Sound Thinking

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Priorities for 2019

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From about Thanksgiving onwards, if you work in this industry, any social outing typically results in being asked the question "So, what do you think about the market? What's going to happen next year?" It's always very difficult to answer – especially because you should never talk seriously about investment markets after the second cocktail of the evening.

The reality is that predicting the future is hard, especially if you try to make exact predictions about where a particular stock market is going to end the year[1]. But the start of the year is a good time to try something a little more achievable: looking at the world and identifying issues that should be priorities for investors for the year. Below are the topics we think are most important for 2019.

1. Volatility: It's back
2. Central banks: Still central
3. Credit: Time to worry?
4. U.S. equities: Are they cheap yet?
5. Diversification: Does it work?
6. Europe: Better off out?
7. China: Yes, it really matters
8. Focus: On what works

1. *Just ask Wall Street strategists who somehow managed to miss the drop in U.S. equity markets that happened in 2018 when they were making projections at the start of the year.*

Volatility: It's back

Market behavior over the last month of 2018 was volatile, without question. Although 5% one-day moves are unlikely to be the norm, we have probably entered a more volatile period of market behavior than the calm we experienced throughout much of past five years[2]. That in itself is not necessarily a problem. Volatility manifests from a variety and combination of things: the amount of "new news" being processed by the markets[3], increased level of disagreement between market participants about likely outcomes, changes in investor liquidity, season, and so on. Long-term investors are only really damaged by that volatility if it is caused by a fear of bad outcomes which then prove to be true, leading to a drop in the value of risk assets[4].

A less discussed but more important result of volatility is how it affects the risk tools and models that many institutional investors use to understand portfolios. Institutional capital market assumptions are typically focused on 10 to 30 years and use very long term historical data to describe the volatility. Many risk models, however, make assumptions about the short to medium term future based on the short to medium-term historical data. A sudden rise in volatility, then, is a more meaningful part of the data being used by those risk models, and will have a relatively strong impact on forecasts. In other words, the recent volatility we have just experienced will, for a while, change the way each portfolio ***looks*** to the investor when analyzed, possibly making the portfolio look riskier than before. Unless the current spike in volatility represents a new normal, separating the effect of these short-term volatility spikes from the long-term likely risk characteristics of the portfolio will need extra attention.

What can investors do about this? Remember the importance of looking at risk and return through multiple lenses, using multiple tools and approaches. None of the tools have the perfect answer, but taken together they can give important insights in risky times.

Central banks: Still central

2019 looks like a bad year to be a central banker. The U.S. economy has been expanding for a long time and in a normal cycle we might expect that monetary conditions would be tightening. The Federal Reserve seems to be in a very uncomfortable situation, with a huge balance sheet to unwind and a high level of market sensitivity to interest rate rises. The fact market pricing today seems to be assuming few or no rate rises in 2019 suggests there are continuing concerns over underlying weaknesses in the economy. We also know the Fed has been reluctant to lead the market, and has tried to only raise rates when the market is comfortable with the proposed rate rise. While the Fed may persist with planned rate rises, skepticism as to the pace of rises is warranted if the market disagrees.

This problem is more global than national. The European Central Bank has similar problems, but with a much less stable economy and much less institutional political authority. While the ECB would

2. *Even with the recent volatility, S&P 500 Index implied volatility (VIX) has averaged 14.9 over the past five years, well below the long-term average of 19.3 (since VIX inception in 1990)*
3. *Technically, the amount of information being processed by the market is likely to have a direct relationship with market volatility and market trade volume.*
4. *Volatility drag is a real thing – assets with higher volatility produce lower return on a geometric basis than those with the same expected arithmetic return but lower volatility – but the biggest problem for investors is simply permanent loss of capital*

certainly like to tighten, on both an interest rate and a balance sheet basis, this would require the Eurozone economy to be more robust and there is little sign of that being the case – particularly with Germany looking decidedly less solid than desired. What's more, European political dynamics aren't conducive for tightening: much of southern Europe would benefit from a combination of debt forgiveness and looser monetary policy, which goes against the assumed role of the ECB as the guardian of sound money in the post-1945 German tradition[5]. The Bank of England is likely to be focused on ensuring Brexit is a success, balancing supporting the Pound Sterling with supporting the economy; again, a bias towards looser rather than tighter seems likely. The Bank of Japan, similarly, continues to drive for higher desired inflation, with little desire to see markedly higher interest rates.

