

# Q3 2015 GAM Multi-Asset Class Solutions Letter

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## World view and outlook

The third quarter proved challenging for investors amid uncertainty over the Chinese and emerging market economies, along with concerns over whether the US was really ready for higher interest rates. Global equities sold off, along with commodities and corporate bonds. US Treasury bond yields also fell, completing a picture of more sober growth and earnings expectations. Analysts' global growth forecasts for full-year 2015 began in late 2014 with a 3.6% figure but ended the third quarter of the year at just 3.0%. Just days after the US Federal Reserve decided not to tighten policy after all, the IMF repeated its call for central banks to keep interest rates at ultra-low levels. The volatility began with the Chinese stock market selloff and currency devaluation, which signalled to investors that the authorities were not in as much control as previously assumed and that the official 7% growth target for the economy was too optimistic. While these concerns are legitimate, the global nature of the market volatility also reflected a realisation that western economies had still not resumed their pre-2008 growth rates. We do not envisage a significant deterioration in financial conditions from here but it is nonetheless sensible to consider whether, after recent turbulence, equity markets are now priced according to a more realistic earnings and growth outlook.

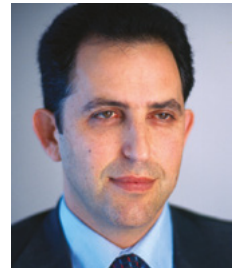
China first. The list of challenges facing the economy will be familiar to many: over-investment in physical assets, excessive corporate debt, an uncompetitive labour market and a currency pegged to a US dollar rising against many competitors. The Chinese devaluation was therefore rational in this context. But investors should note that while the 'heavy' side of the economy is undoubtedly slowing, consumption now accounts for around half of output and appears in good health. Real retail sales are growing at over 10% a year, wages are strong and western companies such as Apple have reported healthy demand for their products. This increasingly important part of the economy will have a crucial role in maintaining domestic growth but also in supporting overseas economies such as Europe whose brands are in high demand in China.

For emerging markets though, the Chinese slowdown has affected equities, currencies and bonds, revealing a concerning dependence on China's economic success for their own. With China accounting for around half of all industrial commodity demand, any slowing of activity was going to badly hurt major producers of such materials, like Peru and Chile, while also increasing competition for exports generally. Simultaneously, the strengthening US dollar has now left a funding mismatch between locally-derived revenues and dollar currency debt. The third source of volatility for emerging markets has been the prolonged saga of when the US Federal Reserve finally raises interest rates. The latest meeting of the rate-setting committee

suggested that concerns over China were contributing to the delay, creating a negative feedback loop in which emerging market weakness elevates uncertainty over US interest rates which in turn creates further volatility for emerging markets.

Turning to the developed economies, the recent turbulence has prompted investors to re-evaluate the pace of recovery. The period since 2008 was supposed to follow a sequence comprising extraordinary policy response, rising confidence, improving growth and inflation and ultimately interest rate normalisation. However, for the US, UK and Europe, growth forecasts remain lower than their 10-year pre-crisis averages. Japan is the exception but then it has been mired in low growth since the 1990s. Corporate profitability also remains mixed. In the US, revenues for the S&P 500 companies are in outright decline as a result of declining world trade, the strong US dollar, falling energy prices and subdued consumption. The last point is especially pertinent since, ex autos, consumers haven't quite resumed the spending patterns of the pre-2008 era. Simultaneously, US companies face a rising cost base due to healthcare and pressure to raise wages. In Europe, earnings forecasts have been growing but given how central exports have been to the recovery there it would be naïve to assume that the market will be immune to recent global volatility. By contrast the UK stock market's pain has arrived in brutal fashion, with earnings forecasts falling significantly amid the selloff in global commodity markets. Japanese equities are arguably a bright spot despite its wider economy. There, companies enjoy a healthy earnings outlook thanks in part to management focus on return on equity. They have also benefited from a cheaper currency as well as investments in technologically innovative areas such as robotics. Against this varied backdrop therefore, recent market adjustments can be seen as going some way to placing equities on a sounder footing relative to today's more modest economic and earnings outlook.

In other asset classes, developed market government bond yields fell as growth and inflation forecasts were revised lower and investors rushed to safety amid the market volatility. Unsurprisingly, high yield bonds sold off amid growth fears and also higher borrowing costs for energy-related issuers. Some of this move was probably disproportionate relative to the actual ability of



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**Past performance is not indicative of future performance.**

**GAM**

many of the non-energy issuers' ability to repay their debts. In currencies, US dollar strengthening continued to dominate the scene as investors sought US bonds for safety and fears rose of a global currency war originating from China and the rest of Asia. Sterling fell against its trading partners as it became clear that the UK was not in a position to pre-empt the US in raising rates due to a mixed economic outlook. The euro gained traction despite suggestions of more quantitative easing from ECB President Mario Draghi while the yen similarly made advances even though the Bank of Japan lowered its growth forecasts and hinted at more bond purchases. At this stage, there seems to be no end to the current period of dollar domination, even if US rate rises get pushed back to 2016.

### Portfolio positioning\*

Given the finely balanced outlook, we sought to ease back equity allocations in multi-asset portfolios to a more neutral-type stance. Regionally, we preferred the US, Europe and Japan over other equity markets, particularly emerging. Our managers performed broadly in line with the global equity index during the quarter while holding up relatively since the Chinese devaluation. Returns from our US managers were challenging as those stocks with balance sheet debt de-rated amid rising corporate bond yields. However, European, emerging market and selected global equity managers fared better. Fixed Income & Credit lost some ground, with total return funds disappointing even as yields fell. We are currently reviewing the blend of managers in this asset class given that some more vanilla, directional approaches could improve the transmission between our outlook on the traditional bond indices, any corresponding change in allocation size and the resulting returns. Alternatives generally performed better, both equity long/short and macro styles. We continue to seek out new managers in this area since generating uncorrelated performance will be crucial if broader equity markets remain

volatile and/or returns are more subdued. Finally, where held, Tactical Asset Allocation was able to partly defend against the market fall during the quarter via a combination of equity option structures and independent thematic trades. The latter included long US dollar positions versus Canadian dollar and Korean won as a proxy for falling oil and slowing Korean exports respectively. Other themes included slower China via Australian bonds, UK disinflation via gilts and peripheral European bond spread tightening via Spanish and Italian sovereigns.

### Conclusion

Risk is an intrinsic characteristic of investing, particularly where equities are concerned. This is not to say that bouts of volatility occur without reason. In this case, markets were responding to elevated uncertainties in the emerging world while also calling for some justification of valuations in the developed economies. However, we do not forecast a global recession or sustained bear market. Some adjustment has already been made by equities and we believe this bodes well for more sustainable returns in line with the modest but steady progress we have been seeing across the major economies in the last few years. Central banks also remain supportive but fundamentals are not so bad that investors' only hope is for external intervention. As markets regain their poise, we will be emphasising regional and manager selection within equities while working the capital preservation and tactical asset allocation elements of portfolios even harder. The third quarter of the year was therefore a reminder, if one were needed at all, that the pre-2008 financial world is going to take an extended period to restore and indeed may never come back in the way that some expect. Equities for their part cannot be expected to drive unquestionably upwards without pausing from time to time to assess progress in economic growth and earnings. Investment ability is now likely to be at a premium.

\* 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 will be informative

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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