The Trusted Alternative

Manager Notes from New York 24th-28th September 2018

As part of our research process our investment team meets with an average of 800 investment managers every year. Many of these meetings are face to face in various locations globally. Below we provide a summary of the latest views from some of the world's best managers.

GENERAL OVERVIEW BY KEVIN ARENSON, CHIEF INVESTMENT OFFICER

Having spent the full week in New York, many discussions were focused around the US economy and the trade war with China. Views have shifted somewhat with less confidence on a deal being done as Trump has become more hard-line in his negotiations with China. In a bid to insulate its economy from a combination of credit default risks, slowing growth and any fallout from the trade war, China has moved towards a more stimulative stance, albeit gradual. The PBOC has been injecting money into the banking system through loans to commercial banks in order to incentivise them to purchase local government bonds which will fund infrastructure projects.

The intended result is pick up in credit growth and an increase in infrastructure spending, the growth of which has slowed sharply in the first half of 2018. Tax cuts for business and investors are also going through the National People's Congress with the aim of encouraging investors to continue lending. While the long-term goal for China remains to deleverage and focus on structural reform it is currently a balancing act between that and avoiding a collapse in growth. Meanwhile in the US, the direct impact of a trade war appears de minimis to date and there has not been any effect on confidence thus far. However the second order effects could pose a greater risk. Further rounds of tariffs could lead to tightening of financial conditions which could derail the pace of growth. It was interesting to note the differences in opinion regarding the US economy, where three different scenarios were laid out.

The first points to how well the US is doing currently. Confidence is high but there is an indication of a slowdown in interest sensitive areas like housing, vehicles and big ticket items for households. The US consumer is in good shape with confidence hovering near an 18 year high. There is little concern about credit, however spending is not reckless and consumers are cautious on pricing. As interest rates increase the supply of residential homes is very tight with some buyers being sidelined. The market is currently pricing in four rate hikes by the end of 2019 with one before the end of this year. There is no reason for the Fed to not continue along this hiking path given it currently has the lowest unemployment level in history, growth is strong, wages are increasing and inflation is low and stable. This in turn will be supportive of the US Dollar combined with the fact that some of the most significant impacts of a trade war will be felt in currency markets. If US trading partners use currency as a tool to retaliate against trade policies in a bid to increase the competitiveness of exports, this will be very supportive of the US$.

The second scenario suggests that there is no such thing as decoupling between the US and the rest of the world. Whatever happens globally feeds back to the US and if economies outside of the US slow down this could feed back to the US and derail the Fed's hiking plan. In this scenario US assets are most at risk and it is a scenario that very few are pricing in currently.

Finally the third scenario is focused on fiscal stimulus becoming global. Here we could see each country copying what the US has done by starting to think for itself and adopt policies that are best for its own economy, focusing on domestic drivers of growth. This would result in an acceleration of deglobalisation with the resultant impact of pushing inflation higher.

From an equity market perspective, this environment and differentiation in views calls for a more bottom up, stock picking approach where returns will come more from alpha rather than beta. This is positive both for active management and for absolute return and hedge fund strategies.

The ongoing trade conflict has hit emerging markets most notably in China. However other regions have also sold off, impacted by the strong USD and increasing interest rates. If US rates continue to rise then emerging markets could be headed for a crisis as money that has chased yield will reverse. However despite a predicted 4 rate hikes by the end of 2019, future rate hikes will depend on US GDP growth. The current run rate of 4% is certainly not sustainable and we should see a slowing of the pace of growth in 2019. Individual emerging markets have also had their own issues. Argentina has been a key focus for many. A combination of central bank policy error, key exports being hit by the worst drought in 50 years, a stronger US$ and higher US treasury yields has pushed the region into economic crisis. The pain has been most notable in the currency which, when combined with pressure from rising oil prices, has put pressure on Macri to act. Again views were not consistent. Some believed that the new policy of draining money supply might stabilize the currency but the economy would almost certainly enter a recession. This could be negative for equities and put more risk on Macri's re-election prospects. Others were positive from a more fundamental perspective believing there was good value, particularly in debt instruments. Whatever the views by region investors will be watching what happens in the US as the biggest guide as to whether there will be a new EM crisis.

Moving to Europe there are indications that it has bottomed and is starting to turn. In 2017 Europe grew above trend, but has seen a softening in the first half of 2018. The external sector was the biggest drag to growth despite a small rebound in exports as continuing trade conflicts impacted global trade and fed uncertainty. Auto sales hit their weakest level in five years hurt by tougher emissions testing post the VW diesel scandal. The UK was particularly weak, though perhaps fuelled more by Brexit and trade concerns than emissions testing. Looking at employment we are beginning to see a big pick-up in wage costs indicating higher future inflation, a key factor for the ECB as it prepares to end its bond purchasing programme at the end of 2018. Country by country political concerns continue to weigh on investors' minds. Angela Merkel's weakened position in Germany has led to months of uncertainty and diminished Germany's role in international affairs. Italy continues to dominate headlines with its fiscal policies under scrutiny and growing concerns around its debt crisis. Views here remain bifurcated with some believing it could decide to leave the Euro in the near future whilst others believe the risk is overstated. Whatever the outcome it is worth noting that some of the world's largest investment managers have a number of shorts against Italian financial institutions. The other key uncertainty within the Eurozone is Brexit. While many opine that a deal may be struck at the last minute, the dissent alone it has caused within Teresa May's conservative party has weighed heavily on markets. The uncertainty has led to some managers avoiding the UK as a region to invest with one noting that he had specifically excluded the UK from his investment universe because of political risk linked to Brexit.

