CIO BLOG

Mouhammed Choukeir | Chief Investment Officer
Investment Strategy | January 2020

TAILS OF THE UNEXPECTED VII

Markets are exquisitely unpredictable, and each year, events – financial, economic, geopolitical, or otherwise – occur which few see coming, but cause powerful ripples to the prices of securities. Instead of consensus-tinged forecasting, we continue an annual tradition of exploring what unlikely but feasible events are not priced by markets in the year ahead. These *Tails of the Unexpected*, pushed to the overlooked "tails" of probability distributions, have the potential for outsized impact. If they occur, how would our portfolios perform? Do we have plans in place to protect against adverse market events? Are we positioned to prosper?

Let's dive right in!!

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Swirling Sterling

Negotiations go extremely well and the British pound hits $1.75

- **Consensus view:** Markets are pricing in another choppy year of negotiations between the United Kingdom and the European Union. This is clear from the post-election surge in Sterling having dissipated rather quickly; it hit $1.35 in the immediate aftermath of the results but fell right back to $1.30 the following week. The realisation rapidly dawned that the election merely signalled the beginning of negotiations surrounding the future relationship with the EU, not the end. Prime Minister Boris Johnson is sticking steadfastly to his position of the UK leaving the transition period at the end of December 2020 with a permanent trading relationship in place with the EU. Most find this untenable, with such negotiations usually taking years to conclude.

- **What the consensus view is not pricing in:** The consensus may not be pricing in sheer exhaustion! Most minds are anchored by the recency bias of the last three years, where much "noise" has been generated by missed deadlines and crossed "red lines". However, following the original referendum, and now a general election, it is clear most British people want to leave. Most Europeans want this over with too, with little appetite for "punishing" the UK at the cost of prolonging the morass. And while trade deals usually take longer, a negotiated settlement may be easier in this instance given near-identical starting positions on many rules and regulations. It also gives the UK the ability to cut taxes and regulatory red tape, actually breathing life into idea of the "Singapore on the Thames".

- **Potential market reaction:**
  - **Macro:** Sterling hits $1.75 and €1.55 as a major headwind for the UK disappears. Pent-up corporate capital expenditures jump along with consumer spending. Bad inflation ("cost-push") is replaced with the good kind ("demand-pull").
  - **Equities:** All else equal, one can expect large-cap UK equities to fall given the inverse correlation between Sterling strength and repatriated profits at the multi-national behemoths that populate most of the FTSE 100. However, much of this will be blunted by a genuine, comprehensive trade deal with the UK's largest trading partner, helping investors "look-through" any short-term currency headwinds. Moreover, domestically oriented companies, as many of the mid-caps on the FTSE 250 are, will rally. All companies will benefit from the more favourable tax and regulatory backdrop.
  - **Bonds:** Government bonds will sell off aggressively as investors dump safe-haven, low-yielding assets and invest in riskier ones. The yield on the UK ten-year gilt may double, even treble, from the current level of 0.80%.

- **Our positioning:** In most strategies, a net bias to risky assets and an overweight to UK equities leaves us well positioned for the upside. However, this outcome would negatively impact the non-Sterling parts of our global-oriented portfolios, which is precisely why we have trimmed the non-Sterling exposures by insulating ("hedging") part of our US equity positions and all gold holdings against a rise in the value of Sterling.

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Trading up

A comprehensive trade deal with China is agreed, ushering in a renaissance for global manufacturing; global GDP grows by 5%

- **Consensus view:** While most forecasters (e.g. IMF, central banks) do not expect a recession in 2020, there is little expectation of an economic boom either: the consensus view is for yet another year of slow, meandering economic growth across the world (i.e. global GDP about +2.6%). This is largely due to depressed manufacturing output, and poor capital expenditures by corporates unwilling to invest heavily in a late-cycle environment, particularly as "phase two" trade negotiations between the US and China are expected to be difficult.

- **What the consensus view is not pricing in:** US and Chinese negotiators appear to have closed a "phase one" trade deal. They are also strongly incentivised to complete "phase two" given the US election year on one hand, and a Chinese social contract predicated on growth on the other. Moreover, while economies will continue to receive powerful support from central banks, there also is evidence fiscal policymakers will be more active – this could prove a game-changer. Far from a recession, global economies may well re-enter expansion mode from the current "slowdown" stage.

