

Themes and Trends – December 2015

The following comments are based on our discussions with investors and investment managers over the last quarter. We have referred to investors in the comments below but in most instances investors will be working closely with their consultants and you can infer that a reference to one is a reference to the other also.

The long anticipated US Fed tightening finally commenced in mid-December and the walls didn't come crashing down; although most commentators expect the US Fed to be very measured as it implements ongoing tightening, investors will continue to keep this in mind in respect of how the flow on effects may impact borrowing costs, currency valuations etc. and implications thereof, particularly in respect of emerging economies.

Opinion on China varies greatly, not so much in relation to the level of reported growth (almost universally assumed to be questionable) but more in relation to how slowing economic growth will be managed and how it will be structurally transitioned from exports and construction to a greater focus on internal consumption. How successfully China can do this and how painful will be the transition for their trading partners, the region and ultimately the global economy is a question that may not have a comprehensive answer for some time yet.

Other concerns exist, such as the divergence between the US economy (commencing its tightening cycle) and Europe (still in an easing cycle) but the above is likely to dominate and will also be a particular focus for Australian investors.

Themes and Trends we have identified since our previous quarterly update are as follows:

- Investors anticipate a meaningful increase in the level of debt defaults amongst oil and gas companies (O&G), and across related industries, and some broader weakness in credit spreads across the board, although default rates are expected to remain low. This has been exacerbated by recent runs on a small number of high profile credit mutual funds which held risky assets arguably mismatched against the liquidity terms promised to their retail investor base. Although this event led to a sharp increase in yields and widening of credit spreads, the root cause of the problem appears to have been limited in scope; initial fears of contagion seem to have largely dissipated and in some cases been replaced by the sniff of a potential opportunity.

While some investors may be brave enough to selectively exploit the O&G opportunity directly, a number of others perceive this as a tactical opportunity in the ex-O&G names and the broader market. Although the potential returns may not be of the same scale (perhaps high single digits), the risk and return trade-off may arguably be more attractive and investors may be prepared to experience some short term volatility given reasonable confidence levels that spreads will narrow again; assuming they do, credit could be one of the better opportunities in 2016. Investors seeking to exploit this tactical opportunity will have in mind exiting or reducing exposures once the thesis eventually plays out; however, strategic positions seem likely to be maintained on the basis that there is still reasonable value in credit at current spreads irrespective of short term noise;

- Although emerging markets debt remains somewhat of a niche asset class to some, it is an area of interest, given the historically attractive risk-adjusted returns, and is becoming more familiar to investors. Investors are conscious though that fluctuations in currency can significantly impact on performance; the implications of investing in local versus hard currency denominated debt, some blend thereof or an actively managed allocation between them are being considered carefully. Further, the steep slide in commodity prices

has created a starkly bifurcated market; with commodity exporters on one side and commodity importers on the other. Investors are very keen to engage managers that can actively allocate across these countries to reduce risk and enhance returns. However, recent volatility may be delaying action by first time investors in the asset class;

- Some long-term bears are having a re-think about emerging market equities on the back of their dramatic underperformance relative to developed markets. However, US tightening, concerns about the extent of the China slowdown and its impact on commodities and the pervading volatility across investment markets will possibly delay some investors from increasing exposure in the short term. Investors are conscious of value traps and some will be wary of getting in early in the event some of the current concerns are justified and these markets weaken further before they recover. However, most discussions with investors suggest that those with a long term outlook are beginning to seriously consider an investment. Not surprisingly, given the significant divergence in economic fundamentals across different emerging countries, investors are focusing on managers that build portfolios with high active share;
- Australian investors have not been greatly enthused about private equity since the time of the global financial crisis. Interest in private markets has tended towards brownfield infrastructure and blue-chip property. Perhaps the value proposition may have shifted sufficiently for private equity to warrant greater attention; however, we have not seen a great deal of activity in the recent past. We thought it was interesting that FSS has committed to Fintech venture capital as a hedge against the potential disruptive impact such new businesses may have on the broader banking and financial services industry; perhaps, as we hear more frequently, the unique risk and return drivers of specific opportunities, rather than the asset class itself, will be key to renewed interest;
- Impact investing generated headlines and it was observed that there are few intermediaries producing and marketing these investments. However, many investors are already exposed to impact investments; albeit not necessarily identified as such. Examples include CBUS as a major investor in property and the owner of its own property development business, HESTA looking to invest in health and community services, Media Super continuing to invest in film and television, NGS Super pondering investment in schools, Tasplan investing in Tasmania and so on. At face value, these related investments might be dismissed as a parochialism of sorts but these assets must still satisfy sole purpose requirements and are considered to be generally uncorrelated to the more vanilla exposures. Arguably, these funds are uniquely placed to identify value within their particular orbits; and
- The outcomes of the Paris Climate Conference were generally perceived to be positive and many people are relieved (assuming the objectives are ratified) that the talks did not disintegrate as was the case in Copenhagen. Investors have been deliberating for some time about the risks and opportunities inherent in addressing climate change (and responsible investing more broadly); the ambitious Paris commitments and the fact that individual country INDCs (Intended Nationally Determined Contributions) will need to be progressively revised up, if the ambitions are to be realised, means investors may need to roll forward their scenarios and focus even more of their energies and resources on this issue. Many non-Government stakeholders (including investors) participated in the Paris Conference and numerous discussions took place around the periphery of the State-based negotiations; we anticipate many new thoughts and ideas in the year/s ahead.

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