Market Update - Lessons from Hollywood

Q2 & Q3 2018

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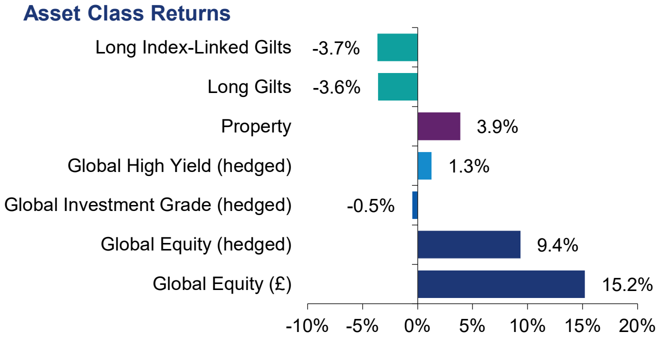
What does Hollywood teach us about investment markets? Please humour me for a moment here before you dismiss me as a movie buff in the wrong profession. Imagine you are 30 minutes into a 90 minute blockbuster. It has been plain sailing for our protagonist so far – great job, great family, a house in the suburbs and outings with friends on weekends. Now, if you are a regular movie goer like me, you know that something is not right, you don't know what it is but you know that there is a twist around the corner - life is going to get a lot more "exciting".

We are seeing a similar screenplay develop in the world of investment markets. As of the end of Q3, equity markets have been enjoying one of the longest rallies in history (noting some volatility post quarter end). Risk markets including credit have seen some sustained support from coordinated central bank action post global financial crisis. How long will this last? Over the last 6 months, we have seen certain themes such as rising geopolitical risks, Fed rate hikes and the end of ECB's Quantitative Easing posing questions on the sustainability of this risk rally.

The chart to the right shows performance of various asset classes over Q2 & Q3. In all this divergence, I believe there is one underlying theme that unifies the various markets – **the expectation that volatility is likely to increase over the medium term**. Investors should be **wary of adding more risk at this stage in the cycle** and resist the temptation to chase incremental return in this low yield environment.

Asset Class Returns



Source: Thomson Reuters, IPD

Bearing this in mind, clients could consider:

- **More rates and inflation hedging (especially with Brexit in mind)**
- **For clients who are looking to reduce equity, there are opportunities to maintain expected return within high quality credit or real assets;**
- **For clients looking to maintain equity, explore lower risk alternatives such as option strategies or volatility controlled strategies;**
- **In all cases, consider rotating into higher quality assets and exploiting the illiquidity premium to help generate the returns.**

Credit

Credit spreads have been volatile

Credit Spreads

Source: Thomson Reuters

Market Conditions

Volatility in public markets

– The Fed and BoE look to continue their rate hiking cycles which has been negatively impacting demand for Investment Grade credit.

– High Yield and Emerging Market Debt performed positively but experienced volatility due to geopolitical risks impacting investor flows.

Crowding in private markets

– European Direct Lending is becoming more mainstream and is showing strains in terms of risk and return metrics.

Issues to consider

Hunt for yield

– Whilst the US raised rates and struck a more hawkish tone, we remain in a low yield environment and the hunt for yield is likely to continue.

Late in credit cycle

– We are late in the credit cycle, especially in the US, and are seeing lending standards loosen (e.g. 75% of leveraged loans are issued without covenants).

Volatility vs. defaults

– We do not see an immediate catalyst for a spike in defaults, but we expect spread volatility to increase in the medium term.

Potential solutions

Private Debt

– Investments in this space should be selective and should focus on having strong risk protections and seniority in the capital structure.

Diversification

– Within public markets, we recommend well diversified strategies such as Absolute Return Bond funds, with flexibility to take low risk positions in response to changes in market conditions.

Equity

Global Equities performed strongly

Equity Market Returns

Source: Thomson Reuters

Market Conditions

Resilient in volatile times

- Global equity markets continued to rally over the last six months, as positive earnings data (primarily in the US) and supportive macro indicators drove returns.
- Geopolitical risks (e.g. Brexit concerns in the UK) resulted in mixed performance in these markets.
- A rise in global trade tensions coupled with the US dollar strengthening resulted in EM detracting, albeit a trade deal between the US, Canada and Mexico during September improved sentiment.

