



Investment Letter – Q3 2015

“To labour over the same thing...is to be controlled by, rather than to control, what you do.”
Fragments, Heraclitus, as cited in Enneads IV, Plotinus

Back in January 2014, just after the Federal Reserve (Fed) announced the tapering of quantitative easing (QE), the global media went into overdrive. Prominent economists provided a front for the Federal Reserve’s hyperbole division, preaching that the long awaited US recovery had finally arrived. Continued falls in real GDP, record inventory accumulation and deteriorating activity surveys were glossed over, attributed to the usual suspects of bad weather and transitory seasonal effects. After years of low interest rates, these economists advocated finally bringing policy accommodation to an end.

Fast forward a year and the US economy was beginning to falter. Those same economists now professed serious concerns over the troubling outlook for wage and price inflation and the hidden slack in the labour market. The world economy was exhibiting the classic signs of a growth shock with commodities rolling over first, followed by instability in currency and conventional fixed income markets. This quarter saw a double dip in commodities, ended the bull market in Chinese equities, ushered in a bear market in Emerging Market Equities and provided a meaningful correction in developed markets. As markets began to panic about lack of growth and an impending rate rise in the US, the summer months saw considerable market turbulence. After the relative calm of July, the sheer scale of August’s volatility took many by surprise, as it reached its highest level since 2009. The Eurostoxx 50 (an index of Europe’s 50 largest stocks) moved up and down an extraordinary amount, a total move of 24% intra-month, ending down over 9%. The S&P 500 (the main US equity market) fell more than 11% over six consecutive days. The moves in the US benchmark were of such a magnitude that a similar move has only happened twice since 1900: on Black Monday in 1987, and when Germany invaded France in 1944. In many ways, September picked up on the unresolved issues that were left behind in August. The sell-off in commodities and emerging markets gained further momentum as recessionary fears over weakness in China deepened. That was enough to raise further questions around sustainability of global growth and developed market valuations were tested at various points. World equity market capitalisation has fallen back below \$60 trillion for the first time since February last year as it appears that the world’s central bankers’ asset purchase programmes, designed to create wealth and economic growth, have not yet succeeded.

It was this turmoil that set the stage for the Federal Open Market Committee’s (FOMC) decision over a potential interest rate rise on September 17th. Putting it into perspective, there have been about 700 rate cuts globally in the 3,367 days since the last Fed rate rise on June 29th 2006, while central banks have bought around \$15 trillion in assets, and portions of the world are now in negative interest rate territory. But despite all of this stimulus, it has become clear that deflationary pressures have still built up in the economy. And so it was that we found ourselves, a mere 18 months after predictions that the US economy was roaring, with the announcement that the Fed is unable to bring itself to hike interest rates even 25bps. But the biggest shock in the announcement was not that the Fed did not hike. It was not even Janet Yellen’s extremely dovish comments. It was the fact that, for the first time, one FOMC member predicted negative interest rates in 2015 and 2016. Unsurprisingly, initial market optimism very quickly gave way to an all-out rout, as investors saw the reluctance to tighten as a sure sign of serious health problems in the economy. Yellen’s hawkish comments the following week did much to assuage worries; but the Fed still has a very difficult challenge ahead, with very few options left open to it.

The past quarter has seen a shift in outlook, as investors began to wonder whether central banks still have the ability and the tools available to address a potentially deteriorating global economic environment. By the end of the quarter, the six major economic activity surveys in the US indicated that the US is by no means out of the woods. In fact, without the manipulation of indicators brought about through monetary stimulus, it is arguable that we would never have left the recession in the US and the rest of the world. And so with the Fed still hinting at raising interest rates, but worried by weak economic growth, the question is now whether the underlying dynamics of the economy are strong enough to shake off the recent instability and allow markets to continue their ascent. As the first meaningful economy to try to normalise monetary policy, the US has the eyes of the world focussed squarely on it. **The Fed’s next move is crucial. Any policy mistake at this point would have a global impact, something of which the**



Fed is all too aware. The minutes of their most recent meeting contained the statement, odd for a traditionally inward-looking central bank, that international weakness had been a primary factor in its decision to hold interest rates at zero.

We wrote in April's quarterly report of our fear that the ECB may lose control of its monetary policy programme. As the likelihood of the Fed raising rates this year continues to diminish, perhaps we have reached the point that another central bank is no longer fully in control. Perhaps they will push out the end of loose monetary policy once more, and instead of raising, they will be forced to join the ranks of central bankers across the globe still providing stimulus for risk assets.

Investment Performance

This quarter saw volatility finally return to markets after nearly five years of supportive monetary policy. The turbulence, while not for the faint-hearted, has had one major benefit: it has provided us with opportunities to increase our exposure to certain markets at considerably better levels than earlier in the year. As we mentioned in our last quarterly letter, we used anxiety over concerns about a Greek exit from the Eurozone to increase our exposure to UK Equities. When the market weakness continued into this quarter, we took the opportunity to increase our exposure to European Equities following a considerable sell-off mid-July. However, our positioning remains cautious across developed equities. We have made limited investments into the US and continue to look for opportunities to add to our exposure. And in the UK we have little exposure to large capitalisation equities, which sold off most quickly during August's volatility given their greater reliance on international trade and a favourable environment for commodities. We have focused on smaller companies and managers with a value-bias, which have both managed to perform well during this period. Further afield, the weakness in Asia and Emerging Markets that was setting in over the second quarter of this year accelerated in Q3. As the selloff, particularly in China, became increasingly indiscriminate, we felt that the negative sentiment had gone too far and rotated into more market sensitive investments.

Fixed income markets in general have continued to confound investors. Government Bonds, particularly the longer dated, maintained their outperformance against expectation. Our view continues to be that conventional fixed income offers very limited protection against rising interest rates and plenty of downside risk. We still hold underweight positions in fixed income and, where we are invested, prefer to invest via alternatives. Overall, it was the absolute return portion of our clients' portfolios that provided the greatest support over this difficult quarter. During the almost uninterrupted positive run for equities and fixed income assets over the past 15 months, absolute return funds have underperformed traditional asset classes. But these strategies come into their own in choppy markets where sentiment has turned negative, as they have the ability to take positions that benefit when asset prices move both up and down. These holdings either held value or made positive returns over the quarter, insulating the portfolio against the wider falls in markets. We continue to believe that absolute return funds will be important sources of return in an environment where the next phase of global growth may take longer to set in. Our central view is that the global economy is not about to hit the buffers, but we will continue to position portfolios with care, looking for managers who have the ability to identify where there is value in the market.

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