Having noted above the impact of rising oil prices on emerging markets its worth mentioning that the consensus amongst a number of managers is that oil is going higher, possibly to US$100 or above. There is an outside risk that it spikes to US$150 as storage has been depleted and the market is very tight. The market is currently out of balance as a result of sanctions on Iran. Saudi Arabia is struggling to increase production and supply constraints from the US will continue into mid-2019. All of this combined results in pushing the price higher, which combined with higher inflation, could mark the end of the current economic cycle.

STRATEGY VIEWS - CREDIT AND EVENT DRIVEN BY TIM BECK

Within emerging markets there were few outright bullish views but some are seeing targeted opportunities (e.g. Argentina) where there has been significant price action. The bias is to be in credit/fixed income securities rather than equities. Concerns were noted over future flows in EM given the huge amount of US treasury issuance scheduled for 2018 and 2019.

Managers are seeing limited opportunities in longs in performing credit. Opportunities are better on the short side, but the success of this will be largely reliant on the timing of a market downturn.

Distressed debt managers are seeing more opportunities than might be imagined given where we are in the economic cycle. They have generally been active in deploying capital through the year though cash levels remain moderately higher than is typical. This is mainly due to the huge pace of change in various industries. Overall managers are now becoming more cautious in deploying risk given overall asset valuations. Within emerging markets distressed debt, the expectation is for things to get worse before they get better so opportunities may increase in 6-12 months. Some are seeing defaults starting to come through in direct lending funds and Business Development Companies ("BDCs"), but these are so far very small situations.

Merger arbitrage has benefited from a robust volume of deals. Many managers were hit by NXPI and this has reduced risk taking in positions with any sort of risk associated with the deal. The resultant impact has been a bifurcation in the market with very tight spreads for safe deals and wide spreads for those with an element of risk. The reduction in risk has been seen largely in multi-strategy funds or those with a lack of direct focus. For those focused on purely merger arbitrage and able to more closely analyse deal risk, this creates attractive opportunities. Combined with the robust volumes most managers are fully invested.

STRATEGY VIEWS – GLOBAL MACRO BY AKSHAY KRISHNAN

Most discretionary macro managers did not have high conviction views on currencies with some expecting the USD to continue to strengthen against EM and DM peers while others believe the USD rally is close to an end. The bias in interest rates remains short in the US with some managers pushing out their shorts from the front-end to 10y and beyond as the Fed gets more fully priced. Views on global rates were more mixed. The clearest theme appeared to be in commodities where most managers are bullish on the oil price on the back of Iran sanctions curtailing supply. There is little directional risk in equities at present.

Relative value managers are seeing better opportunities in US and European rates with the US in the midst of a rate hiking cycle meaning more Fed meetings are "in-play" and Europe is increasingly focused on a potential ECB exit. Specific opportunities around bond auctions and calendar future rolls look more interesting into Q4 compared to the quiet summer period. As we head into 2019 there will be increased focus on a replacement for LIBOR which could have a significant impact on many markets including the vast amount of derivatives whose pay-off is tied to LIBOR. There is some cautiousness on market liquidity which is believed to be shallow and can deteriorate significantly in more volatile periods.

Quantitative equity managers remain very excited on the potential alpha opportunities from continued proliferation of alternative data sets and increased application of machine learning techniques to quantitative investing. There is a greater focus on collecting raw data as some of the manufactured data sets are limited in their usefulness. The early results from data sets including credit cards, social media, satellite imagery, and competitor intelligence (extrapolating private company information to publicly traded companies) have all been promising. One common view from quant managers is that systematic futures strategies have been a struggle even for the most sophisticated and well-resourced groups. The limited universe of products to trade and lack of data in comparison to single name equities produce challenges to implementation.

Overall managers are running less directional risk in FX and rates with a small bias to be long USD and short US rates, particularly in the long-end. Bullish views on energies are expressed through energy equities and outright positions in crude and brent. Views on EM are mixed with favoured longs being in Argentina credit and Brazil rates matched with shorts across other emerging markets. Italy remains a key position with two managers in particular retaining a short bias. Overall risk in equities is muted.

SUMMARY

All of the above points to a time of uncertainty where directional risk is being reduced. Asset prices are generally high and where there is value, the associated political or fiscal issues weigh heavily on investors' minds. We continue to focus our efforts on finding niche strategies where managers have a strong competitive edge and better ability to generate alpha rather than relying on beta. We remain focused on the risks present, building in protection in our portfolios as we see necessary.

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