Investment roundtable

Our panel of portfolio managers assess the performance of portfolios in the third quarter, while addressing the impact of divergent central bank monetary policy and a resurgent US dollar.

Hosted by Nicola Eggers, Head of Discretionary Portfolio Management

Topics covered include:

Asset class correlation

Divergent central bank policy

US dollar strength

Geopolitics

High yield outflows

Participants:

Rupert Howard
Senior Portfolio Manager, Discretionary

Nick Montgomery
Portfolio Manager, Discretionary

Jaime Arguello
Head of Barclays MultiManager and GlobalAccess Funds

Olivier Asselin
Head of Specialist Investment Management (Fixed Income, Equities and Structured Funds)

Nicola Eggers: **Fixed income and equity markets have both continued to perform well during the third quarter. We have been correct with our overweight allocation to equities, but have missed the fixed income rally to an extent. What factors are driving this and how are we adjusting portfolios to compensate?**

Olivier: I don't think this is just a story for last quarter, it's been going on for longer than that. I would say there are common factors – one of which is accommodative monetary policy – that have benefited both equities and bonds.

Other than that, each asset class has been shaped by different things. Equity market participants are focused on earnings expectations, and so far the earnings expectations horizon has been reasonably bright, giving the asset class good support.

Fixed income investors are more focused on GDP and in the US you have a good story, but it is far less impressive in Europe. When you add the European situation to a question mark on China, you end up having an overall growth story that is less supportive than the earnings growth story. Another issue during the quarter was that the asset liability managers within pension funds were pushing to reallocate away from equity into fixed income, while investors were also looking for a carry trade in the absence of yields in core European fixed income. They had to go to the US to find yield pickup, thus the spread between the two regions dragged US fixed income into a lower yield trend.

Nicola: **Has that led you to make any changes within your equity and bond portfolios Olivier?**

Olivier: Decisions are not the same with single asset classes as with global asset allocation, but on the fixed income side the markets look expensive, therefore we are cautiously positioned underweight duration versus the benchmark target duration. We like the credit story as the risk-on trade has clearly benefited equity and credit markets, meaning we have benefited from credit exposure. What we have lost going underweight duration in a bull market, we have made up through our credit/corporate exposure in portfolios.

One market (equity or fixed income) is more right than the other – it is not sustainable over the long term to have record low yields from a rates and credit perspective and such bullish equity markets. At some point, I would expect some adjustment one way or another. We need to resolve this million dollar question not only at the single asset class level but at an overall asset allocation level – which market is right?

Nicola: **As a multi-asset portfolio manager Nick, have you seen this issue and taken positions because of it?**

Nick: Having a high correlation between equities and fixed income is difficult from an asset allocation point of view. We were overweight US equities which have been best performing, and we were also focused on the performance of European equities which have softened due to worse macro data.

Rupert: I would take a little bit of issue with any statement that says bonds and equities rallied during the quarter. What's been highlighted over the last three months is the huge change in the US dollar. If you look at the MSCI World Index in US dollar terms, it was negative in the third quarter, but in sterling and euro terms it was positive, due to the weakness of both currencies compared to the US dollar – it depends on where you sit as an investor.

Broadly the themes are central bank accommodation, the dispersion of growth between the US and Europe and the fact that earnings continue to look reasonably robust.

Jaime: Our view on fixed income wasn't quite right. We didn't have much duration risk in MultiManager portfolios, and we expected the Fed to act sooner than is priced into the market. In terms of expected relative performance, we see better returns from equities than fixed income going forward. Fixed income has benefited as a safe haven from geopolitical risks, given a number of potential scares in the quarter.

Nicola: We have seen increasingly divergent policy between the European Central Bank (ECB) and the Federal Reserve (Fed) during the quarter, as tapering comes to an end in the US and the ECB tries ever harder to stimulate an ailing eurozone. What impact has this had and how do we see it developing into the fourth quarter?

Jaime: The main impact was seen across currencies. The market might, at some point, lose confidence in the ECB, if its actions appear to be too little too late, or the structure of monetary policy in the context of the mix of countries doesn't work. The markets expect quantitative easing to be as positive in Europe as it was in the US – but the evidence is not there. The potential support it has given other markets might not materialise.

