Themes and Trends – December 2016

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.

Investors generally seem more comfortable with the growth outlook for major global economies and the flow-on implications for smaller and developing countries. However, enthusiasm for sharemarkets is tempered by valuations for some major markets being close to all time highs.

Australia is somewhat of an exception to the more positive global outlook given mediocre economic growth rates and less than encouraging consumer confidence indicators. A number of commentators have suggested that the Government has the scope and should borrow to invest in productive infrastructure to give the economy a kick along; so far that has fallen on deaf ears.

With the US election now decided, investors are inclined to be optimistic and to cherry-pick the (economically) positive aspects of the President-electôs policy platform; namely, big corporate tax cuts and major spending on infrastructure and defence, and to dismiss as hyperbole less favourable statements such as those relating to import tariffs on US trading partners.

Reflecting a generally strengthening global economic outlook, investors anticipate some broad increase in sovereign and investment grade bond yields; however, there is no anticipation of spiralling inflationary pressures (although the US is viewed as a risk).

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

- As above, investors are still somewhat cautious on equity markets and mildly bearish on bond markets. Investment strategies with scope to perform in up and down markets continue to be a focus as do selective private market assets that can be expected to provide decent returns over the longer term (note, this is not the first time we have made this observation). However, many investors are constrained, by liquidity and volatility considerations, from making sizable allocations to these asset classes.

  Sovereign wealth funds (and similar) by contrast relish their freedom from competitive pressures and unanticipated outflows, and their ability to singularly focus on long term outcomes, and have been approaching private markets with gusto;

- Reflecting expectations of poor returns from high quality fixed income, a number of super funds ôbit the bulletö during the period and reduced the CPI based objectives for their conservative and/or stable investment options; these options are usually heavily weighted to fixed income and cash and the alternative to reducing targets would be to increase risk in these portfolios or to add more illiquid investments (if practicable);

- The Governmentôs intention to open up the default superannuation system to greater competition may exacerbate liquidity issues if existing default funds have less reliable inflows and/or are at risk of substantial outflows. Some investors believe this could impact their ability to access the longer term illiquid investments that might otherwise be particularly suited to their needs. Conversely, some proponents of the mooted change argue that competition will lead to fund mergers and that the fewer larger funds will then actually have greater scope to invest in these assets. Unsurprisingly, perspectives tend to reflect whether the investor is inside or outside the default system currently;

- Meaningful numbers of engaged and politically aware super fund members heeded the warnings of numerous commentators that a Trump win would be negative for equity markets and therefore they made significant defensive allocations to cash. While their trepidation turned out to be well founded, market falls lasted barely a day before reverting to previous levels. Having said that, Trump will (in theory) be President for four years or eight, not two days. Geopolitical events will continue to be a bane for funds juggling choice and flexibility with investing for the long term beneficial outcomes of members;

- While interest in the benefits of adding emerging markets debt (EMD) to multi-asset portfolios is increasing, many investors who are comfortable with emerging market equities are still wary of emerging markets debt. Although slowly changing, relatively few investors have stand-alone exposure to emerging markets sovereign or corporate debt but most have an allocation to emerging market equities. Historically, Australia has been an equity dominated market with some of the highest allocations compared to other global pension markets. Australian investors are generally more knowledgeable about equities and believe they can grasp the nuances of managing emerging and developed market equities whereas understanding the complexities of investing in the debt (particularly sovereign) of emerging market countries is a work in progress;

- Somewhat surprisingly, while the EMD asset class is gradually becoming better understood, the frontier markets debt sub-asset class has attracted particular attention. Elements of frontier markets debt that investors find compelling include the large opportunity set compared to emerging ex-frontier (in terms of number of names), the non-correlated nature of the individual frontier countries (although serial correlation contributes to this) and the relatively low default rates within this sub asset class;

- Emerging market equities continue to be seen as reasonably appealing, reflecting selectively attractive valuations, recent fiscal consolidation and positive demographics. This has been muted by concerns surrounding US leadership and some of the rhetoric of the election campaign pointing towards a more insular US economy. However, many point out that cost implications of following through on populist tariff policies, both for consumers and in respect of relocating manufacturing to the US, would likely be prohibitive;

- Reflecting increased global expectations of higher inflation and US interest rates in 2017 and beyond, 3-month LIBOR rates have reached levels not seen since early 2009. This has helped to increase yields across the leveraged loan sector as many contracts reset over the last two quarters as LIBOR pushed through floors. This has generally turned investor attention to this sub-asset class often favoured in rising rate environments; and

- The Australian and New Zealand Governments announced their joint óAustralia New Zealand Infrastructure Pipelineôinitiative in October, incorporating an informative and user friendly interactive website; this includes considerable detail about mooted and actual infrastructure projects in both countries. However, some investors have expressed frustration that the Australian Government does not engage more directly with the superannuation industry on how to structure these projects to be more suitable for their needs. State and Federal Governments are generally focused on budget bottom lines (and therefore the maximisation of sale proceeds) but there is an argument that this should be weighed up against the potential benefits for many Australians of enabling super funds to get a running start in accessing these desirable investments.