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AROUND THE TABLE

AN EXCHANGE OF INVESTMENT IDEAS
CRESTONE INVESTMENT FORUM / MARCH 2017

investing in
times of
uncertainty

The background of the lower half of the page is a light gray surface with numerous white circles of varying sizes. These circles are arranged in a way that creates a sense of depth and movement, with some appearing to float or rise from the surface. The circles are scattered across the entire lower half, with a higher concentration towards the bottom.



Around the table

David Griffith

HEAD OF INVESTMENT STRATEGY, MULTI-ASSET
BLACKROCK

Vimal Gor

HEAD OF INCOME & FIXED INTEREST
BT INVESTMENT MANAGEMENT

Hasan Tevfik

AUSTRALIAN EQUITY STRATEGIST
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Ron Temple

MANAGING DIRECTOR, HEAD OF US EQUITIES
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Matt Sherwood

HEAD OF MULTI-ASSET
PERPETUAL

Adam Bowe

EXECUTIVE VICE PRESIDENT, PORTFOLIO MANAGER
PIMCO

Scott Haslem

CHIEF ECONOMIST AUSTRALIA
UBS

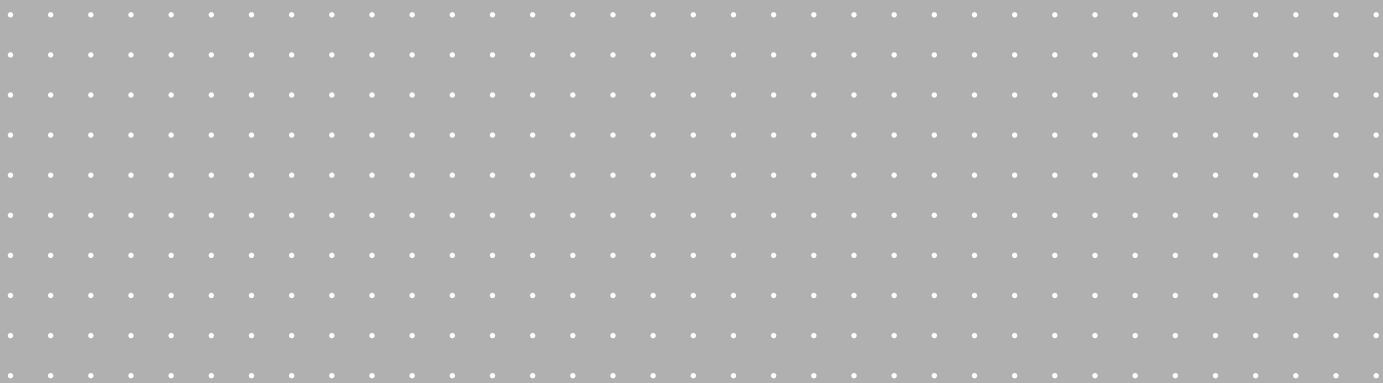
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investing in times of *uncertainty*

The world has changed. In response to the global financial crisis (GFC), central banks sought to do ‘whatever it takes’ to revive the global economy. This has seen monetary policy take centre stage and dominate investor thinking. Now, for the first time in years, central banks are no longer dominating investor decisions.

Rising inequality, stagnant wage growth and disillusionment with established political parties have led to a rise in political ‘populism’. These politicians are playing to large groups of disenfranchised people who feel left behind in the post-GFC environment which has seen asset prices and standards of living increase. This new wave of populism is a source of uncertainty for markets. This is despite investors thus far seemingly ignoring it to push some markets to record levels.

At the latest Crestone Investment Forum, we asked panellists how they were positioned for these changes, and whether this uncertainty will ultimately lead to market volatility. In addition, we sought answers on whether the reflation theme is important for markets, what it means for asset valuations and how they anticipate taking advantage of such a major environmental change.