Rupert: That also helps to explain the peculiar behaviour of the bond markets this year. In the US in particular, strengthening economic data is much clearer evidence of a more robust economy moving out of recovery and in to growth, yet bond yields have been falling, which creates a lot of difficult questions to answer. It does seem now that a lack of growth and the risk of deflation in Europe has dragged down yields aggressively, also having an impact globally – dragging down US yields. It has caught a lot of people on the wrong side of fixed income this year, but hopefully that is now starting to normalise and the behaviour of the bond market should be more reflective of the fundamentals moving forward.

Nick: There is an interesting debate about this concept of divergence and the strength of the US. There are strong

arguments for why the US continues to do well, but you can't dismiss that other global macro data is slowing and, even in US equities, there is a 30% exposure to foreign sales. The debate is around how that will impact the US growth story.

Nicola: One of the big themes of the quarter has been the strength of the US dollar, particularly against the euro, which has been weakened by ECB action. How have we factored this into investment decisions?

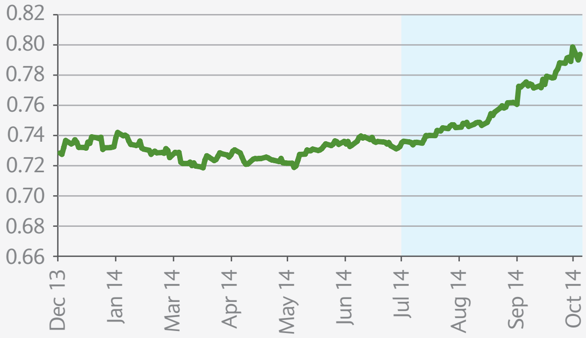
Rupert: The third quarter was validation for us on a view we have held for some time now. We moved positive, as a house, on the US dollar in 2013, which has been painful, but clearly over the last three months that viewpoint has been very helpful. We have seen a significant unwinding of Sterling strength driven by the US dollar and the Scottish independence debate. Also, for euro investors, we have seen a material weakening in the euro. We have not had to make many changes to our portfolios in the quarter, and we feel the benefits we are experiencing now are unwinding the pain

US dollar strength indicates weaker global economy

The strength of the US dollar not only indicates the health of the US economy, but is also related to softer data in the rest of the world. Weaker global demand for commodities combined with increased supply is depressing prices, with oil in particular suffering.

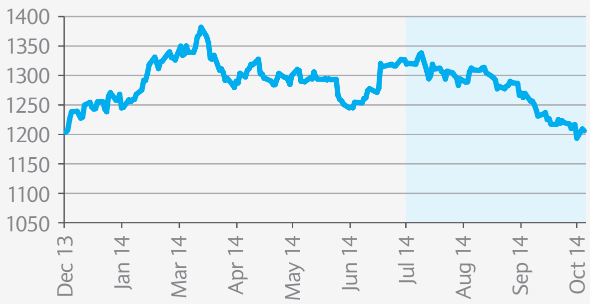
Global commodity markets are priced in US dollars, meaning they have become relatively more expensive for buyers in two of the major markets for commodities - Europe and Japan. The yen fell more than 5% against the US Dollar in September, while the euro declined almost 4%, offsetting to some extent the fall in prices and impacting demand further.

US dollar gains against the euro (€ per $)

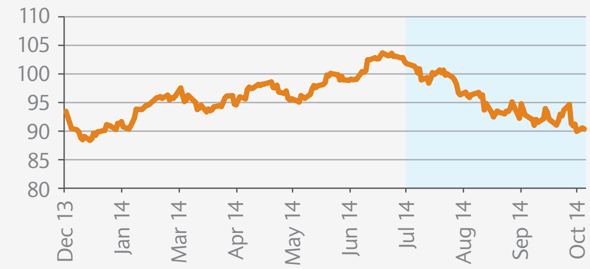


An increased demand for US risk assets in the third quarter also lowered demand for safer haven assets which provide no yield pickup, such as gold.

Falling gold prices ($ per oz)



Falling oil prices ($ per barrel)



Gold Oil $ vs € Source: Bloomberg

we felt last year and at beginning of 2014. We don't think this trade has finished yet and we believe the dollar will strengthen further.

Jaime: In the case of MultiManager, we hedge everything except emerging market asset classes, therefore eliminating much of the volatility. In terms of dollar strength versus emerging market currencies, the impact was negative but minimised because we were underweight that asset class.

