This special advertising supplement is not created, written or produced by the editors of Pensions & Investments and does not represent the views or opinions of the publication or its parent company, Crain Communications Inc.
The U.S. presidential election is over, but the investment repercussions continue to confirm and confound expectations.

“We always thought that a Trump win would not be bad for financial markets and the economy,” said Jean-René Adam, co-chief investment officer of Hexavest. “But we thought the market was expecting a nightmare. Consequently, we’ve been surprised by the quickness of the recovery of the stock market.”

It seems that many equity investors think that a Trump presidency is the best-ever news, which is a bit of a U-turn from the pre-election zeitgeist. Yet managers point to the same effect after Brexit, albeit over a longer period of time. “We aren’t surprised at the reaction because the Trump business-friendly policies will increase near-term cash flows for companies,” said Adrian Helfert, Head of Global Fixed Income at Amundi Smith Breeden. “Of course, the actual policies that will be implemented and their medium and longer term impact remain uncertain.”

In the bond markets, the effect has not been nearly as benign. But bond managers were already on alert for increased volatility and changes in central bank behavior. Indeed, the theme of divergent monetary policy runs through the strategies of many bond investors. “In the U.S., monetary policy is running out of road,” said Quentin Fitzsimmons, senior fixed-income fund manager at T. Rowe Price. “However, the Trump victory and the alignment of the Senate and the House of Representatives significantly increases the prospect of a looser fiscal stance in the U.S., and that could reduce the burden on monetary policy.”

Observers see little sign that bond markets are discounting the potential for a kick-start to higher growth. There is a possibility that fiscal easing could appear just as inflationary pressures begin to bite. One place this effect would surface is in bond yields, which have risen sharply in the wake of the election, perhaps presaging the end of the long global bull market in bonds.

Investment managers are exercising a degree of caution, though. “The kneejerk reactions have already occurred,” said Rupal Bhansali, chief investment officer for global equities at Ariel Investments. “If anything, in the medium term, more reversals could occur, as despite the Republican majority in Congress, Trump is an outsider without any allegiances or obligations to side with his own party on all issues.”

Global investors are already aware that bond markets in the future won’t be the same as in the past. There is a marked divergence in yield curves between countries that are following stimulative monetary policy and those operating more restrictive ones.

T. Rowe Price’s Fitzsimmons drew attention to the interplay between the activities of the European Central Bank and the Bank of Japan, which anchor that divergence. “It has the potential to increase volatility and place U.S. dollar strength at the center of most financial calculations,” he said.

Changing central bank policies send some managers toward safety, namely gold.
“We are bullish on gold in the long term,” Hexavest’s Adam said. “We were overweight gold stocks for most of the year but we sold our holdings in the summer because of a hype in sentiment and high valuation. We expect to go back there at some point as we see it as the best hedge against central banks — and we don’t think they are done with unconventional monetary policy.”

“What investors really need to be cognizant of is regime change in central bank behavior,” added Amundi’s Helfert. “The ECB and the Federal Reserve may shift from pushing down long interest rates to thinking that because this is negatively impacting financials, perhaps they should let these rates rise a bit to drive the economy via credit growth.”

NEW REALITY

Others suggest that another shoe is yet to drop. “We think investors have only priced in the positive aspects of the Trump victory, not the negatives,” Adam said. Specifically, Trump’s approach to trade may mean not just potentially positive outcomes for U.S. investors, but may also result in retaliation. A trade war has inflationary implications and also creates the possibility of stagflation. Cutting taxes and increasing spending will result in fiscal stimulus, but may also increase the deficit. It isn’t yet clear what the reality of a Trump administration will be.

It’s also important to consider equity valuations and their relationship to what is happening in the economy.

“The stock market has had a strong performance,” Adam said, “but there has been no earnings growth globally over the last three years. That means that there is a disconnect between equity and the fundamental.”

While all managers acknowledge that equity valuations are high, higher than any point in the last six years, “what really matters are the fundamentals of the individual businesses you’re investing in,” said James Hamel, portfolio manager for growth strategies at Artisan Partners. He suggested that fundamentals still make sense, even if many stocks aren’t as cheap as they used to be.

Many equity investors are moving away from developed markets in their search for upside potential. Looking across developed markets, managers find it hard to find much that is attractive not only in U.S. equities — which are the most overvalued — but also in European or Japanese stocks. Even though there was a brief opportunity to buy U.K. businesses quite cheaply in the three days after Brexit, that window wasn’t open for long.

