CLARITY

The newsletter from Clear Path Analysis

SPRING 2016

Diversification and risk protection are in vogue and alternatives shine

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Noel Hillmann
Managing Director.
Clear Path Analysis

Welcome to the second edition of Clarity, our regular newsletter for subscribers to our industry reports, surveys and bespoke breakfast briefings.

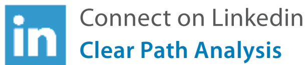
This edition comes at an exciting time, not just for financial markets globally, but also for us as we launch our range of report and survey subscriptions to our upcoming publications, selected by industry category. More details to follow within the report.

At the start of the year concern about global financial markets, led by Chinese stock market wobbles and exacerbated by deep uncertainty over the direction of all prices, led many institutional asset owners to re-focus on how diversified their investments were and fund managers to consider if they provided wide product choices. The upshot was the renewed spotlight placed on 'alternative' investments, an issue we examine in depth through the eyes of two leading global economists and an investment strategist.

Also included are details of upcoming reports, publications we're seeking partnering Report Sponsors for and very importantly, details of how you can subscribe to a series of reports in one click.

Kind regards,

Noel Hillmann,
Managing Director,
Clear Path Analysis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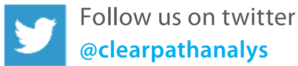
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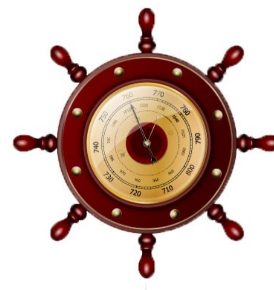
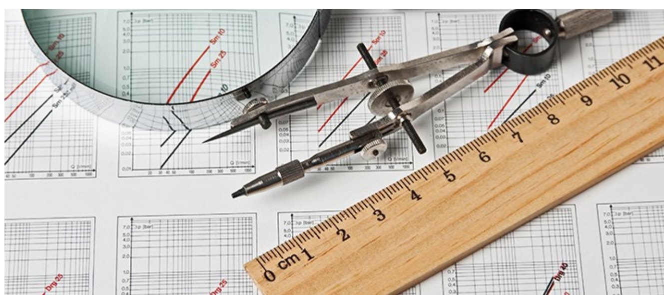


Insurance Asset Management, Europe 2016



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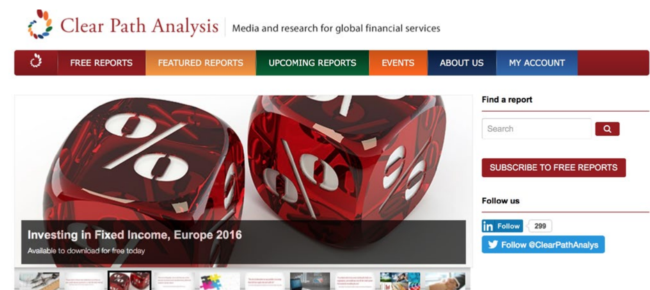
Environmental, Social and Governance Investing 2016

De-Risking Investment Strategies, Europe



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DEBATE

The Fed moves, should there be a shift towards alternatives?

Moderator

Noel Hillmann
Managing Director, Clear Path Analysis

Panellists

Jeremy Lawson
Chief Economist, Standard Life Investments

Daniel Morris
Senior Investment Strategist, BNP Paribas Investment Partners

Bob Baur
Global Chief Economist, Principal Global Investors

Noel Hillmann: Considering the volatile start to the year, both in emerging markets and commodity sectors, was the Federal Reserve's decision to raise interest rates a good timing call or a decision taken too early?

Jeremy Lawson: With the information that the Federal Reserve ("the Fed") had available at the time it seemed like a reasonable call to make as financial stress had settled somewhat after the volatile months of August and September.

The Fed had made further progress on their employment mandate and at the time it did look as though the economy had skipped a beat through much of the second half of the year although they didn't have the Q4 Gross Domestic Product ("GDP") data at the time.