Nick: The weakness in the commodity markets has, in part, been driven by the strength of the US dollar – being underweight commodities helped us.

Olivier: Other things to consider include a revision of earnings expectations between different regions. The dollar is strong against a basket of currencies, but that has been more pronounced against certain currencies, for example the Japanese yen. This is not good for US exporters but is good for European and Japanese exporters, although we won't see that in the earnings numbers for three months or so though. This is not something that has yet been figured out by equity analysts in terms of impact.

You might also find correlation between the US dollar and emerging market bonds. A stronger dollar could impact local emerging market debt, while weaker emerging market currencies are also more sensitive to inflation risk. Emerging market (EM) debt and equity, along with commodities, are the asset classes to monitor on the back of the stronger US dollar.

Rupert: The impact of a strong US dollar on the US equity market is much more mixed. You can find a clear correlation between weak commodity and oil prices and a strong dollar, but there isn't any clear correlation or pattern regarding how the equity market will behave in a strong dollar environment. During the 1990s when the dollar was strong, US markets were bullish – while in the financial crisis the dollar was strong and equity markets were terrible. There aren't any conclusions to draw about whether a strong dollar has predictive power over US equities.

Nicola: There has been a lot of publicity recently around outflows from high yield funds, as valuations appear to be becoming stretched. What is our view on high yield and do we still hold it in portfolios?

Jaime: In terms of high yield, there are a number of red flags and concerns at present. One is the lower quality and underwriting of loans, a lot of low quality companies have been able to come to the market and raise debt easily, which they couldn't do in normal conditions. There is increased leverage, greater collateralised loan obligation (CLO) issuance and lower liquidity – not as good as it should be.

In terms of portfolios, we are underweight high yield with a small exposure. Our strategy has been to increase the quality and it is an asset class we are concerned about.

Olivier: High yield has fully benefited from ample liquidity in the market and the carry trade has been playing a major role, as investors piled into assets in the high yield sector. We reduced exposure to high yield about two months ago, when yields and spreads were close to historical lows. We think that was the right decision, given the level of yields, combined with fundamental views around the solidity of companies - the trough in terms of spread was 330 bps, and now it is trading 100 bps above that. We all know that entry doors are wider than exit doors because this is not the most liquid asset class, so reducing our position was a good move, because, at some point, when people want to liquidate positions they might have difficulty.

We halved our exposure to high yield, and we are now meaningfully underweight, although I would not see the high yield risk in isolation. If we see further pressure on the high yield market it will spread into other high beta asset classes making it hard to remain positive on equities.

Nicola: Did you make any adjustments during the third quarter for geopolitical issues, and are you actively monitoring this from a portfolio perspective?

Olivier: Geopolitical impact was not really reflected in our decisions.

Rupert: We have discussed geopolitics, whether its Ukraine, Middle East or China, and our conversations have been around how this might broadly impact portfolios. Our confidence in the US cyclical upswing is such that we believe it is likely to overwhelm most other geopolitical factors in terms of how markets are going to behave. The US is very important – the last time we had major geopolitical issues (Arab Spring), the US was in a clear economic downswing so it exacerbated the problems. This time around it feels different, the US is improving which is a big positive and negates the impact of geopolitical problems. The direction of travel for most risky asset classes is positive because of the nature of the economic cycle.

Jaime: The Fed is not keen to derail the markets with hawkish language when we have a lot of other issues, so it does have a direct impact in that way.

Nicola: What have been some of your best and worst contributors in the third quarter? How are we adapting those positions for the fourth quarter?

Nick: The energy sector was weak across the board in the third quarter, particularly some of the US energy stocks which had a very good first half. This can be attributed to movements in oil prices. On the positive side, the best performers were US consumer stocks such as Home Depot and Bed Bath & Beyond, a positive indicator for the strength of the US consumer story.

Rupert: Gold stands out as having had a difficult quarter, which is a corollary of the strength of the US dollar. In currency terms, being long the dollar was a big benefit, but the allocation to gold was difficult. We also saw some more volatility within the high yield space – where we have seen spread widening and increased volatility – otherwise credit and sovereigns were well behaved.

Olivier: The third quarter was more volatile than the second. The underlying market in which we invest had a challenging July and September, while August was friendlier. In that context our duration position was clearly a slight detractor to the overall position. We probably underestimated the fixed income rally even at a single asset class level, although the contribution from credit exposure was good.