But emerging markets are cheap, said Adam at Hexavest, particularly some of the more developed ones that are integrating with the global economy. He pointed to the fact that while the MSCI Emerging Markets index is trading at close to 12 times 2017 earnings — in line with historical valuations — it’s still trading at a 30% discount to the MSCI EAFE, down from its typical 15% discount.

DOWN THE CURVE

Fixed-income investors are also increasingly interested in emerging markets, which have traditionally been engines of growth yet sources of risk in portfolios.
“We see investors pushing further down the path beyond traditional hard currency bonds in emerging markets,” Amundi’s Helfert said. That includes emerging market corporate debt and local currency sovereign debt in certain countries. All emerging market debt segments offer opportunity, though only those investors with an appetite for liquidity risk and currency exposure will choose the local currency option. And not all emerging market countries are equally attractive.

“Country choice is very idiosyncratic,” said Kenneth Mongaghan, Head of Global High Yield at Amundi Smith Breeden. “It can be much like high yield. We look for those that have sought a transition to a consumption-led economy, while considering the degree to which the economy is dependent on commodities such as oil, how exposed it is to private sector leverage and how dependent it is to external capital.” In general, emerging market economies are operating with less external capital.

“We see an improving curve in emerging market debt,” added T. Rowe Price’s Fitzsimmons. “Countries that have had to strive to prove themselves now have to be crystal clear and robust about their institutional frameworks, independent judiciaries and central banks. So we are seeing moderate upgrades to the debt in some countries — Brazil, South Africa — and that is fueling our interest.”

Fitzsimmons said investors need to be tactical about when to time an increase in emerging market debt allocations, but he believes there’s a long-term argument for an increased structural commitment to this part of the bond market.

That said, some managers continue to steer clear of emerging markets.

“The five-C bubble in emerging markets has not fully unwound,” said Ariel’s Bhansali. “The five Cs are: commodity bubble, credit bubble, construction bubble, consumption bubble and a currency bubble.”

She pointed to credit concerns in Turkey, India and South Africa, and said that although consumption bubbles have started to correct in Brazil, less headway has been made in India, China and South Africa.

“The five-C bubble was 15 years in the making — starting in the late 1990s — and we’re only five years into the unwind,” Bhansali said. “I see a significant risk of a correction in emerging markets starting with EM sovereign bonds.”

Currency too is having a moment, as managers report investor interest in the U.S. at least in an additional sleeve of currency, or as a stand-alone asset class. Again, this idea is a bit of a play around divergent monetary policies, which throw up both tactical and strategic opportunities in developed market currencies.

Global interest rates still pose a problem for investors, even when there may be opportunity in trading currency pairs, for example.

“What is the endgame for the global interest-rate environment?” asked Artisan’s Hamel. “It seems like a race to the bottom. I don’t know how we undo this gracefully without there being an accident along the way.”

When thinking about accidents or market turmoil, many investors focus on volatility, which has been at his-
it was a record bounce back. It didn’t take global equity markets even one day to plunge and rebound after the surprise result of the November U.S. presidential election. Yet few equity managers are completely sanguine about prospects for the future.

“We prefer to wait for actual policy decisions instead of speculating on them,” said Rupal Bhansali, chief investment officer at Ariel Investments, explaining why her firm has made no changes to its investment strategies. “We are taking a wait-and-see approach.”

At Hexavest, co-chief investment officer Jean-René Adam explained that the Trump election confirmed that the anti-establishment movement is gaining momentum globally, which doesn’t bode well for upcoming European elections and referendums. He increased an underweight position in the euro versus the U.S. dollar in anticipation of these elections, but has made no other major changes.

Equity investors marvel at the market’s benign reaction to the election and continue to maintain allocations and strategies.

A Rosy Future for Stocks?
Even though global equity markets look much as they did before the election, the unease about growth, interest rates and monetary policy remains and can be seen most obviously in the more jittery performance of emerging market stock markets.

KEENLY VALUED

Still, with U.S. equities keenly valued, many managers are focused on emerging markets. “We have a strong conviction about emerging market stocks,” Adam said. “As a group, their economies are growing at about 3% a year; that’s less than the 7% we saw several years ago. But it’s way better than developed economies.” He pointed to markets such as South Korea and Poland as particularly attractive, and has some interest in Mexico, though he’s holding off on that pick until the Trump effect is better known.

