FINANCIAL PARTNERS

Weekly Digest

Week ending **8 November 2015**

In September a fund manager synonymous with BRIC (Brazil, Russia, India and China) investments made a filing with the Securities and Exchange Commission (SEC) to have their BRIC fund 'acquired' by a broader Global Emerging Markets (EM) equity strategy (Securities Act File No. 333-206459). When the concept was first mooted some fourteen years ago this club of four economies had giddying prospects. This waning of demand underlines a number of salutary lessons for investors.

A macro story is not the same as an investment case

Brazil, Russia, India and China have all, in their own ways, demonstrated that solid or even spectacular GDP growth may not translate into returns for shareholders. It is true that a positive growth backdrop should provide a tailwind to companies hoping to profit in these markets, but for investors to prosper it requires a confluence of factors such as a suitably cheap entry point, good management that focuses on enriching minority shareholders and a safe and supportive regulatory environment that encourages businesses and protects property rights.

Thematic investing can be dangerous

A key risk of thematic investing is that the original rationale for a trade is heuristic at heart, making it difficult to determine when your original investment rationale went. Whether it be EM growth, biotech, ageing populations etc. it is difficult to know when to get out; EM countries in the main continue to grow at a faster clip than Developed Market (DM) countries; populations continue to age; biotech continues to be in demand, but without referring to valuation (or some other objective measure) it is difficult to know when to step away from the trade because themes rarely signal their end in the same way that valuation does.

Furthermore popular themes are innately compelling, meaning that from the moment the investment is made you are emotionally engaged with it. This feeling of affinity can lead to a powerful emotional tie even in the face of a changing reality, making the sell decision extremely difficult.

Nothing is forever

A quick peruse of human history reminds us that change is one of the few true constants; whether it be political or economic, regimes are impermanent. In a similar vein, investing in a particular market because it has done well makes an implicit assumption that the sector will continue to do well and importantly, in order to make a decent profit, that this continued success is not already encapsulated in share prices. If the growth does not materialise, or if it is already reflected in share prices, then profits will be underwhelming. The good news is that declines are also rarely permanent and as a result there are profits to be made in well-chosen businesses that appear to have lost all hope.

Stay diversified

Emerging markets offer substantial risk and reward to investors and there are large variations in terms of prospective returns between regions and single nations. Generally speaking, unless there is a profound valuation justification for choosing a sub-set of EM equity, it is prudent to stay broadly diversified. The historical returns differential between the best and the worst market is often huge, for example there are dozens of percentage points' difference between the local currency 12 month returns of the BRIC nations to the end of October 2015. Absent of an extreme valuation opportunity it seems it is sensible to diversify away some of the idiosyncratic risk within EM investing.

Invest away from the herd

Investment themes may well benefit from substantial inflows as their popularity grows and all stocks could be buoyed by this tide but investors are fickle beasts and liquidity works both ways: when there is a rush to leave a previously 'hot' trade the pressure on share prices is immense. That is why we look to invest out of the spotlight, away from fads. In fact being valuation-driven enables us to sometimes be the providers of capital for people looking to exit a trade. This allows us to access a market at a cheaper level than would otherwise be possible. We like to take the view that if everyone is talking about something there is no edge.

Source: Bloomberg. Returns in US dollars unless otherwise stated.

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The **Marketplace**

- Global equities flat in US dollar terms
- Markets confident of December rate rise
- Strongest US jobs report in nine months
- Update on third quarter earnings season
- Weak Chinese trade data over the weekend

Market **Focus**

Global

- Global equities were flat to marginally down last week in US dollar terms for the first time in five weeks. In local currency terms, developed markets added 0.9% while emerging markets rose by 1.1% (0.6% in US dollar terms). In China, the Shanghai Composite Index entered a technical bull market on Thursday, having risen by more than 20% from its most recent lows on 26 August.

United States

- 10 year US Treasury yields edged up by 18 basis points (0.18%) last week to 2.33%, their highest level since July. Many fixed income asset classes were marked down last week, as investors raised their expectations for a December rate hike by the Federal Reserve.
- The implied probability of a US Federal Reserve hike in December is now close to 70%, based on prices of Federal Fund Futures. This will be the first time the Federal Reserve, the European Central Bank or the Bank of England has raised interest rates in over four years.
- Friday produced the strongest labour market report this year. The US economy added 271,000 jobs in October pushing the unemployment rate down to 5%, its lowest level since 2008. At the same time, underemployment fell below 10% (underemployment is a broader measure of unemployment that captures people on the fringes of the labour market, such as those in part-time work but looking for full-time employment).
- According to the National Federation of Independent Business (NFIB), US companies are now more worried about the tight labour market than poor sales. As the US economy approaches full employment, inflationary pressures are expected to increase.
- Third quarter earnings season is coming to an end in the US with 443 S&P 500 companies having reported earnings thus far, 74% have beaten analysts' earnings expectations with 1% in line. The corresponding figures for revenues stand at 44% and 0%.