- **Potential Market Reaction:**
  - **Macro:** Global GDP jumps to 5%, a huge outperformance from the current expectations. Consumers, firms and governments all open the spending taps.
  - **Asset allocation:** Such an environment will clearly favour risky assets such as equities and high-yield debt, with safety assets such as government bonds and gold selling off.

- **Our positioning:** While we have defensive assets in portfolios which will lag in such a scenario, our net bias remains to risky assets, particularly equities. Indeed, we maintain defensive positions to protect against the vagaries of equity markets, but believe the equity risk premium is positive and worthwhile even in a slowdown. Should an expansion occur, that risk premium may well double.

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3 Private inequity

The weight of expectations brings Private Equity ("PE") markets down

- **Consensus view:** The past decade has been one of rip-roaring success for PE investments, with record capital not only raised and deployed, but also distributed back to investors. Indeed, total buyout value jumped 10% to $582 billion (including add-on deals) at the end of 2018 globally, capping the strongest five-year run in the industry's history. Last year figures will likely set another record. High double-digit returns (ca. 20% per annum) are where expectations are set for many.

- **What the consensus view is not pricing in:** Low interest rates and steady GDP growth in the US and Europe have helped the industry, but the real juice in returns has come from selling assets acquired at cheap valuations in the years after the great financial crisis at much headier multiples now. This thunderous recent performance has diverted waves of new liquidity towards the asset class: a decade ago, a $1 billion fund raise would have been notable; today, some funds raise more than $100 billion. Dry powder, or capital which is raised but not yet spent, is above a record high of $2 trillion (December 2018, Bain & Co.) This has led to a transformed landscape: PE firms are forced to deploy ever more money not only at richer valuations, but also on increasingly speculative underlying investments. This is a dangerous convergence of factors.

- **Potential market reaction:**
  - **Macro:** There are trillions invested in PE, but such "alternative investments" tend to be relatively small in the overall portfolios of most investors. They are often a larger proportion for family offices, or similar investors, who are comfortable with the illiquidity profile of such asset classes. Also, while investment banks are intimately connected in the process of buying and selling private companies and raising the capital to fund many of the transactions, the traditional banking system has fairly limited exposure given regulation mandating conservative balance sheets and appropriate risk-weighting. This means a disorderly wind-down of some large PE funds would not pose a systemic risk to global economies in the way the bust of mortgage-backed securities did in 2008, but there would still be a strong risk-off reaction.
  - **High-yield debt:** This is probably the most directly impacted asset class, since much high-yield debt is issued by companies owned by PE backers. One can expect spreads to widen and yields to double, even triple, from near historic lows now (ca. 5%).
  - **Asset allocation:** A fall in PE valuations would likely mirror a similar fall in valuations at publicly-traded companies; the two are correlated. A risk-off environment would lead to falling safe-haven bond yields and a jump in the price of gold.

- **Our positioning:** As it says in every prospectus, investors should not be swayed by past returns. For PE, the next decade will be far more challenging than the previous one, and 2020 may well be the year the unravelling begins. In our flagship strategies, we have no direct exposure to PE, and remain vigilant to the valuations in publicly equity markets where we are invested. We continue to hold low-yielding safe-haven debt and gold precisely to protect against equity market downturns, which come unannounced. We do hold a modest allocation to high-yield debt but are cognisant of its risk profile and liquidity characteristics.

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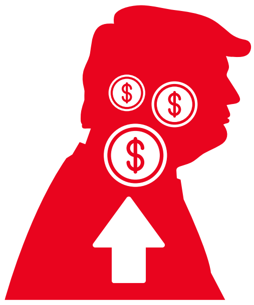
Donald Ducked

Donald Trump loses November's election, causing corporate taxes to rise appreciably in the US



- **Consensus view:** At present, bookies indicate 10/11 odds (i.e. approximately a 50% probability) of the incumbent US President winning re-election come November. History would suggest the prevailing economic conditions are the most important factor for his success. In this respect, Mr. Trump has a huge advantage: unemployment is at a record low; wages are rising briskly; chances of a recession in 2020 are put at about 25% by the US Federal Reserve. This has helped his popularity with "the base" to remain remarkably stable. While most expect this to be a year full of rhetorical fire and fury, policy continuity is the default position for most investors.