Artisan Partners is looking for companies that are positioned to benefit from accelerating profit cycles. “Emerging markets are a fertile area for finding businesses with both competitive advantage and specific risks, such as potential sovereign interference, illiquidity and currency risks,” explained James Hamel, portfolio manager for growth strategies at the Milwaukee, Wis.-based firm.

He too sees opportunity in South Korea, specifically in the cosmetic company AmorePacific, which sells both in freestanding retail outlets and online. “They derive considerable revenue from China,” Hamel said. “This is a play on a growing female middle-class demographic.” He also invests in Tencent, the internet company that appears to have a lock on China, where Facebook and Google are largely unavailable.

Ariel’s Bhansali is looking for investment ideas where no one else is looking. “France is viewed as a socialist country with poor economic and fiscal policies and a poor macroeconomic backdrop,” she said. Yet the country boasts a number of successful high-tech, high-value-added industries such as aerospace defense and security.

SECULAR GROWTH PROSPECTS

Ariel has two such companies on its buy list: Gemalto, in security, and Safran, a leader in aerospace defense. “Both have strong secular growth prospects and trade on low, mid-teens multiples while generating lots of cash,” Bhansali said. “They are examples of overlooked companies that are right under many investors’ noses.”

Some managers see opportunity in Japan. “There is more upside in Japanese equities certainly than in U.S. stocks,” Hexavest’s Adam said.

“Japan is cheaper, and for good reason,” Artisan’s Hamel said. “They haven’t been able to get out of their own way.” The country has been trying to manufacture inflation unsuccessfully for over two decades. Investors don’t believe that the promised growth will arrive, so the market is one of the cheaper developed economies in the world, he explained.

Hamel owns a number of familiar Japanese names — Nintendo and Shiseido — but also unfamiliar ones such as Lion Corp., a midcap consumer oral care company. “It has a wonderful opportunity to double or triple margins with just a little bit of growth,” he said.

Beyond Japan, Artisan focuses on specific investment themes, two of which are health care innovation and industrial process innovation, which includes companies in the fields of automation and robotics.

“Robots will be needed to keep up with the demands of consumption as the world’s population of productive workers just can’t keep up,” Hamel said. He cited Harmonic Drive, a Japanese company that makes sophisticated low tolerance gear reducers that are components in robots.

“Over the last three years, it’s really paid to focus on companies that are bringing truly novel drugs and solutions to the health care market,” he added. “For us, that means a narrow group of innovative companies founded on real science, such as Generon, Dexcom or Boston Scientific.”

WEAK GLOBAL ECONOMY

It’s just as important to know what not to buy.

“We’re highly bearish on energy stocks,” Hexavest’s Adam said. With the price of oil sticking at or below $50 a barrel, he doesn’t think U.S. production will increase materially, and with a weak global economy, demand is likely to stay low. That said, some stock prices are still as high as when the oil prices were at $100 a barrel.

A growing trend across equity markets is low-volatility investing, which has some managers on alert.

“We see lots of assets going into low vol, and that area is getting crowded,” Adam said. “Those stocks that meet low-vol criteria are becoming very expensive these days.”

Low vol is part of a clearly identifiable trend away from pure active investing, and it’s a trend that active managers see picking up speed.

“Active investors need to demonstrate that they are providing value for stakeholders,” said Hamel at Artisan Partners. “Otherwise you won’t be able to demonstrate the ability to earn your fees.”

Weighing the pros and cons of passive versus active investing also requires investors to make long-term decisions about market behavior. “When markets don’t offer very easy upside opportunities, investors start thinking again about active investing, where skill matters,” Ariel’s Bhansali said. “Good active investors can generate positive returns even in markets with a very negative macroeconomic backdrop.”

She cited the example of Toyota, characterizing the company as a phoenix that has risen from the ashes of the Japanese economy which suffered from the triple macro shocks of a weak global economy, the Tsunami and an appreciating yen in 2012. Bad news can present good investment opportunities, instead of being a threat.

“Emerging markets are a fertile area for finding businesses with both competitive advantage and specific risks, such as potential sovereign interference, illiquidity and currency risks”

James Hamel

portfolio manager, Artisan Partners
A Complicated Picture in BONDS

Fixed-income investors still seek yield but wonder about increased volatility and whether the credit cycle will extend

What’s a bond investor to do? It’s been years since interest rates provided enough return to help investors meet their objectives. Indeed, in some markets negative yields are real, not a mythical situation.

