Themes and Trends – March 2017

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.

Few investment conversations of any length have not at some stage veered towards discussion of the relative significance of a reasonably positive global economic outlook on the one hand and what might President Trump do next on the other (and the implications of Brexit and the French election to a lesser extent). Given óTrump-riskô is not something that can be managed with any degree of confidence, other than through broad portfolio diversification, many investors are ring-fencing their concerns on these issues and going about the task of investment management as best they can on the assumption that nothing too disastrous is likely to occur.

There is also a view that President Trumpõs somewhat theatrical and assertive approach to the role of POTUS represents a rolling series of óambit claimsô that are not expected to be met but are actually targeting more modest outcomes. That suggestion may have some merit but it does not necessarily provide reassurance in respect of some of his interactions with other world leaders.

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

- Despite concerns following the US election and US interest rate hikes, emerging market equities have continued to perform strongly since the end of last year. Many investors believe this robust performance will continue given macroeconomic and fundamental improvements driven by rising commodity prices, better earnings numbers and generally improving fiscal and current account balances. The overall impression is that investors have taken a risk-on stance in emerging markets. However, there is still concern over Chinese debt and state-owned banks; and US interest rate and tax policy could see the US dollar rise sharply. Additionally, an assortment of geopolitical risks loom over all markets and a serious event or series of events would see emerging markets impacted if investors flee for the relative safety of US treasuries. Reflecting this, while investors generally seem to be risk-on, they are mixed in how they are approaching the emerging markets, with some chasing the biggest bang for their buck via high beta managers while others are looking for an element of downside protection and therefore favouring more conservative approaches. Encouragingly, this also demonstrates an increasing level of sophistication in how investors are approaching emerging market equities;

- Reinforcing the above, State Street released research showing that sovereign wealth funds have increased exposure to emerging market equities in recent years, correspondingly reducing developed market exposures, and most have no intention of reducing. Presumably this reflects expectations of greater long term relative return potential even if there are periods of weakness in the shorter term;

- Investors remain wary of high yield bond valuations and the spread trade more generally but recognise this benign credit cycle can continue given the leverage levels are far away from the levels experienced pre-Global Financial Crisis. There is much stronger interest in leverage loans (bank loans) given their adjustable interest rates and that LIBOR has by and large exceeded the LIBOR floors embedded in many bank loans. Absolute return credit strategies are also attracting consistent interest. Some investors have thought about including emerging market debt in this mix but most come to appreciate that credit and emerging market debt are quite different markets requiring very different skill-sets;

- There has been a clear shift in interest towards value in global equities given the very long-period of outperformance by growth. However, investors are still unsure whether the value rally last year was a grasp for yield amongst low quality companies in the face of uncertainty (which would be impacted by higher interest rates) or was the beginning of a genuine value cycle. Interestingly, high quality growth stocks have performed strongly year to date. Again, as with non-investment grade credit, some investors are realising the length of a cycle generally has no bearing on whether that cycle will continue but it is the fundamentals that really matter. And many high quality growth companies are strongly increasing their earnings;

- However, there are some long term focused investors who are wary of listed equity markets generally. They identify that the recent bounce in markets post the US election has a lot of good news priced in and equities are arguably fully valued given the level of interest rates. Empirical evidence would suggest this can continue for a long time; however, a major geopolitical event or events could easily render all this good news somewhat irrelevant. Additionally, historically low interest rates also mean central banks have one less trigger they can fall back on in the event of market shocks. Reflecting such concerns, these longer term investors have continued to focus on select private markets (debt, equity and infrastructure) but they are also keeping some dry powder to take advantage of market corrections;

- We note that in 2017 the UN PRI will focus on the undertakings of the signatories to its 2016 “Statement on ESG in Credit Ratings” (many of whom are Australian) promoting the incorporation of ESG into credit ratings, which investors can then use in reviewing/analysing their portfolios. We will watch progress with interest but we also note the scale of the undertaking and the resources that will be required;

- Post-retirement considerations/concerns continue to be a focus of investors. The observation has been made that the original design of the superannuation system assumed home ownership at retirement. However, with home ownership on the decline and housing affordability worsening (at least in Australian capital cities) this is becoming less and less the norm; the difference in required savings to fund an agreeable lifestyle in retirement depending on these circumstances is large. Many are saying that housing affordability and the super guarantee need to be considered further if the super system is to do more than take pressure off Australia's future pension liabilities and to provide a tax effective savings vehicle for those who least need it; and

- Australia's pool of super savings now stands at over $2 trillion. If stakeholders in this industry can find ways to work collectively (as put forward by various people at the recent CMSF Conference), this is a growing pool of influence that can impact policy outcomes. Governments may find this a source of some tension if and where this conflicts with their own objectives but they may need to strike a balance if, on the other hand, they want the industry to support various of their own initiatives.

  Sustainable investing has been, and continues to be, a focus in recent years (particularly for the not-for-profit funds) and housing affordability and aged care are now within the sights of key industry groups. State and Federal Governments appear keen for super savings to be directed toward investment in these areas – many believe it will be incumbent on them to work with investors in developing structures/solutions that will be suitable to their needs.