Their models had been telling them that underlying labour costs and inflation pressures would start to pick up and the evidence that has been provided so far has been consistent with that.

From this narrow framework it is fair to say that the Fed was right to begin the normalisation process.

What the Fed misunderstood, and what has been picked up by some of their officials, is that a significant negative feedback loop has developed between tighter Fed policy, the stronger dollar, financial markets, global economic growth and inflation.

Although the Fed funds rate increased for the first time in this cycle in December, the Fed actually began to tighten significantly as soon as they began to taper their asset purchases. This can be seen in the sharp increase in the Shadow Federal Funds Rate ("SFFR") (which takes account of the impact of quantitative easing) and significant increase in the trade weighted dollar since early 2014.

As the dollar appreciated significantly financial conditions tightened across many emerging markets, weighing on growth, encouraging capital outflows and contributing to increased financial stress that was already being pushed up by deteriorating growth in China and the unwinding of the commodity boom.

As was clear from last week's meeting, the Fed is rightly much more nervous when it looks at the global economy and financial markets, as historically increased financial stress has fed through to weaken the real economy.

Keeping policy loose for longer does increase the risk that they will temporarily rise above 2% but having missed their inflation target for so long, a period of above target inflation wouldn't be the worst mistake that they could make!

On the other hand tightening too aggressively would be a big mistake given the poor shape of the rest of the world and fragility of financial markets.

All in all this episode demonstrates just how complicated it is for the world's most important central bank to begin normalisation policy on its own when much of the rest of the world needs easier monetary policy.

Bob Baur: Actually, if anything, the move may have been a little too late as we are getting late in the business cycle and more typically the Fed starts its monetary transition a little earlier, so it could have happened a while ago.

It is possible that the Fed is a bit behind the inflation curve; the price deflator for core personal consumption expenditures is rising at a 1.8% pace, up from 1.7% at the prior reading and 1.3% not long before that. This 1.8% rate is very near the Fed's target. The core consumer price index is 2.2% and accelerating, wage growth is picking up fairly nicely, labour force participation rate is coming up and labour slack is clearly shrinking so it was timely on the Fed's part to get started.

It is true that the rate hike has been hard on emerging markets. However, this is less a result of the Fed and more a result of the strong dollar which has already been surging for 18-20 months. Liquidity has been shrinking but the strong dollar is really helpful in some

sense for emerging markets as it is re-distributing the reasonably robust growth in the U.S to the rest of the world, which is positive.

The volatility in January and February didn't really have anything to do with the Fed's decision as this was the final capitulation of the plunge in oil prices and the strong dollar.

Daniel Morris: We don't see it as a dramatic or gross policy error. I tend to agree that if they had done it in September, certainly without the comments they gave relating to concern about external factors, it would have given us less volatility subsequently. When they raised that as a more prominent concern then we had anticipated we were then left thinking, 'what did they feel about the external markets and how that would reflect their decisions'. This means that there is much less clarity on what the path is going to be going forwards.

From a fundamental U.S economic growth point of view, it was justifiable even back in September to have done a hike. Whether this would have necessarily prevented the volatility in the markets that we saw at the beginning of the year is not necessarily true.

There was never going to be an ideal time for them to suddenly go from these very low interest rates to a hike without it having some kind of impact.

Noel: China's government seems to be supporting a gradual slowdown of the economy, particularly within heavy industry sectors which is likely to have a greater effect on the rest of the world who import to serve these markets. Does a China soft slowdown of this type actually equate to greater dangers to the world economy than Chinese domestic economic figures indicate?

Bob: It is hard to know how fast China is really growing. It is clear that the industry heavy part of the economy is in a real recession and the Communist Party of China ("CPC") is talking about laying off 1.8 million people. Other estimates have been much higher than this. The consumer economy, on the other hand, seems to be growing pretty well as this is more domestic-demand driven and doesn't need the kind of imports from other countries to support it.

