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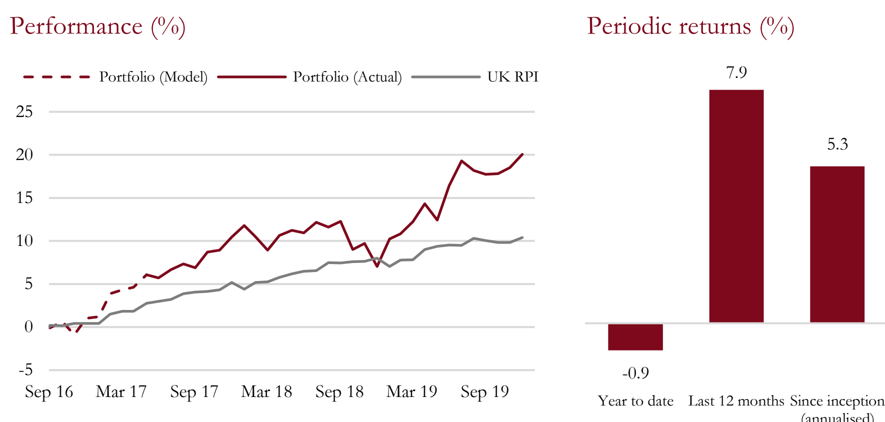
Investment Committee Update

February 2020

AT A GLANCE

- The pace of global economic growth is likely to remain at or slightly below its long-term average, and central banks seem committed to keeping easy monetary policies.
- Financial markets appear to be looking through the coronavirus outbreak as a temporary phenomenon, but we're not so sure the mood will remain positive if the situation becomes more serious.
- Leading indicators around the world are improving for the first time in three years, including manufacturing surveys, and the strength of the data is a positive surprise for many.
- Although most industry sectors have participated in the stock market's recent rise, much of the performance has been driven by a few of the world's largest companies.
- We're not making any changes to asset allocation but have decided to add some protection to portfolios against a possible drop in equity markets using put options.
- Fourth-quarter earnings results in the US have been positive but valuations are starting to look stretched, particularly in the technology sector.
- The volume of negative-yielding bonds has soared to $14 trillion, but we continue find value in high yield and emerging market debt denominated in US dollars.

Figure 1: Multi-asset strategy (sterling moderate risk)



Monthly returns (%)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
2016									-0.1	0.7	-1.6	1.9	1.0
2017	0.2	2.6	0.4	0.3	1.4	-0.4	0.9	0.6	-0.4	1.7	0.2	1.4	9.4
2018	1.2	-1.2	-1.4	1.5	0.6	-0.3	1.1	-0.5	0.6	-2.9	0.6	-2.4	-3.1
2019	3.0	0.5	1.3	1.8	-1.7	3.5	2.5	-1.0	-0.4	0.1	0.7	1.2	12.2
2020	-0.9												-0.9

Source: Saranac Partners.
Performance figures from inception (31 December 2016) are based on model portfolios, simulated from a full record of trading decisions and execution levels are readily available for review. Dividends have been included on an accruals basis. All performance is shown exclusive of fees.

MARKET PERSPECTIVES

We have been highlighting early signs that the outlook for the global economy is brightening for a couple of months now. Further encouraging data since the start of the year pushed stock markets higher in anticipation of a healthier economic backdrop.

Markets then suffered a fall after a new coronavirus spread rapidly in China. Several large cities were locked down in Hubei province, whose capital, Wuhan, is where the virus broke out.

Zeitgeist: the long-term context

Although there is a risk that the virus could affect global supply chains and disrupt businesses, we believe there is no reason to change our longer-term views about the investment environment. Despite record low levels of employment in the US and other developed countries, there are few inflationary pressures.

The pace of global economic growth is likely to remain at or slightly below its long-term average, and there are few signs of any excessive imbalances. Yet central banks appear committed to maintaining easy monetary policies, and

could even accelerate their stimulus measures if the coronavirus becomes more disruptive.

Geopolitical risks remain. Trade tensions between the US and China have stabilised, but the situation in the Middle East remains volatile, and the US presidential election adds uncertainty.

Macro drivers: medium-term environment

Manufacturing surveys are now rebounding, and our macro indicator has shifted firmly to its positive quadrant (figure 3). Economic data in the US is now joining the upswing following a period of weakness, which could be a positive response to the recent 'phase one' trade deal with China.

Many leading indicators are now climbing higher for the first time since early 2016. For example, the Citi Economic Surprise Index is showing that most data is coming in ahead of expectations, especially in the US and emerging markets (figure 4).

