

Moving defensively into 2019

December 2018

As we head into the closing stages of 2018, it has become clear that we are seeing a regime shift in global markets. After faltering in February, equity markets in the US hit all-time highs in September, and were driven for much of the year by the exceptional performance of the technology sector. However, it is becoming apparent that the tech leadership story has at least subsided, and volatility, which was dampened for much of the year, appears to be here to stay as we move into 2019.

The year ahead is still likely to be characterised by the continued shift away from quantitative easing, which will see financial conditions tighten further, and despite possible signs of a temporary truce in the trade war dispute between the US and China after the G20, investor optimism has again been muted. This all contributes to our view that the new year is likely to see relatively low returns and a higher volatility environment, with dynamic asset allocation and bottom-up security selection becoming ever more important sources of added value for investors.

Given this backdrop and our focus on risk-adjusted returns, we will maintain our defensive posture through hedges which have performed strongly in recent months, as well as increased allocation to defensive assets like US treasuries, and high-quality investment grade bonds. As we outlined last month, our hedges performed very well in what was a volatile October. Since then, the backdrop has not changed materially, and as a result we have maintained many of our equity hedges for downside protection purposes.



Eugene Philalithis

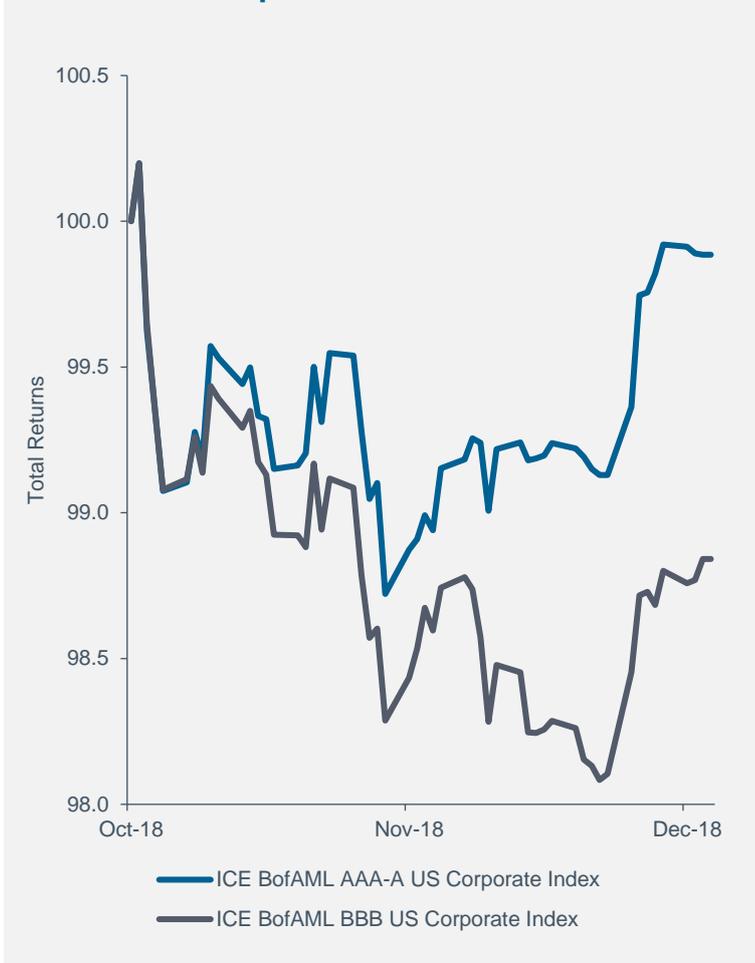
Portfolio Manager

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While we often discuss our selective allocations in risk assets, it is important to note that we are also highly selective in how we allocate to defensive assets, with investment grade bonds a good example at present. The BBB market has grown significantly in recent years, and has been driven by both downgrades and new issuance from existing BBB issuers. As these bonds are one grade above high yield, there are increasing concerns over higher levels of leverage and the risk of downgrades, especially given the difficulties this would present for the high yield market to absorb these larger issuers. In recent years, returns in the BBB space have moved in line with higher quality investment grade bonds, but we have seen spreads widen significantly in past months and BBBs underperform, which implies a return of risk premium to BBBs. This all leads us to being very selective in our investment grade bond allocation, and we are focusing on shorter-dated issues in this space with a bias to high quality.

But while we are clearly shifting further into defensive territory, this does not mean we are battenning down the hatches completely, and our defensive posture will be balanced by selective exposure to risk assets. Some examples of this include emerging market debt, where we are seeing increasing attractiveness in hard currency issues, as well as reducing some of our currency hedges on local currency bonds, which have served us well in 2018 with emerging market currencies struggling as a strong US dollar persisted. That said, we have not removed all of our emerging market currency hedges, and are remaining tactical in this regard. We have also continued our move away from European high yield bonds, and are increasingly negative on US high yield as we favour Asian high yield exposure.

A return of risk premium for BBBs?



Source: Bloomberg, 13 December 2018

As we close out this year and rates continue to normalise, this means that income levels are starting to improve. But transitioning into a regime of higher yields will not be straightforward for investors. Moving into 2019, we remain cautious and focused on preserving our clients’ capital through defensive positioning, as well as leveraging our research capabilities to take advantage of opportunities as they present themselves.

Yours faithfully,

Eugene Philalithis

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