Three key themes emerged from the forum

- **Volatility remains unusually subdued** but is expected to return given heightened geo-political risk, regulatory uncertainty and increased market valuations. Politicians are taking the reins from central banks as dominant drivers of markets—however, whether the shift from monetary to fiscal policy will be effective is a great unknown.
- **The world is undergoing reflation**, with the focus shifting from deflation to steady inflation. There is now broad acceptance that US interest rates will rise, which will have a direct impact on markets, most notably for bonds.
- **Diversification and active management are critical** to navigating through this changing environment. These are proven methods for managing risk and return in an uncertain world.

UNCERTAINTY CAN BRING VOLATILITY... AND OPPORTUNITY

Investors are currently faced with an unusual mix of market influences.

On the one hand, the global economy is improving and there is the potential for stimulatory fiscal policy. This is particularly the case with the US which could see growth continue to accelerate. On the other hand, political and regulatory uncertainty is heightened, and inflation is set to increase at an unknown pace. Asset markets, particularly equities and housing, appear to be fully valued and pricing in an arguably over-optimistic outlook.

Markets have taken these changes surprisingly well. Volatility has remained particularly low, bond yields have only moderately increased, and the S&P 500 index has climbed more than 10 percent since the November election of Donald Trump. The Australian dollar has fluctuated—but surprisingly, it is almost at exactly the same level it was in the week before the November US election.

Whether this sanguine environment can continue is unknown. However, participants at the Crestone Investment Forum thought that it is unlikely, and that volatility would return over the medium term.

GEO-POLITICAL RISK IS SET TO BE A KEY DRIVER OF VOLATILITY

Investors have rarely paid so much attention to geo-political risk. Now, however, discussions are commonplace about European Union (EU) participation, French political parties and the structure of the US congress. While the election of Donald Trump as President of the United States in November last year escalated the discussion, the sheer number of major concurrent events is what is primarily driving concerns.

In addition to the Trump discussion, UK Prime Minister Theresa May plans to invoke Article 50 this month to begin a 'hard' Brexit from the EU—while the anti-euro, anti-EU, and anti-immigration National Front has attracted support ahead of the French elections to be held in April. Last December, Italy rejected constitutional reform (which may pave the way for its own long-term exit from the EU) leading to the resignation of Prime Minister Matteo Renzi. Greece's debt woes also continue to linger in the background.

BUT THE MARKET HAS LARGELY IGNORED THIS UNCERTAINTY

These newly invigorated political forces, and the prospect of increased fiscal spending, has had a positive influence on markets. This is despite the increased political uncertainty, questions over implementation and the potential for sovereign debt levels to increase—which was a major global concern only a few years back. No doubt, stronger economic growth and improved corporate earnings have influenced equity markets, but the strength of the equity market rally since the US election has been very surprising. This has been a boon for investors but it now makes the job of investing much more challenging.

"The market is probably focusing a little too much on the positives," said **Ron Temple**, Managing Director, Head of US Equities and Co-Head of Multi-Asset at Lazard Asset Management. "I do think there is geo-political uncertainty that should be priced in—it's being completely ignored. And I do think the market is ignoring what this could mean for 30 years of globalisation, which was great for equities."

Adam Bowe, Executive Vice President, Portfolio Manager at PIMCO, said many of Trump's election policies are unlikely to be enacted before the US summer, while the magnitude of reform will be less than expected.

"All the positive things that people are pricing are going to take longer, and there's still uncertainty about what it involves."



RON TEMPLE

MANAGING DIRECTOR, HEAD OF US EQUITIES
AND CO-HEAD OF MULTI-ASSET
LAZARD ASSET MANAGEMENT

"The market is probably focussing a little too much on the positives"

UNCERTAINTY CAN BRING VOLATILITY... AND OPPORTUNITY

HOW SHOULD MARKETS REACT OVER THE LONGER TERM?

"We expect this level of uncertainty to continue—we don't think this is one month or one quarter—this is the new MO [modus operandi] we're working in for foreseeable quarters and years," said **Vimal Gor**, Head of Income & Fixed Interest at BT Investment Management.

"The swing has been from central banks, which have largely predictable and reactionary functions, to politicians who don't. The baton has been passed and now politicians will swing in the populist wind. They'll become a lot more erratic and uncertainty will increase."

Scott Haslem, Chief Economist Australia at UBS, says investors must pay greater heed to how these factors will affect the slow growth and inflationary path the world is now on.