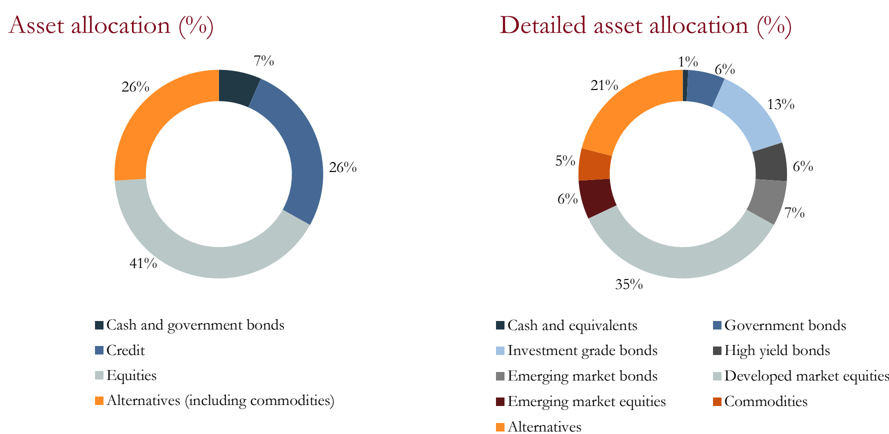
The pace of economic growth could suffer a short-term dip if the coronavirus disrupts businesses and consumers. Although financial markets appear to be looking through the situation as a temporary phenomenon, we're not so sure the mood will remain positive if the outbreak becomes more serious.

Signals: short-term indicators

Our risk indicators had increased sharply in recent weeks as markets rose strongly in anticipation of a re-acceleration in growth. However, they have since returned to more typical levels as markets dipped after the first reports of the coronavirus, particularly in emerging markets.

Growth and momentum factors continue to outperform value substantially, while small cap is lagging behind large cap. Given the extent of momentum's recent outperformance, we are watching for signs that momentum has run too far, which could trigger another bout of volatility and rotation into other areas of the market, such as value.

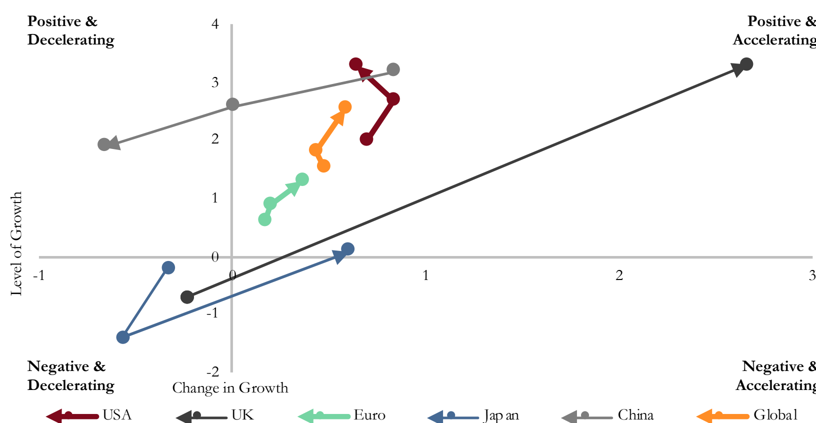
Figure 2: Multi-asset strategy (sterling moderate risk)



Source: Saranac Partners.

Figure 3: Macro indicator

Manufacturing surveys are now rebounding, and our macro indicator has shifted firmly to its positive quadrant (top right).



Source: Saranac Partners.

Although most industry sectors have participated in the stock market's recent rise, concerns remain that a lot of the performance has been driven by a few of the world's largest companies. Yet this pattern has been less prevalent as companies have reported their earnings from the fourth quarter of 2019.

ASSET ALLOCATION

We're not making any changes to our asset allocation at this time. However, we've decided to add some protection to portfolios against a possible drop in equity markets. The most likely cause is an unexpected deterioration in the coronavirus situation across Asia.

Volatility is low as the US market hits new highs, so put options look cheap and complacency risk is rising. We are introducing put options based on the S&P 500 as insurance against the risks of any medium-term correction.

China is far more integrated in the global supply chain today than during the 2003 SARS outbreak, and its economy is far larger and a much more important component of global growth. Although it's impossible to gauge the full impact of the shutdown of various parts of the Chinese economy, the impact is likely to be far-reaching and dramatic.

However, it is also likely that the bounce back will be equally extreme. The timing of this recovery depends on the speed with which the authorities are able to contain the virus.

EQUITIES

Valuations look stretched in the US and are at levels last seen in early 2018. The technology sector is an important component of this premium valuation given the extreme valuation of software and its greater weight in the US relative to other regions.

We've analysed the composition of stock markets in emerging regions and discovered that China now makes up 35% of the index and Asia another 40% (figure 5). The rise of the Chinese internet stocks has significantly altered the make-up of the index. The portion comprising commodities and banks has been displaced by more tech-exposed sectors, such as hardware (Samsung and TSMC) and internet (Baidu, Alibaba and Tencent).

Despite this shift, emerging market equities still trade at a lower valuation than developed markets, reflecting poor past earnings performance and lower profitability.

