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Around the table

AN EXCHANGE OF INVESTMENT IDEAS
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The challenges of investing *later cycle*





Around the table

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The challenges of investing *later cycle*

Global markets continue to successfully navigate a maturing economic cycle, underpinned by strong fundamentals of synchronised growth, still benign inflation and solid earnings momentum. This is despite a steady stream of geo-political flashpoints—from rising threats of an escalating US-China trade war to rising political uncertainty across Europe.

At our recent Crestone Investment Forum, we asked panellists to discuss some of the challenges facing investors as they navigate the later cycle. Overall, tighter credit conditions, rising bond yields and emerging cost pressures are a focus. Finding genuinely uncorrelated alternative assets to diversify portfolios is also seen as key to reducing portfolio risk.

Four key themes emerged from the forum

- **Emerging market equities will continue to face some near-term pressure**—Structural investment themes are attractive in emerging markets, particularly in China and the rest of Asia. However, the panel felt that the tightening of global credit conditions, which still has some way to run, as well as the uncertainty of rising protectionism and a potentially stronger US dollar, were headwinds to a tactically more positive view. Given the recent sharp correction, a de-escalation in trade disputes may warrant a more positive view.
- **Global bond yields are still expected to move higher into 2019**—A decade on from the Financial Crisis, the global economy is only now approaching full capacity—while central banks outside the US Federal Reserve (Fed) have yet to start meaningfully tightening policy. A sharper-than-expected rise in interest rates was seen as a risk to the outlook, potentially driven by an unexpected jump in wage pressures. However, an ongoing steady move higher in yields in 2019 was expected to be the more likely outcome.
- **The domestic equity reporting season suggests prior aggressive cost-out gains had been exhausted**—The reporting season delivered typically in-line results in 2018, but guidance was weaker than expected. A number of sectors were seen to have underinvested—or were facing rising labour cost pressures. Offshore markets, particularly Asia, were viewed as less expensive and presenting some better longer-term structural opportunities than Australia.
- **Finding alternative investments that are genuinely not exposed to the market remains key in the later cycle**—Managers of alternative assets are facing challenges given the wide range of potential scenarios that could unfold over the coming year. They also face challenges as bouts of volatility do not persist and style trends (such as growth versus value) continue for much longer than expected.

DO EMERGING MARKETS PRESENT A BUYING OPPORTUNITY?

After a broad slowdown in Q1 2018, global growth has become less synchronised through Q2 and Q3. With increasing signs that global growth leadership has been shifting towards the US, this has put upward pressure on the US dollar.

The panellists discussed how this is likely to impact emerging markets, and whether the recent pullback in emerging market equities presents a buying opportunity.

DOES LIQUIDITY WITHDRAWAL HAVE IMPLICATIONS FOR EMERGING MARKETS?

Graham Hay, Deputy Portfolio Manager at Antipodes Partners, reminded panellists that we are coming out of a seven to eight-year regime of credit expansion, sponsored by co-ordinated central bank intervention of a scale not seen before. "In 2018, we are slowly seeing the removal of the scaffolding that has propped up markets."

The outcome of tighter credit conditions has been evident in our own housing market, particularly for those trying to secure a mortgage on an investment property—and the withdrawal of liquidity also has implications for emerging markets.

As noted by **Hay**, "There is a school of thought that the down cycle in emerging markets was really interrupted by this co-ordinated QE [quantitative easing] and that, as we see the withdrawal of QE, the repair cycle still needs to play out."

"China is at the epicentre of what is going on in Asia by virtue of its size," said **Hay**. "Although China is transitioning to a service and consumption-based economy, it hasn't abandoned the growth model of large-scale investment in infrastructure and urbanisation."

As a result of China's historic growth model, there has been a build-up of credit in the Chinese economy. It has many tools at its disposal, which are being rolled out to try to avoid a financial crisis and any subsequent asset price deflation.

On the subject of trade wars, the panellists felt that restrictive tariffs were being used as a political tool by the US to bring China to some sort of agreeable trade arrangement. So far, the upward pressure on the US dollar has succeeded in exposing some fragilities in the broader emerging complex. While broadly more robust than even five years earlier, panellists agreed that a determining factor for emerging markets in the coming years will be how aggressive the Fed is with raising interest rates.