Tightening may still happen, but it will do so against headwinds, and with fear from central bankers that if they do too much too fast they may cause economic instability. A final element – further political pressure on independence – is certainly present, although much of the discussion currently under way over-emphasizes both the degree to which that independence has been honored in the past. In other words, if the monetary policy setting system can survive LBJ physically picking up the Fed Chairman while yelling at him then it can likely survive whatever the next couple of years bring[6].

What can investors do about this issue? Think hard about what parts of the portfolio have been put in place because of an implicit assumption that we are in a rapidly rising rates environment, and make sure that the size and nature of those positions are still justified. Look at foreign assets too: flatter U.S. rates may provide more support for EM assets, while a more accommodative policy from the ECB may be seen by markets as either an acceptance of weakness in the Eurozone economy (bad news is bad news) or as a sign of future growth (bad news is good news)[7]. There will likely also be currency implications: if the U.S. holds relatively steady while other economies remain looser then continued dollar strength could be the outcome, driven by continuing high carry.

Credit: Time to worry?

During the last few years we have been given comfort in market downturns by the fact the credit markets have been mostly unaffected. This has been despite significant debt issuance, and in particular, increasing issuance of lower quality debt covered by looser covenants. This decrease in debt quality has been driven by the very low interest rate environment, as investors have reached for yield, accepting lower credit quality for slightly higher yields. Until October this year that bet paid off.

That may no longer be the case. Across the credit spectrum, spreads have begun to widen from historically very low levels, and there remains plenty of space for that spread expansion to continue as concerns mount. While the levels of actual defaults remain low, credit markets take time to work through downturns. An additional level of concern comes from the changes in market structure that

5. *The debate at the time of the introduction of the Euro was at least in part over whether the Euro would become the Greater Deutschmark or the Greater Peseta. So far the model has been more the former, but the constituency for the latter is large and growing more voluble. Investors should not assume that this question has been answered for ever.*
6. *And we should thank our lucky stars that we are a long way away from the days of FDR setting the gold price from his bed in the morning, and nationalizing gold. It's easy to forget where much of the stuff in Fort Knox came from.*
7. *I said this piece was about raising things to think about, not necessarily predicting outcomes after all. It is hard to work out which way the market will move on this issue – what it decides to do at the time will be a strong signal of the way ahead.*

have happened in the last few years, with the ongoing rise of bank loan products marketed as attractive in part because of their interest rate protection in what some investors were concerned would be a strongly rising rate environment. The rise in the use of credit ETFs remains a concern too: instantaneous liquidity products covering a less liquid market, where investors could potentially realize results different than expected in stressed conditions, particularly as the amount of liquidity being provided by Wall Street is now significantly lower than it had been during previous market downturns[8]. What also remains unclear across the entire credit complex is what exactly would happen in a downturn – in particular, how the new market structure affects recovery rates, and where illiquidity issues may cause technical problems.

To be clear, we do not believe the most likely case is for the U.S. economy to produce a recession this year, nor for there to be an immediate full-blown credit crisis. A continuing widening of spreads, combined with a modest rise in defaults, dropping liquidity, and lower than expected recovery rates, however, would not be comfortable for investors who had regarded spread sectors as a key driver of portfolio total return. In discretionary portfolios this concern has already caused us to start to move towards higher quality fixed income allocations where appropriate. The underlying role in portfolios of fixed income is primarily diversification and capital protection – 2019 might be a good time to remember that primary function.

U.S. equities: Are they cheap yet?

Over the last few years many investors have fallen into a way of thinking about the U.S. equity market which could be damaging prospectively. The U.S. equity market has risen massively since the Global Financial Crisis – it has been almost ten years from the trough of that market! Some of this rise has been due to earnings growth, some by low interest rates and some by the strong recovery of the U.S. economy. For much of the last few years valuations have been very high – and still the market has risen.