The danger of a problem in China really varies by country and how closely one's economy is tied to China's. The biggest danger relates to commodity and energy where the problem is not lack of demand, as oil demand in China is still going up, but, in the case of commodities, is more to do with supply.

We feel that China's economy is stabilising as they have had 18 months of a very slow increase in stimulus and we are starting to see the effects of that. The latest numbers were mixed but there were some positives as electricity output is now positive year-over-year, fixed asset investment was up a little bit from December, whilst loan growth is still very strong and this is a positive in the short run not necessarily in the long run. The fiscal stimulus is also starting to ramp up.

The biggest risk in China is if there happened to be a large bank default. There is tremendous over capacity which has led to the problem in the industrial sector and some layoffs are starting to happen.

We don't feel that we're near 'the day of reckoning' because the excess capacity and very fast loan growths are at levels that are approximate to those in other countries. I have seen figures that show total debt in China is in excess of 300% of GDP but we feel that the day of reckoning that may come from this is further on down the road.

Daniel: It is right to think about not only what is happening within China but also the implications for the rest of the world who have been dependent on that growth.

One of the key issues facing emerging markets, not just this year but for some time, is China's reorientation to the new type of economy that they want, which is more dependent on consumption, domestic demand and less dependent on investment, exports and so on.

We do feel this will work but it won't be a smooth process. The implications are that all of the emerging markets whose growth depended on all those commodities being exported to China now need to find a new growth model as well.

The broader negative implications are primarily for the commodity exporters to China. It is something that is manageable and isn't something that threatens a broader global financial crisis or recession.

There may be a lack of awareness however in some of these emerging

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countries as to how significant the challenge is.

Jeremy: It is very difficult to model China in the way that one might have done a traditional emerging market.

We have done some work that shows that over the last 30 years, more or less every economy that has built up the sort of internal balances that China has built up since the global financial crisis, went on to have a very deep economic shock or crisis of sorts.

However, in almost all of those other cases, countries were financing their credit and investment booms from foreign capital inflows and thus running large current account deficits.

In China's case the investment and credit boom has been financed from domestic savings. And so while credit and investment has been badly allocated, the adjustment mechanism will be very different than it was for most emerging markets during the Asian crisis.

In particular, instead of getting a sudden stop in capital flows that force a currency or banking crisis, growth is likely to be ground down more slowly as the central bank consolidates bad debts on its own balance sheets and more gradually delevers the economy.

Of course, regardless of whether or not China goes through a hard landing, rebalancing can feel like a hard landing for those emerging markets and developed economies that were very dependent on the old model of Chinese growth.

This is adding to the general sense of economic malaise across the emerging world. Too many investors thought that the boom in emerging markets that took place between 2002 and 2010 could be sustained. In fact, it was a highly unusual period both in terms of the scale and the breadth of the convergence of emerging markets on developed country living standards.

"You need to ascertain whether your investments are being managed in a more proactive and dynamic way then perhaps they may have needed to be in the past."

We are now entering a period in which that convergence will on average be slower and also much patchier across economies. From an investor perspective it is therefore incredibly important to look very carefully at each market and country and be clear what you feel the driver of growth and market performance is really going to be. You can't assume that emerging markets are a one way bet.

Noel: Given the uncertainty around future rate rises by the Federal Reserve, Bank of England and European Central Bank, how can asset owner's best hedge themselves through the use of alternatives?

Daniel: One area that people are going to have to think about, even within the conventional asset class space, is how much more volatility in markets there will be.

We are looking into volatility much more as an asset class, trading volatility itself and expecting there to be more opportunities to do so.

We have seen huge moves this year, where it wasn't that profitable to just buy and hold at the beginning of the year compared to the opportunities you could have had, if you were able to some degree know when it was right to move into and leave a certain asset class.

You need to ascertain whether your investments are being managed in a more proactive and dynamic way then perhaps they may have needed to be in the past.