WITH EMERGING MARKET EQUITIES DOWN 15-20% SO FAR THIS YEAR, DOES THIS PRESENT A BUYING OPPORTUNITY?

Hay pointed to Japan in the late 1980s and early 1990s as a template for the situation in China today. "After the credit bust of the late 80s and early 90s, Japan was a place most people retreated from. Over the following five to seven years, a vibrant set of Japanese companies emerged that were internationally focused and in growing industries. They ended up being fantastic investments. I think China is in a similar position. The transition to consumption and services inevitably creates opportunities."



GRAHAM HAY

DEPUTY PORTFOLIO MANAGER
ANTIPODES PARTNERS

"In 2018, we are slowly seeing the removal of the scaffolding that has propped up markets."

Brett Gillespie, Head of Global Macro at Ellerston Capital, has been looking for stress points in emerging markets. He observed that the original underperformance in emerging markets started with a slowdown in China that was in train at the start of the year.

"If we look at the 20% sell-off in equities, the last 10% or even 15% has come from tariff concerns. So, if you want to get emerging markets right, you've got to get tariffs right."

"We think there is a very large flow vulnerability in emerging markets, particularly in the bond markets because so much money has flowed to emerging markets over an eight-year period of very low yields. We recently saw the biggest one-day emerging market bond outflow on record."

In the short term, **Gillespie** has a neutral view on emerging markets. There has clearly been an escalation in tariff discussions but, with a meeting between President Trump and President Xi Jinping in November, panellists felt there may be a truce on the horizon.

"Trump is winning the polls by bashing China on trade," commented **Gillespie**. "If China gives Trump the win he wants leading into the mid-terms, that would be a big risk-on development. Emerging markets would outperform and the losses in emerging markets would be recouped. However, if trade wars escalate, emerging markets will remain under significant pressure."

Scott Haslem, Chief Investment Officer at Crestone noted that "as we approach mid-term elections in US, there could be more volatility in equity markets or bond yields could rally, as Trump attempts to push the envelope as hard as he can to attain a win in the trade war with China."

Prashant Chandran, Head of Derivatives at Western Asset Management, took a more positive stance on emerging markets. "Can you look at what has happened in China and say that trade wars will drive China to a hard landing? A hard landing for China is probably GDP with a 4% handle. We feel the US would back off before that point."

Elsewhere, we have seen improving bilateral negotiations between the US and its neighbours (Mexico and Canada) from what was a similarly combative starting point. There has also been some easing in tensions with Europe.

"China has reserves at [USD] 3.1 trillion and capital controls are in place," noted **Chandran**. "Sure, data has been coming in softer, but the question remains, will there be a hard landing? We still believe this is an engineered soft landing and note that China has tools at its disposal. They can cut the reserve requirement ratio or further devalue the currency."

The Crestone view: *We are neutral emerging market equities. We remain positive on selected themes like Asian technology, but macro concerns (such as US dollar driven capital flight and growth headwinds from rising protectionism) warrant caution ahead of historically more compelling valuations.*



BRETT GILLESPIE
HEAD OF GLOBAL MACRO
ELLERSTON CAPITAL

"If you want to get emerging markets right, you've got to get tariffs right."

WHAT WILL END THE CYCLE?

Earlier this year, US Treasuries moved above 3% but have now retreated to 2.85%. Panellists discussed whether we have enough inflation left in the system to see rates move higher from here.

IS THERE ANY INFLATION LEFT IN THE SYSTEM?

Anne Anderson, Head of Fixed Income and Investment Solutions at UBS Asset Management, is of the view that QE withdrawal has barely started. "The reason why this is all unfolding so slowly is because the withdrawal of stimulus is just that. So, we have the ECB [European Central Bank] starting to taper in October and the Fed still firmly on course. If you saw Europe stabilise, there might be a broadening of growth, which could take upward pressure off the US dollar."