Jaime Arguello

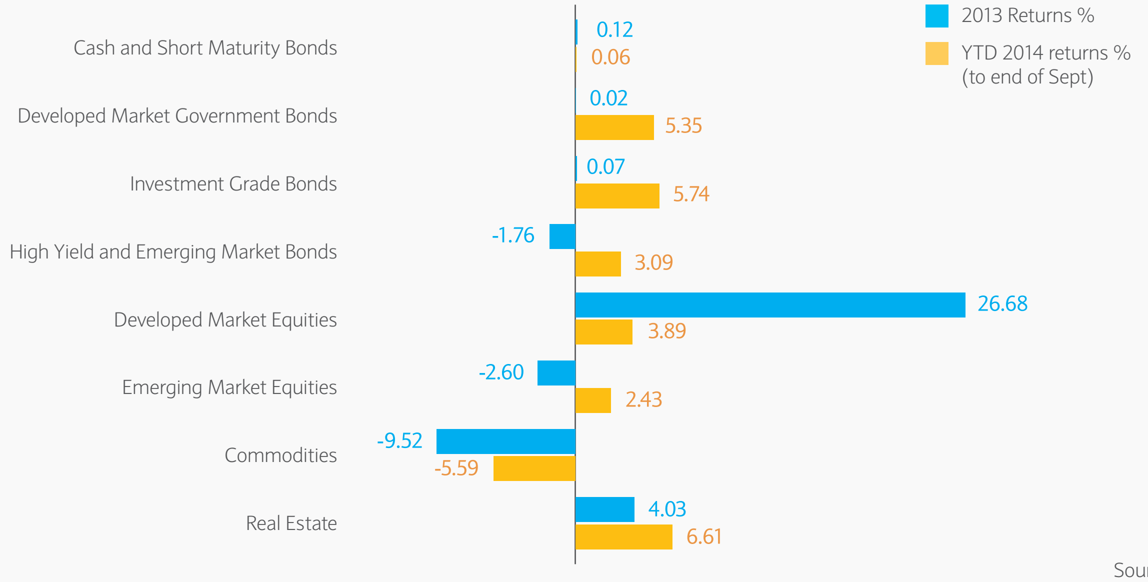
We adopted a more defensive position at a stock picking level which worked well, while maintaining credit exposure, and cutting back on riskier investments. Our investment in an Asian Equity ex-Japan fund was a particular positive, with year-to-date performance 500bps above benchmark – largely due to the country allocation favouring China and India.

Jaime: The quarter was good until September, when there was a downturn – mostly in EM equities and fixed income. In terms of what worked well in the quarter, UK equity allocations were good with managers protecting well on the downside, while Japan was also a positive allocation.

Rupert: I would add that an increase in M&A activity, both real and rumoured, is also important. Shire in the UK and Covidien in the US both benefited from increased share prices, while SAB Miller was the subject of takeover rumours in the third quarter and performed better because of that. It's very difficult to try and predict where you will see M&A equity, although hedge funds in the arbitrage space might be worth looking at.


Nick Montgomery

Total returns across key global asset classes



Source: Barclays

Note: Past performance is not an indication of future performance. For discrete five-year returns, see appendix. Figures quoted are % net returns.

Index Total Returns are represented by the following: Cash and Short-maturity Bonds by Barclays US Treasury Bills; Developed Government Bonds by Barclays Global Treasury; Investment Grade Bonds by Barclays Global Aggregate – Corporates; High-Yield and Emerging Markets Bonds by Barclays Global High Yield, Barclays EM Hard Currency Aggregate & Barclays EM Local Currency Government; Developed Markets Equities by MSCI World Index; Emerging Markets Equities by MSCI EM; Commodities by DJ UBS Commodity TR Index; Real Estate by FTSE EPRA/NAREIT Developed; Alternative Trading Strategies by HFRX Global Hedge Fund. The benchmark indices are used for comparison purposes only and this comparison should not be understood to mean that there will necessarily be a correlation between actual returns and these benchmarks. It is not possible to invest in these indices and the indices are not subject to any fees or expenses. It should not be assumed that investment will be made in any specific securities that comprise the indices. The volatility of the indices may be materially different than that of the hypothetical portfolio.