That said, global fixed-income investors can find opportunities — in certain markets — by employing more opportunistic and flexible investment approaches. But Quentin Fitzsimmons, senior fixed-income fund manager at T. Rowe Price, cautioned investors to remember the traditional function of bonds.

“Fixed income’s role in a portfolio is to achieve a certain degree of return by way of a steady income, but also to ensure a degree of capital preservation, stability and provide a degree of diversification against riskier asset classes,” he said.

Bond management has become muddled. On one hand, it is still the ballast of the portfolio and on the other, investors are chasing yield. Neither approach is wrong or even inappropriate. It’s just that investors can’t do both at the same time.

TIGHTER CORRELATIONS

“If you want to anchor your portfolio,” Fitzsimmons said, “then you’ll need to look at the higher-quality part of the market. If you are chasing yield, then you will need to be prepared to weather tighter correlations with riskier assets like stocks.”

For investors with an appetite for more equity-like risk, though, high yield continues to be fruitful.

“The energy and metals and mining spaces have come back some, but have different drivers to the rest of the high-yield sector,” said Adrian Heifert, Head of Global Fixed Income at Amundi Smith Breeden. “Because of this, bond selection makes a huge difference. Active fixed income allows investors to access spread over risk-free yields rather than simply thinking about straightforward yield and duration metrics.”

This focus on relative value is clear in Amundi’s approach to emerging markets. “We don’t see a high-growth environment for emerging markets,” said Heifert. “The pace of growth will be lower in future. But the differential between emerging and developed markets is widening and, as long is the growth pace remains fairly stable, that will help drive emerging market valuations going forward.”

With the reminder about the role of bonds in the portfolio in mind, the good news is that the arena of higher-quality bonds is growing. “We’re seeing a tremendous amount of rerating of countries such as Hungary, Croatia, Serbia, Malaysia,” Fitzsimmons said. “These markets are moving toward the safer end of the spectrum and that gives investors more choice.”

STABLE SPECTRUM

Although they’re safer, these markets are on the edge of the more stable spectrum and could be buffeted by significant macroeconomic events. The domestic financial improvement in these markets will also reduce the long-term risk premia here.

CONTINUED ON PAGE 12
“We see both the U.S. high yield and investment grade markets as modestly tighter than the median spread for the last 20 years,” said Kenneth Monaghan, Head of Global High Yield at Amundi Smith Breeden. “But overseas, European high yield is trading at significantly tighter spreads than historic average.”

Amundi sees more upside as US spreads can tighten further. And that will be music to the ears of the investors who Monaghan said have been asking to take on more risk by traveling down the credit spectrum.

He refers to these investors as “tourists in our markets. These are investors taking levels of credit risk, emerging market risk or currency risk that they may not have previously been willing to do, but now have to out of necessity.”

As the prospect of significant increases in government bond yields look unlikely for at least the medium term, Monaghan suggested that it’s possible some of the tourists will become permanent residents.

MARKET CONFIDENCE

Of course one of the major overhangs in the fixed-income market is the prospect of a rise in U.S. interest rates.

“I don’t think we can be complacent about what the effects of an even small increase in interest rates are going to do to market confidence,” said T. Rowe Price’s Fitzsimmons.

Rising oil prices are another risk for fixed-income investors, though few managers see this as a realistic prospect. That leaves rising interest rates and a consequent strengthening of the U.S. dollar as the big risks.

“We’re in a moderately defensive position,” Fitzsimmons said. “We’re very focused on capital preservation and on not taking undue duration risk. A secondary issue is the potential political play-off between monetary and fiscal policy, alongside the continued focus on a changing political landscape.”

The reason that some of the current dynamics may not change rapidly is the global savings glut. “This still helps keep yields reasonably low,” said Helfert. “A sustainable large shift in global yield curves will likely wait until investors see the whites of the eyes of increasing nominal GDP growth. And I don’t see the whites of the eyes of increasing GDP growth yet.”

That’s one reason that Amundi Smith Breeden has a truly global duration stance, with a negative position in U.S. duration. “We actively look to offset negative duration positions with positive exposure in areas where yields may decline further and thus bond prices rise,” he said. It also means that he is looking for global alternatives with higher yields, a search that has led to Australia.