Bob: Within equities and bonds there is a big dispersion amongst the specific issuers, so in some ways this is perhaps a stock picker's heyday. Not all issues are travelling in the same direction as they were in January this year or in the boom of the 2000s.

There may be an opportunity for some long/short funds in high yield or emerging market stocks. The only problem here is that a lot of these excesses may have already happened meaning there is less of any opportunity to take advantage of them than there once was.

In some sense we don't believe that recession is imminent and feel that opportunities exist within regular asset classes. We happen to still like U.S stocks and developed country stocks in general as they have outperformed for some time. We had been optimistic on Japan and European stocks but a little less so today.

A regular investment in equities, investment grade or certain high yield bonds with managers who are able to pick the appropriate ones, is still a good way to go. It is likely that volatility will continue but at least over the next year or so traditional asset classes will be as good as you can find.

We do like real estate in some areas, so that in some sense is an alternative investment that investor may wish to consider.

Jeremy: We see there to be more value in credit than equities at the moment. We prefer being further up the capital

structures and feel that the implied default rates, particularly in investment grade credit in the U.S, are too high relative to what we feel is most likely on the basis of our central view that the US economy will not enter recession this year. With equities we are more concerned as we don't see a lot of strong drivers of underlying earnings growth.

However, it is important that investors are not too heavily positioned for one version of the world. Reflecting this, our multi-asset funds are constructed to perform well in many economic and market environments. For example, equity beta takes up only a small proportion of the total risk budget in these funds and we place significant emphasis on relative value trades within equities and other asset classes. For example, right now we prefer Japanese and European equities, to US equities.

Currencies are another way that we can diversify our portfolios and we particularly like trades that will do well in a generally benign global environment in which the Fed is able to progressively tighten policy, but also in a much more negative economic and market environment. I would note that long yen positions are some of the most reliable diversifiers during period of significant equity market corrections, though it is important to choose the right pairing.

Noel: What role should emerging markets play, as an alternative allocation and route to diversification, through the remainder of 2016?

Daniel: We feel it is too early for investors to be moving back into emerging markets in a very significant way.

If you take equities, besides the challenges that we have already mentioned with China's new economic model and the U.S's rising interest rates, another problem is a relative lack of profitability growth.

If you look at relative return on equity of developed markets to emerging market companies you see that emerging market equities have underperformed on a Return on Equity (ROE) basis and so not surprisingly have underperformed on a price basis.

On the fixed income side we know that there has been a lot of U.S dollar debt issuance for corporates so even though things are a little bit better now because the Fed seems to be holding off for a couple of months, it is just a delay and it is going to come back.

Bob: Emerging markets have broadly underperformed markets since early 2011. With this underperformance one might assume that it would be an appropriate time to take another look at emerging market equities. On a relative basis their valuations are certainly more attractive than they were when the underperformance began back in 2011. On a historical basis there is still not the low level of valuation that would make emerging market stocks really attractive.

In the short term, we have a bifurcated view for 2016 as the rebound that started mid-January in emerging markets in growth and value stocks and moved to high yield credit in February, shows that there is a reflation going on and emerging markets have outperformed fairly dramatically over the past month.

This could continue as the reflation or mild cyclical upturn that we see in the global economy comes to the fore.

This outperformance could continue for another 3-5 months but I am guessing that by the end of the year we will see U.S stocks, growth stocks and the leaders of the rally over the last 3 years start to outperform again.

With the problems in high debt, lack of profits, excess capacity fairly broadly across emerging markets, there is likely to be another period of emerging market underperformance perhaps starting later this year.

"We feel it is too early for investors to be moving back into emerging markets in a very significant way."

Jeremy: You have to be selective when it comes to emerging markets rather than treating it as a homogenous asset class; the relative risks can vary enormously across the individual markets and some of the recent improvement in emerging market sentiment has been simply the result of the Fed's dovish turn.