The result of this price movement has been a common generic assumption that "the U.S. equity market is very expensive." At the peak in 2008 forward P/E was around 14.5, while in 1999 it hit a high of 25.3. The average forward P/E since 1999 is 15.8. Market price movement over the last three months has brought us to a place where that P/E is hovering around 14.6, and the yield of the market is a little north of 2%. This is not exactly cheap – but it is also not exactly expensive, and even is slightly low relative to the longer-term average. The U.S. economy is more stable than most and U.S. company performance has been more effective than other markets. We would caution against the assumption that U.S. equities are particularly expensive.

What happens if the global economy and markets take a further major downturn from where they are today? It is easy to imagine an environment where this happens – but it is harder to see a scenario where this produces materially worse performance for U.S. equity markets versus other markets. While a risk-off environment would be painful, the U.S. remains one of the primary destinations for

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8. *The average age of the trader sitting on the trading desk who is responsible for making markets in these products is also relevant. Few have seen a single full cycle, let alone multiple cycles. That makes it hard for them to have perspective on what can happen when the wheels really fall off.*

safe haven capital. Would a bear market hurt U.S. equities? For sure. Would a bear market hurt U.S. equities significantly more than other equity markets? Possible, but not certain.

This is not an argument necessarily for a strong overweight to the U.S. – at time of writing we currently sit at neutral in discretionary portfolios. It is more an argument for remembering the vital role of the U.S. within equity portfolios, and for remembering that even if we move into an environment where lower total equity risk is needed that this lower equity risk may come from under-weighting other developed markets, rather than the U.S.

Diversification: Does it work?

Investing in risk assets normally pays better than investing in safer assets. Sadly, that means that most of the time it hurts to be invested in diversifying assets: they detract from the top line return (which is irritating) and at times they can even produce losses (which is actively painful). Over the last few years of positive US equity market returns, investors' exposure to fixed income, international equities, and commodities have all, at various times, felt uncomfortable. The 2018 experience was even worse: investors experienced the worst possible combination: negative outcomes from traditional risk assets, negative outcomes (and therefore no material diversification) from some traditional diversifying assets, and strongly negative outcomes from some newer assets (like alternative beta) designed to provide better diversification. Taken together the end result was at best very uncomfortable for investors, and at worse may cause some investors to doubt some of the basic principles of diversification or the underlying case behind specific asset classes or strategies being included in portfolios.

The last month of the year was more reassuring for diversification. During December, even though the equity markets showed poor performance from equity markets we saw better performance (and diversification) from fixed income markets, and in particular government bonds. We also saw some of the newer strategies – alternative beta, for example, which has had a terrible year – begin to produce actual positive performance, and begin to contribute to their stated diversifying objective.

This thought, then, is more focused on trying to make sure we ***don't*** do something. 2018 was an odd year but we have no particular reason to believe 2019 will be similarly strange. A well-diversified portfolio remains the best approach to building good investment outcomes, and the traditional behavior of asset classes is a good starting point for thinking about the roles those asset classes should play in portfolios. Just because most of the rules turned out not to apply in 2018 doesn't mean they have gone away. Continuing to use hedge funds where appropriate within major asset classes can help. Continuing to fund private markets exposures can help. Continuing to focus on the diversifying role of bonds, and in particular government bonds, can also help. Diversification does work: just not always, and sometimes painfully.

Europe: Better off out?

Brexit will be an even bigger topic during 2019, as we move towards Britain's exit date[9]. Most political and market commentators were, at the time of the referendum, anti-Brexit, and that view has generally remained unchanged, affecting both ongoing coverage and some of the short-term price volatility. This has resulted in very few serious public attempts to engage in serious and dispassionate analysis of the benefits as well as the detriments of the UK leaving the EU. This is particularly odd as most of the dire economic forecasts generated by the "Remain" campaign have been dismal failures, even by the poor standards of the economic forecasting community. In fact the UK economy has been doing relatively well, in particular when compared to some of its peers in the European Union.