UK

- The Bank of England signaled on Thursday that the first rate rise in the UK is likely to be postponed until 2016 and possibly Q1 2017, based on lower forecasts for inflation in the short term. Sterling fell by over a percent versus the dollar and the euro on the day.

Europe

- Despite a weaker than expected earnings season in Europe, stocks in the region outperformed last week in local currency terms thanks to the depreciation of the euro (down 2.4% last week and 11.2% year to date) and the pledge of further stimulus from the European Central Bank

China

- Chinese imports declined by more than expected last month, with imports falling by 18.8% year-on-year (-15.2% expected) and exports down by 6.9% (-3.2% expected). The ratio of positive to negative data surprises in China has been stabilising however.

James Klempster, CFA & Scott Gordon

Source: Bloomberg. Returns in US dollars unless otherwise stated.

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Asset Class/Region	Currency	Currency returns			
		Week ending 6 Nov. 2015	Month to date	YTD 2015	12 months
Developed Market Equities					
United States	USD	1.0%	1.0%	3.2%	4.9%
United Kingdom	GBP	-0.1%	-0.1%	-0.7%	-0.3%
Continental Europe	EUR	1.6%	1.6%	14.7%	16.8%
Japan	JPY	0.3%	0.3%	13.1%	17.5%
Asia Pacific (ex Japan)	USD	0.4%	0.4%	-7.0%	-8.5%
Australia	AUD	-0.1%	-0.1%	0.5%	-0.5%
Global	USD	0.0%	0.0%	1.4%	1.7%
Emerging Market Equities					
Emerging Europe	USD	-0.1%	-0.1%	-5.1%	-19.3%
Emerging Asia	USD	1.0%	1.0%	-5.1%	-5.2%
Emerging Latin America	USD	0.9%	0.9%	-24.2%	-31.2%
BRICs	USD	1.2%	1.2%	-7.8%	-11.1%
MENA countries	USD	-1.4%	-1.4%	-11.5%	-20.7%
South Africa	USD	-3.0%	-3.0%	-13.3%	-14.5%
India	USD	-2.4%	-2.4%	-7.2%	-10.4%
Global emerging markets	USD	0.6%	0.6%	-8.9%	-11.9%
Bonds					
US Treasuries	USD	-1.1%	-1.1%	0.4%	1.7%
US Treasuries (inflation protected)	USD	-1.0%	-1.0%	-1.8%	-2.4%
US Corporate (investment grade)	USD	-0.9%	-0.9%	-0.6%	0.4%
US High Yield	USD	-0.3%	-0.3%	-0.1%	-2.1%
UK Gilts	GBP	-0.9%	-0.9%	0.2%	4.7%
UK Corporate (investment grade)	GBP	-0.5%	-0.5%	-0.5%	2.9%
Euro Government Bonds	EUR	-1.3%	-1.3%	1.0%	3.6%
Euro Corporate (investment grade)	EUR	-0.3%	-0.3%	-0.7%	0.2%
Euro High Yield	EUR	0.4%	0.4%	2.8%	3.3%
Japanese Government	JPY	-0.2%	-0.2%	0.4%	2.2%
Australian Government	AUD	-1.0%	-1.0%	2.2%	5.6%
Global Government Bonds	USD	-2.3%	-2.3%	-3.9%	-3.8%
Global Bonds	USD	-2.0%	-2.0%	-4.1%	-4.2%
Global Convertible Bonds	USD	0.3%	0.3%	1.6%	1.3%
Emerging Market Bonds	USD	-0.4%	-0.4%	3.1%	1.1%

* Estimate

Source: Bloomberg

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Asset Class/Region	Currency	Currency returns			
		Week ending 6 Nov. 2015	Month to date	YTD 2015	12 months
Property					
US Property Securities	USD	-2.1%	-2.1%	-1.7%	2.0%
Australian Property Securities	AUD	-0.3%	-0.3%	9.2%	11.9%
Asia Property Securities	USD	-2.3%	-2.3%	1.8%	1.7%
Global Property Securities	USD	-2.2%	-2.2%	-1.1%	0.7%
Currencies					
Euro	USD	-2.4%	-2.4%	-11.2%	-13.2%
UK Pound Sterling	USD	-2.4%	-2.4%	-3.3%	-4.9%
Japanese Yen	USD	-2.0%	-2.0%	-2.8%	-5.6%
Australian Dollar	USD	-1.4%	-1.4%	-13.8%	-17.7%
South African Rand	USD	-2.4%	-2.4%	-18.3%	-20.5%
Swiss Franc	USD	-1.7%	-1.7%	-1.1%	-3.2%
Chinese Yuan	USD	-0.5%	-0.5%	-2.3%	-3.8%
Commodities & Alternatives					
Commodities	USD	-2.6%	-2.6%	-18.3%	-29.2%
Agricultural Commodities	USD	-1.7%	-1.7%	-12.6%	-11.6%
Oil	USD	-4.3%	-4.3%	-17.3%	-42.8%
Gold	USD	-4.6%	-4.6%	-8.0%	-4.6%
Hedge funds	USD	0.0%	0.0%	-1.6%	-1.9%

* Estimate

Source: Bloomberg

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