"That path seems a lot narrower than previously, and is surrounded by immense event and political risk. Social disillusionment globally, the clash of civilisations—these are all on a multi-year perspective, things we need to pay a great deal of attention to."

Haslem said markets will be constantly pivoting around these factors, including the US's negative policies (such as protectionism) and positive policies (tax cuts, less regulation and fiscal stimulus).

WHAT DOES THIS MEAN FOR EQUITY MARKETS?

"The market has become a bit too focused on the good news rather than necessarily the bad news—but at the same time, if the bad news comes and the good news is at least expected, it might balance it."

"It's the first time we are starting to see a synchronised global growth recovery, although modest, not just in the US but Europe, emerging markets and China," said **David Griffith**, Head of Investment Strategy, Multi-Asset at BlackRock. "We're relatively constructive on global growth and over the short to medium term, relatively constructive about risk assets given there is still policy uncertainty out there."

AND THE AUSTRALIAN DOLLAR?

Crestone Investment Forum panellists offered wide predictions around its USD 0.76-0.77 trading range through February.

"We have been bearish on the Aussie dollar over the last few years and it has moderated more recently—in particular, with the game changer of commodity prices," said **Griffith**.

Rising Chinese investment has bolstered commodity prices, as well as Australia's terms of trade, reversing the massive downdraft over the past three years. Those benefits have also flowed directly into mining companies such as BHP Billiton and Rio Tinto.

Matt Sherwood, Head of Multi-Asset at Perpetual, said the Australian dollar will trend towards USD 0.80 in the short term, but in the long term, remain at about current levels.

"Australia is still pretty strong. It has highly rated sovereign debt, interest rates that trade at premiums and trade exposure to China. Our exports are also defensive—people don't use less coal in a downturn."

One trend that has broad consensus is a strengthening US dollar. This is thanks to rising inflation, a potentially more hawkish Federal Reserve, strong wages growth, and protectionist regulations such as the border adjustment tax.



SCOTT HASLEM

CHIEF ECONOMIST AUSTRALIA
UBS

"Social disillusionment globally, the clash of civilisations—these are all on a multi-year perspective"

REFLATION HAS FINALLY ARRIVED

In response to the GFC, global central banks embarked on unprecedented monetary expansion to promote growth and inflation.

However, declining commodity prices, excess Chinese capacity and technological advances saw inflation stay stubbornly low, with most developed economies struggling to meet even modest inflation targets of around 2 percent. The threat of deflation also seemed to be omnipresent, especially in Europe and Japan.

That began to change last year when three important developments took place:

- commodity prices rebounded off multi-year lows;
- quantitative easing programs run by the Bank of Japan and European Central Bank were effectively tapered; and
- US wage growth improved as the economy reached 'full employment'.

Inflation is now back on the agenda with President Trump's proposed fiscal expansion via infrastructure spending and corporate tax cuts providing fuel to the inflation fire.

At the Crestone Investment Forum, we discussed the reflation theme, and the effect this is likely to have on asset valuations.

HOW HIGH COULD INFLATION GO, AND WHAT DOES THIS MEAN FOR INTEREST RATES?

The primary concern regarding inflation is that it may force the Fed to increase interest rates faster than the market expects if inflation overshoots. The Fed is expected to hike interest rates up to three times in 2017, however expansionary fiscal policy may change that. The most obvious driver for an inflation overshoot would be Trump's proposed policy mix. The concern centres around the potential for corporate tax cuts, increased infrastructure spending, reduced regulation, and higher spending to add to wages growth, and propel an already accelerating economy too fast.

While this seems conceptionally simple, the timing of these policies, their ability to be implemented, and their eventual effectiveness remain hard to gauge. As too does their precise impact on inflation and the global economy for that matter. **Gor** says Trump's policies will be an overall positive for the US but weigh on the rest of the world.

"The pie isn't getting particularly bigger; the US is just grabbing more of it. It means more growth and more inflation in the US, and arguably a steeper yield curve and lower growth and lower inflation in the rest of the world. It's really a cross-market trade."