When we take a step back and try to think more dispassionately about the issues, a different picture emerges. There will be both gains and losses from Brexit. Less immigration from Europe will likely be balanced by easier movement from the U.S., India, Australia, Pakistan, Canada and other countries with historically strong links to the UK. Some business will likely shift to accommodate the UK being outside the protectionist area of the EU, but for most UK firms much of their business is either done domestically or with non-EU countries, and this business will likely be benefited by more tailored regulation[10]. There will be downsides to Brexit, whatever shape it takes, but there will also be upsides, and yet current market pricing and behavior seems to be putting little focus on the good and exaggerating the bad. That may present an investment opportunity, particularly for non-consensus active managers.

The other side of the story is the likely conditions in the broader EU over the next year. The EU Commission has been trying hard to bounce the UK into remaining and there only now seems to be a recognition that the UK may, in fact, actually leave. The economic effect of losing a major financial contributor will be fairly sizable, but the challenges to the EU of a successful Brexit go broader. The EU without the UK has greater power centralized with France and Germany, and the perception that there is one law for them and one law for the rest of the members is likely to increase. The latest example is the differential treatment of France and Italy relative to budget deficits. The loss of the loud voice for lower regulation that has historically come from the UK will also shift the center of gravity of discussion towards more highly regulated approaches. The economic problems of the periphery are large, and not simply confined to the periphery (Italy is not Greece), while even Germany faces increasing economic issues and rising political instability. The European Central Bank has structural restrictions on its activity and is less well positioned to deal with any additional crisis within the Eurozone.

Despite this range of problems, investors have focused on the value to be found in Europe and spent little time looking both at the negative impact of Brexit on risk premia in the other parts of Europe. The contrast between this ostensibly rosy picture, and the ostensibly negative picture for the UK is interesting, and bears watching during 2019.

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9. *And the best assumption remains that an exit is indeed expected. Not only would the machinations required to stop Brexit be complicated to achieve, they would represent a major breach of political trust by Parliament, and would be likely to precipitate a much bigger political crisis than we have seen in a long time.*
10. *Which will no doubt take time to implement. Costs are likely to materialize quickly with benefits accruing over time.*

China: Yes, it really matters

This topic is simple. China represents a large part of global GDP, and an even larger part of global GDP growth[11]. The Chinese equity market is slowly becoming available to external investors, and the Chinese government has strong and clear incentives to provide a steadily increasing standard of living to the ordinary Chinese citizen.

China is not merely an economic power. The non-economic elements of the path China chooses will be increasingly important over the next few years. It is unclear whether the trade discussions currently under way with the U.S. are in fact just trade discussions, or whether they are really a small part of a much bigger and more complicated and aggressive dialogue. If the latter description is more accurate it is likely so because of the actions, beliefs and goals of both sides. If we are in fact in the process of a tussle for hegemony, at least in the Pacific, this has implications for any trade deal reached in the next year. A short-term market bump could be expected on the announcement of a deal, but if the underlying issues remain, more problems would shortly appear.

The key action required here is to spend time better understanding the implications of China on the globe. In part, this is just to gather better context for understanding the talking heads. Understanding of any issue must come from a basis of knowledge, and the average foreign investor likely has little real knowledge about China in an historical and political context. This can lead to over-simplification and incorrect assumptions about the goals and intentions of the leadership and the people – at worst perhaps behaving as though China and the Chinese are like the U.S. and Americans, and basing conclusions about China on knowledge of the U.S.

The solution to this problem is reading[12]– lots and lots of reading . Investors need to become much more familiar with the history, culture and the body of knowledge that informs Chinese leaders. We should all try to form a meaningful opinion about how those leaders, and the economy and country they lead, are likely to behave. Investors who have more than a passing familiarity with the last 3,000 years of Chinese history and culture have a greater chance of knowing in what circumstances it may be necessary to call a deer a horse[13].

Focus: On what works

This final thought is, I suspect, going to be one of the most useful ones during the year: investors should spend their time focusing on the parts of the portfolio process where they can add value, rather than spending time and energy trying to do things that can't be done. That is particularly important in volatile markets such as we have seen in December, which can create the temptation to move the portfolio in reaction to big price changes.

