Multi-Asset Q&A

APRIL 13, 2017 | By Andrew Pease

On the back of U.S. elections and the subsequent market reaction, Andrew Pease and David Vickers have articulated their stance on some key issues including:

- The impact of Trump on our outlook
- Are the likes of rising bond returns behind use, or is the bond bull market still alive?
- What to do with EM?
- Identifying opportunities in an environment of inflated asset prices.

Q1. Andrew, news of a Trump presidency galvanised US equities and various risk assets. To what extent has the outlook for markets and economies really improved, and can the new president's team deliver fast enough to meet market expectations?

The expectation of Trump-policies has rotated investor sentiment into a risk-on posture. Equity markets have rallied and bond yields have risen. Our strategists believe that US equity valuations are stretched, the market is overbought and the bond market sell-off has been overdone. We believe a market pull-back should present a viable opportunity to add risk exposure to portfolios.

Economic data, both in the US and globally, has improved recently, and

this is adding to equity market optimism. The challenges in the US, however, are high profit margins, rising labour costs and a Fed poised to lift rates at least twice this year. Consensus forecasts for US corporate profit growth this year are becoming more optimistic as the economy improves. These expectations are at risk of disappointment if cost pressures eat into profit margins.

Investors could get a boost from Trump policy proposals involving corporate tax cuts and fiscal stimulus. But the new president may have difficulty following through on his rhetoric given that tax cuts have to be funded from elsewhere. Plus, there is threat of an aggressive trade dispute with China, which would put markets on edge.

Q2. Regarding the long bull market for Treasuries globally, could the Trump victoryrepresent an inflection point?

The turning point in bond yields occurred a couple of months before the election of President Trump, but his hints about fiscal stimulus have certainly reinforced the upward pressure on US yields.

Divergence, though, is still a big theme for bond markets. The Bank of Japan has promised to keep the yield on JGBs close to zero, Brexit uncertainty is keeping the Bank of England on hold and the European Central Bank is continuing with its program of quantitative easing.

Most of our sentiment indicators tell us that the US Treasury market is oversold after the big rise in yields. This means that there is a chance that yields could decline if there is disappointing news on growth, or if protectionist actions by President Trump trigger a risk-off phase for markets.

But the US economy is running out of spare capacity and inflation pressures are slowly building. Our fair-value estimate for the 10-year Treasury yield is a 2.5-3.0% range. The medium-term trend for long-term government bond yields is upwards.

Q3. One of the big losers from the US election result was Emerging Markets (EM). After a rollercoaster year for EM, what does our CVS process tell us about the outlook now for EM equities and bonds respectively?

Emerging Markets had a bright start to 2017 as the Trump administration talked down the US dollar, and as economic data surprised on the upside in the major EM economies. We maintain a balanced view, despite attractive valuations. On the one hand, there are positive bottom-up indicators coming through with improvements in earnings and trade. China has been making notable gains toward stabilizing its economy (albeit with continuing pressure from capital outflows). However, there

are also negatives from a top-down perspective, representing a potential threat of deleveraging as Fed tightening gets underway.

A renewed run-up in the dollar could lead to EM facing a potential liquidity crisis. There is the risk of the Trump administration pursing an aggressive protectionist agenda. Our approach – as with many asset classes – is to maintain patience until a pullback from current levels creates an opportunity to build exposure to the portfolio.

Q4. David, after both a quarter and a year of surprises, how has MAGS' performance held up:

- **Relative to its inflation + 4% and volatility objective**
- **Relative to peers?**

Overall, our multi-strategy line-up of funds ended the year on a positive note: the Multi-Asset Growth Strategy Sterling Fund (MAGS) finished up 9.3% for the year gross of fees compared to RPI +4% which delivered 6.3%. Compared to the peer group that we follow we finished 10th out of 39, where actions we took in MAGS Sterling in the run up to Brexit was additive.

Over the course of 2016, we marginally increased the level of defensiveness built into the Fund (we hold a relatively low equity exposure at approximately 30%). This proved favourable given the macro events which subsequently unfolded over the summer; the EU Referendum, followed later by the US Election, Italian Referendum, and a US rate hike. The defensive segment is comprised primarily of Credit, which represents our largest broad asset class by exposure. This preference reflects our desire to participate in risk rallies, through our exposure to credit and through the additional layer of optionality embedded in our convertibles while maintaining the relative protection of a bond-based allocation.

Leading up to the US election, equity allocations were maintained at or near historic lows along with high levels of cash. Diversifying strategies were also added, such as the Putnam Mortgage Strategy which improved balance within our overall fund exposures. Unlike the lead up to the UK referendum, our positioning did not need amending. Whilst the polls implied a Clinton win, markets did not appear to price in a high level of conviction on the US election compared to the market asymmetry evident in the approach to the UK vote.

During the risk-on rally of Q4, performance in both funds was largely driven by our equity exposure, Underpinned by our higher conviction to Europe and Japan. In addition, protection against a potential equity

market drawdown was maintained through derivative strategies which provide us with protection should markets fall.

Going into 2017, the portfolio has a 29% exposure to equities. At the other end of the risk spectrum, as part of our 45% allocation to fixed income, we have 7.5% in US Treasuries.

Multi-Asset Growth Strategy (Sterling)

Asset class breakdown – 31st December 2016

Source: Russell Investments as at 31st December 2016

Q5. In a growing peer group, we are seeing a changing of the guard, with former leaders now lagging. What insights can we infer from the changes?

Peers who were challenged ostensibly had a higher reliance on traditional fixed income, which struggled during the second half. Additionally, the elevated levels of volatility experienced by all asset classes negatively impacted funds which were more trade orientated, as they were whipsawed. Conversely, funds which prospered tended to be grounded by stronger investment processes that allowed for dynamism. These funds attempted to avoid risk reduction at the wrong time. Among those in the peer group who are very static, the “journey” experienced by investors in those funds was riding through deeper drawdowns.

Q6. In asset allocation terms, can you tell us more about the changes in MAGS’ bond exposures? Are there any special areas of interest for you as we go into the New Year?

The returns which have been available throughout the 30-year bond bull run are expected to be less apparent going forward. Yields have ventured into negative territory, and as rates are expected to rise from here on out, it is unlikely that positive returns will be generated purely from maintaining exposure to duration alone. This is not a reversal of the last 30 years, it’s just unlikely that we see the last 30 years being repeated.

Dynamism in managing fixed income allocations will play an increasing role. We expect to see a decline in the degree of diversification benefits historically derived from relying solely on government bond exposures. How we define diversification will broaden to include an array of strategies, extended sector positioning and innovative investment techniques. There are sufficient deflationary forces to keep inflation at bay. It is conceivable to see some duration being added back should yields exceed 2.7%.

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