Manager Notes from the US & Asia November 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.

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Having visited both the US and Asia in recent weeks, it is clear that there is a more sombre mood with various issues weighing heavily on investors' minds. Starting with the US, it is evident that there are increasing concerns as to whether we are nearing the end of the current debt cycle and the resultant consequence for the economic cycle and by default, markets. This was highlighted by a number of managers but Ray Dalio, from Bridgewater, spoke on this specifically at a conference. Bridgewater has studied historical debt cycles (which are combination of short-term debt cycles within a long-term debt cycle) and identified the similarities between them. All follow very similar patterns. The key determinant in terms of consequences for countries is whether the debt is issued in local or foreign currency, with the latter significantly more vulnerable. The top of a short-term debt cycle usually occurs when elevated forecasts on asset prices are extrapolated into the future and these prices start to come down as those elevated forecasts are not met. The short-term cycle then repeats itself. Longer-term debt cycles take the debt levels higher each time the normal business cycle peaks. The late stage in the long-term debt cycle is when central banks struggle to stimulate the economy, effectively "pushing on a string" as Dalio phrases it.

Dalio believes the economy/world is in a position comparable to the late 1930s. Then as now, there is a large wealth gap, which has helped lead the emergence of populism. We are currently 7 years into the economic cycle which is considered late stage and vulnerabilities lie in corporate and government debt. Looking at government debt the numbers don't balance. Debt needs to be issued by the US in order to finance deficits but with interest rates increasing, this will have to be done at higher rates. With the Fed primarily focused on US domestic growth and inflation, it is unlikely to change course due to external factors, and will likely continue to raise rates until it sees inflation abating. We have already seen volatility in markets with liquidity tightening and if the S&P was to have a significant fall before year end, we believe the Fed will need to be open minded about future interest rate increases and perhaps pause to see how things unfold. The debt burden is a long-term negative for the US$. Countries that have debt in their own currency can devalue the currency in order to spread out the pain. While the US has that option, it is more problematic for countries that have debt issued in foreign currency and cannot devalue their currency. The most obvious examples are EM countries with USD issuance and Italy within the Euro.

On the point on populism the view is President Trump has been following the classic steps of previous populists starting with aggressive economic stimulus to boost growth. This can often lead to bottlenecks which in turn causes a pick-up in inflation. Central banks react with faster rate hikes which then leads to an economic slowdown and potentially a recession, thus ultimately forcing central banks to ease again, which in the case of the US could cause a devaluation of US$. The issue of populism is not limited to the US however. We have seen the situation in many countries where people are voting for extremes; Brazil, Germany, US, Italy and the UK in relation to the Brexit vote. This comes about as a result of unrest connected to non-inclusive growth in the world and the unfair concentration of wealth.

Moving to Asia, the mood was perhaps the most bearish I have found it over the past 20 years that I have been visiting the region. The all-consuming issue discussed was the G20 meeting between President Trump and President Xi and whether there would be a short-term deal which could lead to a relief rally in financial markets. So critical was the meeting between the two leaders that the annual Central Economic Work Conference in China was delayed to after the G20. General views were that policies could be more accommodative if the G20 didn't go well. The outcome of the Trump & Xi meeting was seen as a binary one which made the investing environment very difficult. Heading into the G20, while both sides did seem very far apart it did appear as though both sides wanted to do a deal. The view in Asia is the central issue in the US China conflict is a power struggle for global leadership but the immediate decisions centre around:

- Opening up of the Chinese market especially services;
- China will not be treated as a developing country anymore in order to benefit from any concessions; and
- Technology transfer and the protection of intellectual property rights.

The consensus view was there would be a band aid solution short-term but if the main issue is power then it will be difficult to resolve longer-term. However, as the Chinese economy slows down it becomes more important for President Xi to agree a deal.

Besides the G20 and trade tensions, there are further internal concerns in China. Government policy is very much in focus with concerns around President Xi's changing the constitution by making himself President for Life. This has created some discontent within China. There are also increasing questions around whether China is moving away from capitalism and more towards communism. Some of this comes from more state interference in the private sector such as in the education sector and controls around gaming regulation. Saying that, much of the interference sounded reasonable such as regulation of time that children can spend gaming online and a focus on extra curricular education.

There was also talk of having a member of the communist party on all private sector boards. This will come down to whether Chinese leaders feel that the private sector has played its role and there should be more state involvement, but the fact that the subject is even being discussed is making the market nervous. Some think President Xi is trying to get control over Alibaba and Tencent with rumours circulating that Jack Ma was pushed out of Alibaba by the Chinese government. The government held a meeting with business leaders on 1 November (most likely to try to dispel these rumours) out of which came various policy initiatives:

- to improve the operating environment for Chinese businesses;
- to reduce funding costs for private businesses which have been higher than for SOEs;
- to protect the security of business leaders, i.e. not to arrest business leaders for corruption;
- to cut corporate tax, VAT and income tax.

With respect to economic growth, there has been a divergence from the synchronized global growth that we saw earlier in the year. The Chinese economy faces many headwinds. It has seen growth for the past 20 years which has led to imbalances building up in the system. The Central Bank has stopped tightening and cut reserve requirement ratios but funding pressures remain for corporates suggesting this transmission mechanism is somewhat broken. Debt/GDP has gone up meaningfully since the financial crisis and now is around 300%. Household debt has increased significantly leading to less disposable income. Lower disposable income has been compounded by falls in stock market, mortgage payments and Ponzi type Peer to Peer lending. Two areas where spending has not and is not expected to decline is healthcare and education. Against this potential of a slowdown, the government has a large amount of assets including land and SOEs which could be sold if they need to raise capital.

Other views across the region more broadly included the fact that as the Fed gets close to neutral interest rates, this could be good for emerging markets, and the US$ which could start to weaken into next year. Also with a lower oil price, some high beta economies like Indonesia and India could do well and for India, this comes at a time when there has been major reforms which have been good for the economy. The view was also the Chinese market has already had a meaningful correction and could rally on positive news.

Since the trip to Asia the G20 meeting has taken place with both the US and China agreeing to a ceasefire regarding tariffs. While this is positive in the short-term, a final deal still needs to be agreed and combined with the fact that it will take time for things like tax cuts to filter through to the economy, there is potentially plenty of volatility still ahead for 2019.

SUMMARY

The above only goes to strengthen our view that we are in uncertain times when directional risk should be limited. We continue to take active measures to reduce outright long or directional strategies in our portfolios, in favour of those that are decorrelated to general market risk and have better ability to generate alpha going forward.

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