Investment Strategy 2016 Q1. Cautious on Stability. Going Where The Trouble Is.

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Following from our Investment Outlook for 2016 we formulate an investment strategy. A number of high level principles or themes will animate this strategy.

The strategic allocation is actually quite risk averse. The reason for this is that the global economy remains fragile and the performance enhancing drugs or policies prescribed by the world's central banks are losing marginal effect, even if they have worked to a limited degree. The central banks of the world have no leeway or capacity to deal with a recession or other crisis, if such should happen in the next 12 months. Even the Fed has only just begun raising interest rates.

Equity markets have fared quite well in the last 5 years, the S&P 500 index for example, returning over 10% per annum. Global equities (MSCI World) has returned an annualized 5.3% in the same period. US high yield has returned 4.2% and the Barclays Aggregate 2.6% in the same period which on a risk adjusted basis, this is quite respectable. Corporate performance, however, has not kept up and companies have spent the money they raised paying dividends, buying back stock or each other instead of investing in productive assets. Valuations have therefore risen and are highly sensitive to interest rates.

The US Federal Reserve has just raised interest rates and signaled 4 further rate hikes in 2016 and the market is pricing in just 2 rate hikes. The fixed income market is not robust against a hawkish surprise by the Fed and the USD term structure is too important in the valuation of all assets from corporate credit to equities to real estate.

Global trade peaked in 2011 and has been trending sideways. When trade lags output growth productive and allocative efficiency suffer and the risk of inflation rises. That inflation hasn't risen in the last 5 years is evidence of deficient demand. This is corroborated by the weak impact of successive rounds of quantitative easing on real output growth even as it inflates asset prices.

Geopolitical risks have been rising. The energy independence of the US has played an important part in the increased turbulence in the Middle East. The Arab Spring has been unsuccessful and ISIS is seeking the establishment of an Islamic State across Syria and Iraq. The rise of China economically has also led to increased ambitions abroad if not at least to secure its own interests. Europe's unity has been tested in the bond markets and latterly by the election of anti-austerity and Euroskeptic parties in Greece, Portugal and Spain. Right wing nationalist parties have gained traction in core Europe as well. In the UK, an in out referendum on Britain's membership in the European Union is scheduled to take place before the end of 2017. While geopolitical risks are always with us, the last 5 years have experienced an escalation.

Since markets were not driven by fundamentals in the post 2008 era of QE and the central bank, can we assume that fundamentals will return to drive markets in a post QE era? Are we even close to a post QE era?

With this much uncertainty in the markets it is likely that markets will be fickle and sentiment driven, at least in the next 12 months. A guerrilla trading approach may be necessary if one is to manage volatility. Long term investing is laudable but long term investing can and must also include short term risk management and trading. If we challenge established wisdom we will come to conclusion any part of an optimal investment strategy must be itself optimal, we find theoretical support for lower latency strategies. We are not talking about high frequency trading but of adjusting the optimal portfolio to suit the evolution of market prices and information.

Strategy:

Maintain an underweight in US equities. Valuations are expensive, growth is tepid, and the Fed is not expanding its balance sheet. US equities cannot rely on higher earnings multiples with the Fed in neutral and so have to rely on earnings growth, the prospects of which are not looking very attractive.

Restore overweight in European equities. We were underweight risk assets on the whole coming into 2016 simply because the macro environment just looked risky. We are restoring our position in European equities to overweight. European growth is still in recovery mode, earnings are recovering in sympathy, the ECB is still buying assets and thankfully didn't overdo it in December when it disappointed the market with less than expected monetary stimulus. There is potential for the ECB to do more and this could propel European equities. That said, we are taking our time to restore the allocation to overweight and events may derail this deployment.

Underweight Japan. Japan appears to be pushing the limits of policy. The latest macro data is not encouraging and yet the BoJ has stopped short of increasing QE although it has tweaked the current program slightly. Japan has relied on a weak JPY to invigorate the stock market and it looks like the JPY has reached a trough.

We began the year with an underweight in China. Since then the market has fallen 15%. It may yet overshoot and lose more, but it is time to revisit the underweight call, since it has worked. China's regulators have mismanaged the market policies and exacerbated if not precipitated the equity market sell off. The underlying economy, while slowing, is not in crisis. We think the time is right to begin seeking value in Chinese companies.

US duration is very tricky and although model weights are circa 10% for investment grade, we are err on the side of caution. The market disagrees with the Fed on the path of interest rates and is therefore vulnerable. Arguing for duration is the fact that inflation is weak and 30 year USTs are likely to outperform. The mid section of the curve is particularly vulnerable to rate hikes.

US high yield is facing a divergence between sentiment and value. We intend to raise US high yield exposure from circa 4% to circa 10% with a preference for leveraged loans. The bond market has too much energy exposure and exposure to the vulnerable belly of the USD curve.

For our European credit exposure, the ECB’s position on QE is helpful and we are happy to own peripheral duration as well as corporate credit. That Europe has yet to get over the deleveraging phase is helpful to credit and we are balanced between owning high yield and sovereign duration. A sub strategy within European credit is bank capital where the implementation of TLAC has extended a trade which began in the 2011 LTRO and the 2014 asset quality review.

We like the USD on the strength of the US economy, short term cyclical slowdowns notwithstanding. With the ECB maintaining QE and indeed having not done enough, threatening to do more, we see the EUR remaining weak. The JPY is different. While fundamentally the Japanese economy continues to languish, it appears that the BoJ and the government have reached the limits of accommodation and as a result the JPY may have found a temporary base. It may not weaken as quickly as fundamentals would suggest. CNH, however, wants to weaken, and the current weakness masks PBOC efforts to support the currency.

Cash. In turbulent times we like cash, not so much as a dampener of volatility but because there may be assets to buy. We maintain high cash levels, model weight 10%, actual weight probably 20%, in anticipation of buying opportunities in the first quarter. But we are in no hurry. We have a shopping list and we are cashed up but the cheap sale continues and the markdowns continue. Its not a bad thing to be patient.