11. *According to World Bank data, as of the end of 2017, China accounted for 15.2% of global GDP and 22.1% of global GDP growth in 2017.*
12. *This is something that will take time. Think about the amount of time during your life that you have spent absorbing directly through reading or indirectly through TV, film, and conversation about the history and culture of the USA and Europe. We all need to catch up, if not to the same level at least part way. My bookshelf of China-focused books grew a lot over Christmas.*
13. *Those interested to know when this might be the case should Google the interesting, if blood-stained, career of Zhao Gao, who served all three of the emperors of the Qin dynasty and who met an appropriately grisly end.*

The reality is that successful institutional investment is not best delivered by rapid frantic action, reacting to every piece of news with a portfolio change. There are portfolio managers with short time-frames who can be relied upon to focus on very short-term mis-pricings: they will keep doing that, typically in a hedge fund format, and will live or die by the results they achieve. That is not the role that fiduciaries should be playing, and in non-discretionary portfolios we would strongly discourage that type of market timing behavior. Even in discretionary portfolios, where our ability to react to news is much greater, Verus is careful not to chase after shadows. Day-to-day market timing is hard – and not realistically an achievable proposition at the total portfolio level for institutional portfolios. It falls into the category of things you ***can't*** do.

What ***can*** investors do? In most governance frameworks, institutional investors have relatively constrained reaction ability. What matters in those situations is ensuring risk and return goals are clear and adhered to, that the asset allocation matches the long-term goals of the portfolio, and that active risk is allocated where it can do the most good. In delegated-discretion scenarios, such as Verus OCIO, our portfolio management team can be more proactive, with daily discussion of market activity, monthly full reassessment of opportunities and positioning, and flexibility to adjust exposures where we find there is a real dislocation. But even in discretionary portfolios we try to focus on the major calls, rather than day-to-day market ephemera. Getting those big calls right can deliver good outcomes, while trying to market-time short-term volatility is unlikely to do so.

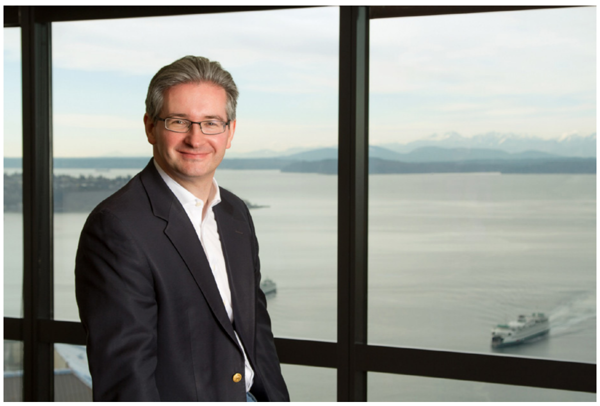
The key point is the same, though, whatever role you play: remember that most of the value creation in the investment process comes from making big decisions well, then implementing those decisions efficiently. Getting distracted by other things is more likely to hurt than help – and we all owe it to those who rely on us to stay on target.

Conclusions

As you can see, this list covers only a few of the many topics that will likely be important over the year. Despite that, though, I think many of these issues will be worth spending time on over the next few months (and, in some cases, years). As is always the case with these pieces, this is designed to be the start of a conversation – not the end of one. I very much look forward to hearing feedback from you, directly or through your consultant, as to where you think this list is on target, and what your views are on the topics outlined above. Best wishes for a happy and prosperous 2019 from all of us at Verus!

ABOUT THE AUTHOR

Mr. Toner has a degree in Law from the University of Oxford in the United Kingdom and is a CFA charter holder (Chartered Financial Analyst). He is a regular author and speaker on a range of investment topics. He is also a member of the CFA Institute and the CFA Society of Seattle. Mr. Toner is a trustee of Charles Wright Academy, an independent co-educational school based in University Place, WA, where he also chairs the endowment committee. He is a member of the Audit / Finance Committee of The Medina Foundation in Seattle. Mr. Toner is also a board member at the Seattle Metropolitan Chamber of Commerce, where he co-chairs the finance & audit committee. He has been happily married to his wife, Heather, for nearly 25 years, and is the proud father of two children.



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