- **What the consensus view is not pricing in:** Usually, established Western democracies see policies tilt between "centre-left" and "centre-right". This time may well be different, with a Democratic victory predicating a substantial leftward lurch in public policy, and thus a big increase in current taxes. Remember, President Trump slashed corporate taxes dramatically in 2017; a return to even the pre-Trump status quo will cause post-tax corporate earnings to contract.

- **Potential Market Reaction:**
  - **Macro:** A Democratic victory will see a substantial rise in corporate taxes no matter who wins the party nomination. Of course, should it end up being Bernie Sanders (i.e. 8/1 odds, about 11%) or Elizabeth Warren (i.e. 14/1 odds, about 7%), a dramatic shift is likely. Taxes will rise on corporations, as well as top earners.
  - **Asset allocation:** This would certainly cause a contraction in US corporate earnings, which would lead to a sell-off for US equities, and very likely global markets too. The risk-off rotations would cause a rush to US government bonds, which would see yields fall dramatically. In the longer term, more aggressive public spending in the US, particularly on infrastructure and skills-based training, would boost productivity.

- **Our positioning:** While government bonds offer poor value in absolute terms – yields are relatively low compared to their history – they continue to be critical in offsetting risks from equities and other risk-assets in multi-asset portfolios. These risks are more effectively offset with a longer-duration positioning, supporting our move from "short" to "neutral" duration across Government Bond holdings. However, we would aim to be quick to reallocate back into equities when valuations are cheap, momentum turns positive and sentiment is still oversold.

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Putin in a shift

A resurgent Russia flexes its geopolitical muscle more than anyone could expect, oil shoots up to $150 a barrel

- **Consensus view:** Markets are pricing in another year of range-bound oil prices as Russia shrugs off the latest US sanctions (i.e. target firms building Nord Stream 2, an undersea pipeline that will allow Russia to increase gas exports to Germany, which the US considers a "tool of coercion"). Even the assassination of General Qasem Soleimani in early-January – a seismic event in the Middle East – raised prices for Brent crude just about 5% (ca. $66 a barrel to ca. $70 a barrel).

- **What the consensus view is not pricing in:** When it comes to oil prices, many focus on the Middle East. However, Russia may actually be the swing factor. In the last decade, Russia has unshackled itself from its post-Cold War funk and reasserted itself on the global stage in a major way: Ukraine's annexation; critical backing for the Syrian and Iranian regimes which has tilted the balance of power in the Middle East; US general election interference in 2016; alleged assassination attempts of former spies, including in the UK; huge African investments, and thus influence. Much of this would have been unthinkable in 2010. At the start of 2020, a strategic attack on a missile bunker in the Baltics or similar is also unthinkable, but that is why it's not priced in. The risk is also heightened as the US president will be under huge pressure in an election year to "rectify the sins" of Russian interference in 2016.

- **Potential Market Reaction:**
  - **Macro:** Russia produced about 11.4 million barrels of oil per day in 2019, accounting for 11% of world output. Any actions that would result in an armed response by NATO against Russia would cause energy prices to skyrocket, with oil shooting up to $150. Instantly, headline inflation – long missing in most of the Western world – would shoot up, but it would be the unwelcome kind generated by a negative shock.
  - **Asset allocation:** Risk-off sentiment would cause equities to sell-off, but bonds will be crushed by the inflation factor. In this environment, gold prices would go through the roof, crossing perhaps the all-time highs (i.e. in real terms) achieved in 1979 when Russia invaded Afghanistan.

- **Our positioning:** We have all been dulled by the constant cacophony of geopolitics. Indeed, there is much evidence that it tends to be a red herring in terms of risk allocations, and thus best ignored for asset allocation purposes. However, it certainly impacts certain markets, such as commodities, if they're directly in the line of fire (pun intended). We have a large allocation to gold particularly to help insulate portfolios somewhat in the event such "black swan" events.

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