"The risk is he is overstimulating at the wrong point in the cycle, and brings out a more aggressive Fed. Markets are very dovish at the moment, and so is the Fed," **Sherwood** says.

"I have said for the last eight years, inflation is not an issue, worry about deflation.... there's very little question that inflation is now moving higher," said **Temple**. He also mentioned the intersection of a tightening US labour market and protectionism could push inflation into the 2-4 percent range.



VIMAL GOR

HEAD OF INCOME & FIXED INTEREST
BT INVESTMENT MANAGEMENT

"The pie isn't getting particularly bigger; the US is just grabbing more of it"

REFLATION HAS FINALLY ARRIVED

Australian inflation is running at just 1.5 percent and official interest rates are pegged at historic lows—although concerns remain about a residential property boom in Sydney and Melbourne.

“Our base case is the Reserve Bank of Australia is on hold for the time being—but if they did do something it would err on the side of a cut,” **Griffith** said. “There are some challenges ahead of the Aussie economy.”

WHAT DOES THIS MEAN FOR EQUITIES?

Moderate inflation is a positive for equities. As such, improving economic growth and inflation within the Fed’s tolerance bands should be beneficial for equities. However, if inflation hits that upper range, it may force the Fed to hike rates faster than expected and this would be a negative for equities.

Equities have been attractively valued relative to fixed income for some time now, and a significant increase in bond yields would reduce the relative appeal. Additionally, higher interest rates would likely see the US dollar appreciate, and this would weigh on corporate earnings and create an economic headwind. Consumption would also likely suffer if rates rose too high and too fast. This is due to the growing indebtedness of society and the need to finance debt at higher interest rates. Both have the potential to drag on the economy and hence earnings which again would challenge current valuations.

WHAT DOES THIS MEAN FOR BONDS?

US sovereign bond yields spiked sharply in the months following Trump’s election as inflation concerns dragged down bond prices. Bonds still have a role to play in portfolios—but investors will need to be far more selective about the type of fixed income assets they own in an inflationary environment.

“I’d be negative on sovereign rate exposure and look more towards the credit market including security selection within emerging markets,” **Temple** said.



DAVID GRIFFITH

HEAD OF INVESTMENT STRATEGY, MULTI-ASSET
BLACKROCK

“There are some challenges ahead of the Aussie economy”

WHEN UNCERTAINTY IS HIGH, DIVERSIFICATION PAYS OFF

Uncertainty is currently casting a long shadow across political, economic and investment spheres. In this environment, risk is naturally high and conviction low, underlining the benefits of diversification.

Bowe cautioned against making high conviction calls in such a highly uncertain environment where valuations remain full. However, patience and a diversified approach will pay off.

"I'm increasingly confident that over the course of the next 12 months there will be some 'nine out of ten' or even 'ten out of ten' investment opportunities. So, I wouldn't be heading into 2017 with high conviction bets because there will be some pretty attractive opportunities as volatility picks up."

TRADITIONAL DIVERSIFICATION STRATEGIES MAY NOT BE AS EFFECTIVE

Importantly though, traditional diversification strategies may not be as effective given the impact that quantitative easing tailwinds have had on bond markets and equity valuations. The current market inflection point, which has pushed up bond yields (and lowered bond prices), accentuated this.

With many bond yields still at ultra-low levels, **Sherwood** warned against anchoring portfolio decisions to long-term risk-return assumptions that were made when assets were at fair value.

"You just need to find new diversifiers in your portfolio," **Sherwood** said.

Bond returns are likely to be lower in this new environment, and their diversification benefits lessened. However, bonds and equities have simultaneously recorded losses in just five of the past 116 years, and those correlation benefits have held up recently. Sovereign bonds have been under particular pressure as inflation concerns have been reignited in recent months—but opportunities remain in corporate credit.

This means that new or alternative sources of diversification are needed to strengthen portfolios and lower their risk.

Alternative assets, such as global macro hedge funds, may benefit from heightened market volatility, while equity event-driven hedge funds could perform well given a recent rise in merger and acquisition activity.