As I noted earlier, some emerging markets are at the beginning of a very long adjustment. In some countries, there has been a significant build up in leverage that will take time to unwind. In others, growth has been too dependent on high commodity prices or trade with a rapidly growing and importing China. At the same time, we do not expect the global business and trade cycle to improve significantly, which means that the traditional export channel of earnings growth is going to be muted for some time

In this environment it is important to look at each country's fundamentals on a case by case basis. Some markets that appear cheap are in fact value traps. In others, such as India and Indonesia, there are genuinely positive reform stories.

Noel: Thank you all for sharing your views on this subject.

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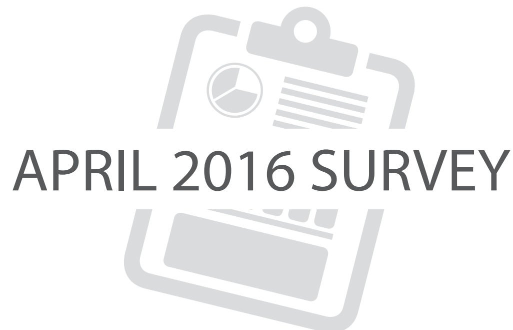

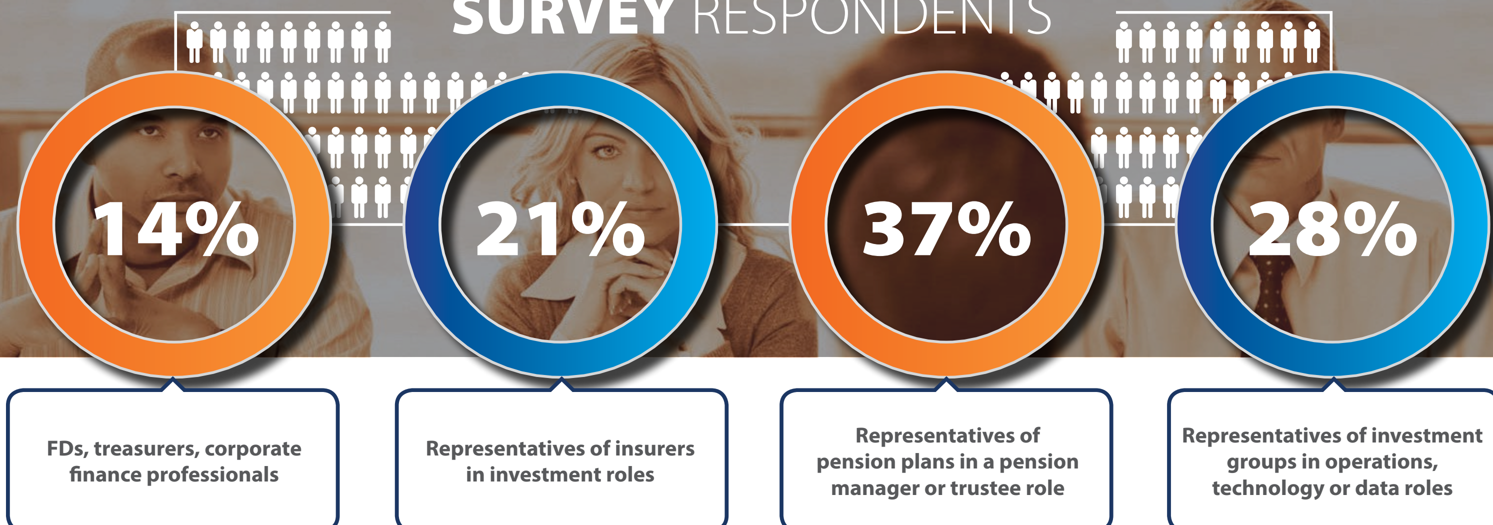

FDs, treasurers, corporate finance professionals

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WHY DO YOU READ WHITE PAPERS AND INDUSTRY REPORTS?