A decade on from the Financial Crisis, **Chandran** noted, "We have only just closed the output gap. We don't think that this cycle is late stage. Corporate profits and earnings per share growth remain strong. We think US growth of 2.5% to 2.75% this year is still par for the course and that puts a cap on inflation."

"At the same time, labour force participation is also increasing," commented **Chandran**. "On Treasuries, we think there is a range of 2.50% to 3%, even as the Fed continues to hike. We see a bit more curve flattening but see the long end being contained. We are staying invested in risk assets and are cautiously optimistic—but optimistic nonetheless."

WHAT WILL END THE GLOBAL CYCLE?

Currently, we have rising inflation and US 10-year Treasuries below 3%. Most panellists saw 10-year Treasuries by mid-2019 yielding 3.25% to 3.75%. They discussed the risks this presents and what is likely to end the current cycle.

Haslem noted, "The world is still reasonably synchronised and robust, while the emergence of US growth leadership is putting upward pressure on the US dollar."

Gillespie was sympathetic to the 'Goldilocks' view that everything keeps moving along the current path. "The question then becomes: Is there a level at which wages pick up quickly? In our view, the reason bonds haven't sold off this year is that we have had one crisis after another. It is a bit like holding a beach ball under water—there is always something to worry about. However, if we get through all these crises, we could have growth running way above trend and US unemployment heading below 4%. So, we are short US rates to the end of this year as we think Fed rates will go to 3.25% by year end and possibly higher if the China trade situation is resolved."

Anderson agreed. "2.85% on Treasuries is low but partly a flight to quality. The Fed doesn't like having the curve so flat."

Hay offered a slightly different perspective. "We have only just commenced a business investment cycle. Until now, we have seen corporates returning capital to investors rather than investing it. We have now reached a point where investment is picking up. We could see Treasuries significantly higher next year. I am also reminded of the period through 2013 to 2015 where, with every negative data point, the market rose further because investors thought that would extend the easing cycle. We could see a scenario now where every positive data point leads to greater concern regarding what it means for policy. As a result, we may not see corresponding strength in equity prices."

The Crestone view: *We are modestly underweight government bonds. We see ongoing above-trend global growth and the end of QE causing global rates to move moderately higher into 2019.*



ANNE ANDERSON

HEAD OF FIXED INCOME AND INVESTMENT SOLUTIONS
UBS ASSET MANAGEMENT

"If you saw Europe stabilise, there might be a broadening of growth, which could take upward pressure off the US dollar."

WHAT DOES THIS MEAN FOR CREDIT?

International credit markets continue to operate with exceptionally low default rates and historically tight credit spreads. Current yields, which are historically low, leave the market heavily exposed to a rise in government bond yields.

HOW ARE YOU ALLOCATING WITHIN FIXED INCOME AND WHERE DOES CREDIT FIT?

Chandran prefers investment-grade debt to high yield but noted, “You really need to pull the indices apart. Investment grade has tailwinds. One is tax reform, which is making it harder for CEOs to issue more debt. We are also seeing large pension funds switching at the margin out of equities and into fixed income.”

According to **Gillespie**, “The key is whether the US looks like it’s overheating. For the time being it doesn’t. For that picture to change would require three to six months of data suggesting that wages are picking up too smartly or inflation is too high.”

Anderson still likes investment grade but prefers Europe to the US. She advocates a range-trading approach in a maturing cycle. “The risk is there are a lot of investors who have been pushed into investment grade. That is amplifying the volatility.”

The Crestone view: Credit spreads, while still relatively tight, have been on a widening path this year. We expect spreads to trend wider from here as global liquidity is withdrawn by central banks, particularly for high-yield markets. Domestic credit spreads likely remain supported by limited new supply.



PRASHANT CHANDRAN

HEAD OF DERIVATIVES
WESTERN ASSET MANAGEMENT

“You really need to pull the indices apart. Investment grade has tailwinds.”

HOW DOES THE AUSTRALIAN OPPORTUNITY SET COMPARE?

With August having been dominated by reporting season, the panellists discussed whether any concerns have become apparent within domestic equities. They also discussed how Australia's opportunity set compares to opportunities offshore.