While cash may not offer strong returns, it does offer certainty and liquidity. These are two traits that should make it a larger part of a diversified approach in these market conditions. This allows investors to quickly take advantage of opportunities when volatility picks up, and presents more attractive entry points.



MATT SHERWOOD

HEAD OF MULTI-ASSET
PERPETUAL

*"You just need to find
new diversifiers in
your portfolio"*

WHEN UNCERTAINTY IS HIGH, DIVERSIFICATION PAYS OFF

DIVERSIFY VIA ACTIVE MANAGEMENT

While diversification can help manage risk, an active management approach can potentially boost returns and allow nimbleness in times of high volatility. This is particularly important given current valuations and the limited potential for equity market multiples to expand. Performance is set to be driven by earnings going forward which typically requires active stock selection to outperform.

Griffith said the shift away from monetary policy had paved the way for active management to deliver. This is because managers have many more factors to focus on.

"Valuations across most asset classes are elevated, and return expectations at the asset class level are looking fairly muted—but there seem to be a lot more opportunities now for active management within sectors and across geographies given the likely dispersion in policy outcomes."

He favours equities over bonds, credit over sovereign debt, value stocks, US small caps, Japan and emerging markets.

Temple also said security selection would be crucial in this new environment with US trade policy and a stronger US dollar impacting individual companies very differently.

"There's a lot of volatility and dispersion. It will be critical for investors to focus on the valuation of the stocks they're looking to buy and recognise that the scenarios they have to consider are changing."

For example, US-based global multi-nationals or US-domiciled banks that earn significant profit offshore may be severely impacted by the proposed border-adjustment tax.

"There's a strong case to be global and ignore some of these regional boundaries that might not be as meaningful as they used to be."

Sherwood said valuations remain elevated in Australia, which is drifting along with commodity cycle prices, and in need of structural reform driven by our political leaders.

"I think there's better value elsewhere in the world. Japan, emerging markets—although risky—will benefit from the early cycle in commodity prices. Europe is quite a good reflation trade—it's got high energy, materials and financials exposure, more than America."

However, **Hasan Tevfik**, Australian Equity Strategist at Credit Suisse, noted that, while Australian equity valuations are high, this is typical at the start of a new earnings expansion phase. He highlighted that commodities and some cyclical stocks, such as fund managers and insurers, are already benefiting.

"Valuations are high but it's not a big issue because you should be expecting strong earnings per share growth from here," he said. "You want to tone down your focus on defensives and growth, and tone up your focus on valuation."



HASAN TEVFIK

AUSTRALIAN EQUITY STRATEGIST
CREDIT SUISSE

"You want to tone down your focus on defensives and growth, and tone up your focus on valuation"

forum *conclusions*

The Crestone Investment Forum presented a rare insight into the current global political and economic environment from the eyes of highly regarded and informed global investment professionals.

It was clear that, while their views differed at times, there appeared to be a consensus that uncertainty is currently heightened—but that it is not being reflected in financial markets. While they were mostly positive on the global economic outlook, the recent rally in equities has seen much of this optimism priced in, especially when one considers the lack of risk being priced into the market.

The solution for investors is to maintain a globally diversified portfolio so as not to take too much geographic, sector or asset class risk. This does not mean a withdrawal from the markets as the timing of any potential correction is incredibly hard to determine. However, it may warrant a more defensive stance, maintaining some cash to take advantage of the opportunities that heightened volatility will deliver.

This is consistent with Crestone's own asset allocations where we are prudently positioned by sticking closely to our long-term strategic asset allocations and taking little 'tactical' risk given the heightened uncertainty. We are, however, overweight cash and ready to deploy it when valuations become more attractive. We are also underweight sovereign fixed income given the inflationary environment highlighted by the forum panellists.

We hope this helps you navigate these uncertain times.

deep insights *are driven by* diverse perspectives

In delivering advice and views on markets, the insights of our experienced investment team are complemented by market-leading research providers from across the globe, as well as the insights from the Crestone Investment Forum. These perspectives are then integrated into our robust, institutional investment process.

To find out more about our views on markets, and how this is driving our portfolio positioning, please ask your investment adviser for a copy of our latest *Core Offerings* report.



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