Issues to consider

Support for growth, but...

- Synchronised global growth combined with continued positive earnings data could provide further support to valuations which already look stretched when compared to historical levels.

Volatility to pick up?

- A sooner than expected hike cycle in the US and unwinding of QE have the potential to introduce volatility. Other risks include trade wars, geo-political risks (e.g. hard Brexit), sector concentration risks (technology) and high levels of leverage.

Potential solutions

Volatility reduction

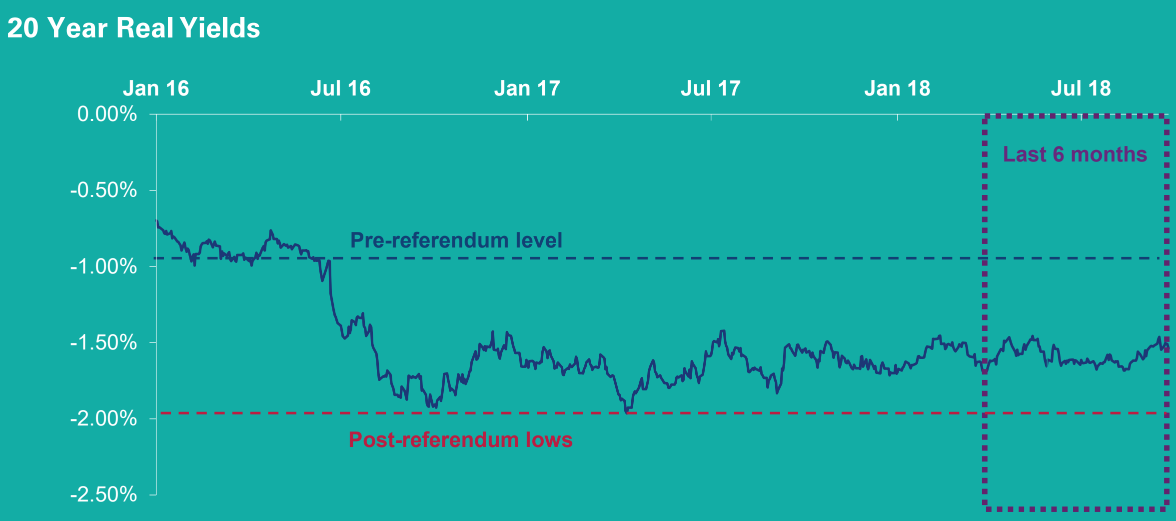
- Clients not wishing to reduce equity exposure outright, could consider strategies such as low volatility or volatility controlled equities. The other option is to focus on downside protection through defensive/quality stocks.

Rotation

- For clients who are willing to look outside equities, there are opportunities to switch into areas within credit markets or income producing real assets.

Rates

Real yields were volatile over the six months



Source: Bank of England

Market Conditions

Rates on the rise?

- The 20 year nominal gilt yield rose markedly (c.21bps), with respective real yields rising by less (c.15bps), in contrast to the downward trend of the previous six months.
- The move in real yields was despite a small rise in market expectations for future inflation, as CPI prints for July and August surpassed expectations.

Issues to consider

What about Brexit?

- As the date for the UK's official exit from the EU moves closer, there is increasing focus on the potential impact on gilt yields, especially under a "no deal" scenario.
- Much would depend on the extent to which gilts' status as a safe haven is retained and the impact of currency on inflation.
- A flight to safety by investors may cause a sharp fall in yields (as seen after the referendum result in 2016).
- Alternatively, a perceived worsening in the UK government's credit worthiness or imported inflation may see yields rise.

Potential solutions

Hedge if you can, but be prepared to be nimble

- We advocate that schemes should not "anchor" decisions on historical yield levels. They should, instead, look to remove rate and inflation risks to the extent they can.
- Those planning hedge increases ahead of 29 March may wish to phase as a means of managing regret risk during a period of potentially heightened volatility.
- Those comfortable with a "under-hedged" position may wish to consider using triggers so they can be nimble and lock in funding improvements should there be a sharp rise in yields.

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