48% "**to understand** the thoughts of the wider industry and stay up to date on an issue / solution they already know something about"

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31% of respondents said they remembered a really good white paper

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- Current issues
- Simplicity of content
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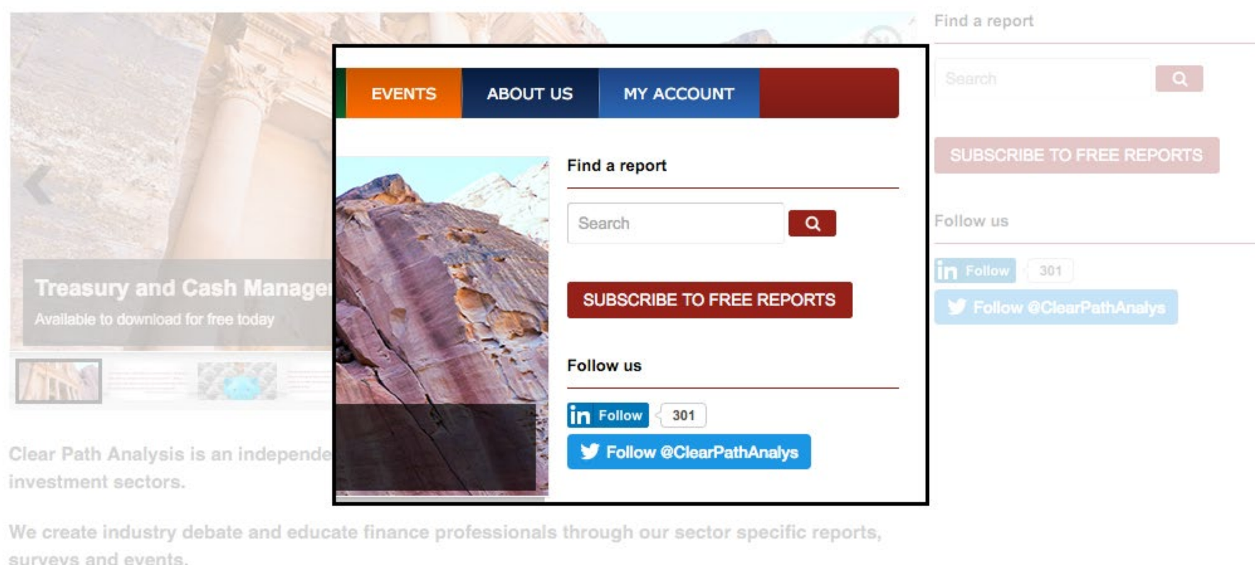

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Survey for new Clear Path Analysis website

In the next few months we're going to design a brand new website, hooray! In order to make sure it's exactly what you, our customers, need from us, we've written a short survey to find out what you think.

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Published 23rd May

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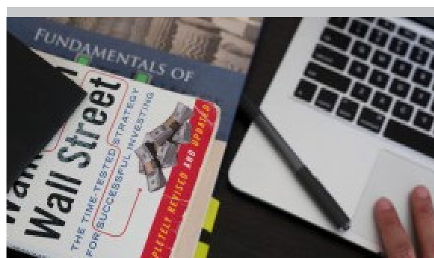
Investing in Global Equities, Europe
Published 30th May

The annual report bringing together UK and continental European asset owners, to explore the diverging drivers for global equities with an examination of individual value and growth opportunities.

Treasury & Cash Management, Europe 2016
Published 13th June

The third annual report where treasurers, cash managers and corporate finance professionals come together to examine the challenges facing treasury and cash management professionals as they seek to generate higher returns on capital, manage treasury risk, improve operational efficiencies and lower funding costs.



Fund Technology & Data, North America 2016
Published 12th September

The fourth annual report bringing together North American fund, asset and wealth managers, fund administrators, pension plans, insurance companies and other institutional investment groups to examine the challenges in building a comprehensive technology and data platform for the front, middle and back office.

Fund Outsourcing & Administrator Operations, Europe 2016
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