are best capitalised on by specialist active management. In the UK, our agnosticism stems from evenly balanced risks, namely commodity respite and relatively robust overall growth on the one hand but persistent imbalances and now the possibility of EU exit on the other. In emerging markets, the challenges remain daunting. The recovery in Brazilian equities in particular feels exuberant given the current stage of the political cycle. But for the asset class as a whole relief from pressures exerted by the strong US dollar and weak commodities are having a welcome effect, suggesting only a modest underweight position for now.

Fixed Income and Credit

Despite – or because of – a challenging first quarter, we believe more than ever that fixed income and credit can offer good risk-adjusted returns. Negative sentiment in the New Year disproportionately hurt mortgage-backed securities and junior financial bonds. But staying the course and even selectively adding to positions makes sense given the inherent stability of the cashflows underlying these credits. Insurance-linked bonds continue to offer low correlation to wider markets but with no major Florida wind event for over a decade we are conscious of the deteriorating risk-reward profile here. Elsewhere, liquid short duration high yield bonds offer a sensible way to participate in the positive stabilisation that the market could continue to see in the coming months. In terms of the more conventional aggregate bond indices, experienced managers taking positions around duration, region and the sovereign-corporate split can add further value here and provide stability to the wider fixed income book in our view. However, absolute return approaches in this arena are undoubtedly more challenged and we will be carefully assessing these in the second quarter.

Alternative Investments

The 5 year rolling returns of the HFRX Global Hedge Fund Index have been steadily declining since the late 1980s, with the first quarter of 2016 doing little to reverse that trend. The fashionable explanation for more recent underperformance has been that investors have herded into positions en masse, prolonging the lifecycle of a trade longer than the fundamentals would warrant. Then when the reassessment finally comes, everyone gets hurt. But to write off the alternatives universe on the back of such sentiment is nihilistic. Instead, a sensible course is to de-emphasise broad market directionality and focus on a carefully risk-assessed set of diverse themes that we believe can produce a reliable return stream while preserving capital over time. This can be expressed most purely in a dedicated target return vehicle but select market-neutral equity long/short and macro managers have a vital role to play here too. We firmly believe that elevated allocations to a more streamlined vision of alternatives will be key to broader investment success in the future.

Flexibility

Not strictly an asset class, but a concept which is likely to play an increasingly important part in multi-asset investing in the future, Flexibility encompasses tactical asset allocation and liquidity. Both can provide a buttress against periods of elevated volatility and cross-asset correlation but more importantly they should allow for the swift and direct capitalising on opportunities as they arise. To this end, attractive themes include long Mexican peso versus sterling to benefit from the energy rebound and so-called Brexit risk; long US inflation as the labour market there inexorably tightens and long US homebuilding stocks versus the S&P 500 as the familiar pre-crisis patterns of household formation begin to reassert themselves. While some would argue that any liquidity in a dedicated investment portfolio is unnecessary, the ability to be nimble is likely to be at a higher premium than at any time since the global financial crisis.

Conclusion

Equity markets and other key gauges of risk appetite have tumbled then recovered in the first quarter of the year, with investors shaken but little the wiser for their troubles. Many commentators will eloquently and persuasively argue for the particular direction they believe markets will follow from here. But without completely rejecting the challenge of market timing, which remains an important driver of investment success, investors can instead choose to pursue a strategy more independent of broad risk sentiment whether in pure equities or across asset classes. In the case of the latter, this will not be easy since seven years of rising markets have distorted perceptions. But the era of the quasi-structural equity overweight is over and alternative approaches will need to be pursued in order to preserve and grow client capital. No less than the validation of professional investment management is at stake.

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