HAS THE REPORTING SEASON REVEALED ANY ISSUES IN DOMESTIC EQUITIES?

Anthony Aboud, Portfolio Manager at Perpetual Limited, has observed two key themes from the current reporting season—cost inflation and accounting tactics.

Cost inflation, he noted, has surprised a lot of people across the board. "Lots of businesses have underinvested and are now seeing tightness in labour markets. I was in Western Australia meeting mining service companies. They are very worried. The last time there was a boom in the west there was almost a recession in the east and more hiring flexibility owing to 457 visas. This time around there is a lot more activity on the east coast. So, we are starting to see some inflation there. Companies are also spending a lot more on technology just to keep up."

In terms of accounting tactics, **Aboud** observed that, to meet guidance, companies are resorting to tactics such as acquisition accounting and increasingly putting numbers below the line as one-offs. "There are lots of games being played to hit the numbers—and the market seems to be turning a blind eye."

While there are parts of the resources sector that **Aboud** likes, he is seeing cost pressure within BHP Billiton and Rio Tinto and feels this will continue. Commenting on oil companies generally, he said "The oils have been harvesting cash flows from higher prices and not reinvesting. They have shareholder bases that now focus on capital returns rather than growth—from companies that own depleting assets."

Sentiment towards the banks is negative—particularly with the findings of the Hayne Royal Commission still to come. Despite this, **Aboud** thinks they have appeal at the right price. "What I like about the banks is the amount of data they are collecting. Take tap-and-go as an example. They still don't know how to harness that data, but they are working on it. But then I think, why would you chase the Australian banks at 1.5-2 times book value when you have offshore banks that are cheaper and further advanced?"

HOW DOES THE OPPORTUNITY SET COMPARE TO OFFSHORE?

According to **Hay**, "The premium local growth companies trade at relative to their global peers is ridiculous. Whilst they may be interesting businesses, they are very uninteresting investments. In Asia, there is a much broader set of businesses doing very interesting things."

Aboud added that momentum is strong around the world but particularly acute in Australia. This has been exacerbated by the flow of money to passive managers or momentum managers. "Some of the value managers are capitulating and buying stocks on 40-times price-to-earnings ratios."



ANTHONY ABOUD
PORTFOLIO MANAGER
PERPETUAL LIMITED

"There are lots of games being played to hit the numbers—and the market seems to be turning a blind eye."

WHAT ARE THE CHALLENGES FOR HEDGE FUNDS?

With returns from traditional asset classes likely to be relatively modest in the period ahead, the panellists discussed where one should look for uncorrelated sources of return and what challenges hedge funds currently face.

According to **Aboud**, the key is to find funds that are genuinely not exposed to the market. In addition, factor risk has made life difficult for many hedge funds in recent times—particularly those that maintain short positions in overvalued stocks and longs in undervalued stocks. “Look for funds with a low net position—but also remember that there is always factor risk, such as when value goes down and momentum goes up.”

Aboud is also wary of leverage. “Make sure that there isn’t the motivation for the fund manager to lever up in order to increase fee income. You want the manager to have skin in the game, such that he or she is more motivated to protect the downside. There are a lot of very highly-gearred long-short funds in the market.”

Gillespie highlighted the wide range of scenarios that could play out over the coming months and years and the large degree of uncertainty surrounding them. “You need to have flexibility within your portfolio. We are positioned for bonds to rise, the yuan to weaken and a Labor victory in Australia, amongst other positions. We try to find scenarios that aren’t well priced in the market and [where we] can obtain a good risk reward without losing too much money in the interim.”

Chandran commented that, “We have seen bouts of volatility that don’t last long. There remains enough ‘buy the dip’ mentality for investors to keep coming in and supporting asset prices. That won’t last forever—and it concerns us. We think you need to keep your global macro view in mind but trade the market around that view.”

The Crestone view: *We are overweight alternative assets, such as hedge funds and global macro funds. We believe an allocation to a lowly-correlated asset class, like alternatives, is now more important than ever to gain portfolio diversification at a more uncertain point in the macro cycle.*



PRASHANT CHANDRAN

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“We think you need to keep your global macro view in mind but trade the market around that view.”

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