Earnings revision data has shown a noticeable improvement, which is in line with the pickup in global growth, particularly in Europe. We expect this situation to reverse in the near term as a consequence of coronavirus.

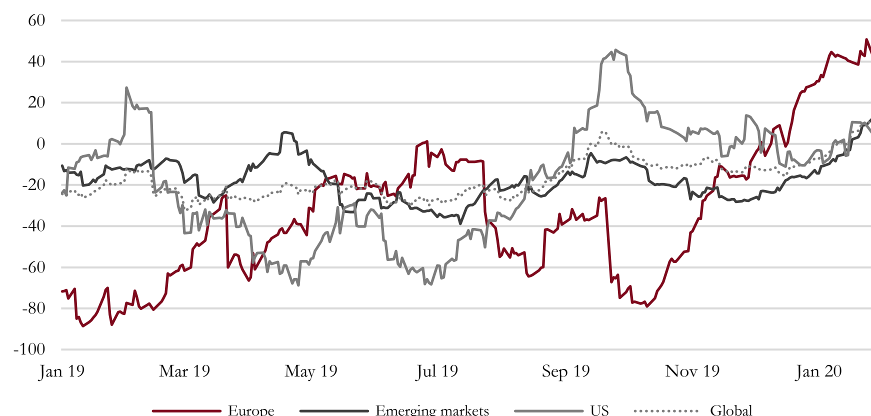
The fourth-quarter US earnings season has generally been positive. A better-than-average proportion of companies have reported earnings and revenues that are better than analyst expectations. Large-cap companies are showing better earnings growth than small caps, largely because they've been better at managing pressure on their profit margins.

Those stocks unable to meet or beat expectations are dropping hard on the news, which is symptomatic of high valuations and lofty expectations.

Growth continues to outperform value, and momentum stocks have also enjoyed a strong run this year.

Figure 4: Economic surprise indices

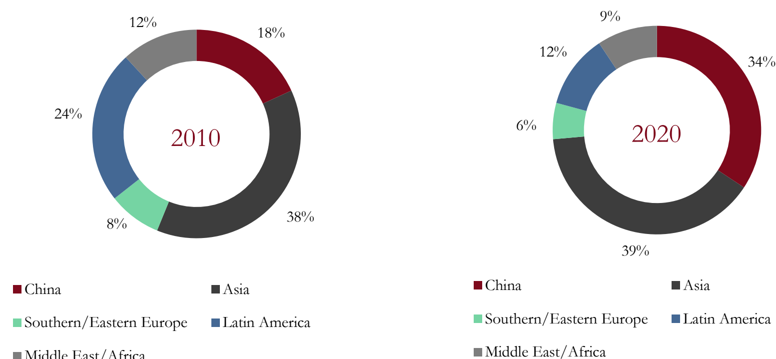
Economic indicators have been coming in ahead of consensus forecasts recently.



Source: Bloomberg.

Figure 5: Index evolution

China has become increasingly dominant within the MSCI Emerging Markets Index over the past 10 years.



Source: MSCI.

FIXED INCOME

Growth concerns relating to China pushed government bond yields to levels close to the troughs of last year. As a result, negative-yielding debt surged by nearly $3 trillion to $14 trillion by the end of January.

However, credit spreads (the difference between government and corporate bond yields) remain at tight levels. There was modest widening following news of the coronavirus outbreak, but that has since largely reversed, in the same way that equities recovered from their initial correction.

Although credit spreads are tight and we have reduced our exposure to fixed income over the past three to four months, we still hold higher-yielding credit in emerging markets and high yield bonds. As this prolonged economic cycle continues, the risk of default remains low and warrants some exposure to the additional yield available in these markets. In particular, emerging market debt denominated in US dollars looks relatively attractive.

ALTERNATIVES

We debated increasing our exposure to gold, which enjoyed a strong month on both Iran and coronavirus concerns. However, we believe our existing allocation in portfolios of 5% to 6% is sufficiently large. The recent increase in prices owing to geopolitical risks may create some near-term vulnerability, and we'll wait to look for better entry points.

Over the month, we switched some of our alternatives exposure from alternative risk premia to macro hedge fund strategies.

CURRENCIES

We believe the US dollar is overvalued, and the consensus market view is that it's likely to give up some ground over the course of 2020. This was also the consensus view in 2019, but it failed to materialise.

Safe-haven flows driven by coronavirus concerns have pushed the US dollar higher. We believe the currency can weaken slowly over the course of this year but do not see an imminent catalyst for such weakness in the near term.

Sterling bounced in the days immediately following December's market-friendly general election result. However, the pound is now coming under renewed pressure as attention turns to the negotiation timetable for a trade agreement with the European Union. The UK government has already introduced the concept of an Australian-style agreement, which looks much like a no-deal Brexit. Sterling is likely to remain under pressure as the negotiations continue.

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