Monaghan, also at Amundi Smith Breeden, said he sees securitized credit as an area ripe for adding to portfolios. It’s a credit play involving bonds that have improved significantly in terms of credit quality, he explained.

“Many investors ascribe a higher premia to these bonds than perhaps they should, given some of the travails of the past,” Monaghan said. It’s outside the mainstream but interesting for investors seeking returns similar to high yield.

SKewed DOWNside

“At this point in the cycle, investors should consider global fixed income, like securitized credit, emerging markets and high yield because of this environment of lower global growth expectations” added Helfert. “The return profile is skewed more to the downside for equity investors than those with protection, i.e., high yield emerging market investors.”

For all bond investors, the key worry is that central bank monetary policy will no longer be effective. If central banks no longer occupy this important role within the financial and economic markets, fixed-income investing will undoubtedly become even more challenging.

“If you are chasing yield, then you will need to be prepared to weather tighter correlations with riskier assets like stocks.”

Quentin Fitzsimmons
senior fixed-income fund manager, T. Rowe Price
It’s no surprise to find, after years of quantitative easing and interest rates that have sometimes dropped below zero, that there’s been a lot of borrowing going on. The problem is that it is beginning to look like an addiction — one that could require a painful detox.

Before the financial crisis, consumers were the ones borrowing excessively. Today, according to Rupal Bhansali, chief investment officer for global equities at Ariel Investments, “the consumer has deleveraged, but corporates and governments have gone on a borrowing binge.”

Many investors assess indebtedness using a debt-service ratio. Bhansali said this approach is misguided as the ratio simply represents interest coverage.

“When interest rates fall, debt-service ratios improve,” she explained. “But at some point, you have to pay back the principal. Because so many companies and governments have borrowed so much, it leaves them very little headroom if things go awry on the macroeconomic front.”

Managers worry that while consumers aren’t borrowing, corporates and governments are now highly levered.
Given global government indebtedness — the U.S. and the U.K. are running budget deficits of 3% to 4% of GDP — an economic shock could be very difficult. And that shock could come from a change in monetary policy.

“The question for the investor is what happens when you de-emphasize monetary policy, as may happen in the U.S., and reemphasize fiscal policy,” said Quentin Fitzsimmons, senior fixed-income fund manager at T. Rowe Price.

**INFLUX OF CAPITAL**

From a purely practical perspective, the growing indebtedness makes the global economy even more sensitive to interest-rate changes.

“Let’s say global rates rise,” said Jean-René Adam, co-chief investment officer of Hexavest. “The economy will slow, but it will also attract foreign investors looking for yield. But if rates rise across a number of countries, that will be uncomfortable, as economies will slow without an influx of capital.”

Should current central bank policies become ineffective, added Adrian Helfert, Head of Global Fixed Income at Amundi Smith Breeden, “and we experience an exogenous difficulty or a geopolitical event, a closing of financial conditions could happen very, very rapidly, creating a negative feedback loop.”

He suggested that some geopolitical risks in Eastern Europe, related to Russia seeking to rebalance its sphere of influence, have been underappreciated.

“Perhaps governments can grow themselves out of the leverage they have taken on,” said James Hamel, portfolio manager for growth strategies at Artisan Partners. “We have an entire generation that believes zero to 2% interest rates are the norm. I’m concerned that this could have the effect of inappropriately allocating capital that should be risk-based.”

**DELEVERAGING IS PAINFUL BUT NECESSARY**

Bhansali pointed to Japan as an example of how painful yet necessary deleveraging is. It took 15 years for Japan’s corporations to deleverage while also enduring deflation. “Debt and deflation are a deadly cocktail,” she said.

Today, though, Japanese corporates have healthy balance sheets and are able to compete in the global marketplace. “They have control of their own destiny because of the self-help actions that they took,” Bhansali explained. “Companies in the Anglo-Saxon world need to learn that lesson. Many are convinced that they are fine if their debt-service ratios are comfortable.”

“Equity investors don’t charge a higher risk premium to indebted companies, even though they are more risky,” she said. “And at the same time, they don’t give any credit to net cash companies. We take advantage of this anomaly by biasing our portfolio toward net cash companies, especially since we don’t have to pay up for them.”

“Debt and deflation are a deadly cocktail.”

Rupal Bhansali
chief investment officer, Ariel Investments