Weekly Manager Views – 19 November 2014

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Interest Rates and Currencies

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- Our view remains that the currency asset class offers some of the best opportunities on a 12 month view. For a long only investor, we believe fixed income and credit offer limited upside, and equity valuations are not as attractive as they have been.
- One of our main trades this year, and one that has been profitable for us, is the long US dollar position against several currencies. Our 12–18 month view is that the US dollar will continue to strengthen, particularly against the euro. However, in the short term, US dollar positioning has become quite stretched. That said, many investors are worried about the crowded nature of the trade so this is not news to anyone involved in currency markets. However, given current positioning, we would not be surprised if the dollar weakened marginally in the near term. Hence, we have reduced our US dollar exposure. We want to be in a position to add on weakness.
- On a longer-term view, the US dollar has only recently begun to make its move closer towards 'fair value', and has much further to run. To illustrate this, we can look at the movement of the broad real trade-weighted US dollar, which adjusts for relative inflation in the countries the US trades with. On this basis, the recent dollar strengthening has been relatively modest. Support for the view that the dollar may still be in the relatively early stages of a more significant move comes from both equity and bond markets. The Dow Jones index has outperformed the EuroStoxx index by around 60% over the past five years. Over the past three years, German government bond (Bund) yields have dropped 170 bps relative to US Treasuries. Until 3–4 months ago, EUR / USD was still around its five-year average. The reasons the US dollar has taken a long time to start appreciating more meaningfully and has lagged developments in equities and bonds has, we believe, been due to the various headwinds it faced in the form of quantitative easing in the US, Mario Draghi's "whatever it takes" speech (which reduced the risk premium of euro assets) and poor weather in the US earlier this year (which led to investors questioning the US recovery).
- Many countries are hoping for further US dollar strengthening as the dollar move is helping to rebalance the global economy. It is worth noting that the governments of New Zealand, Korea, Israel and the Czech Republic all intervened to weaken their respective currencies when the dollar was too weak, prior to the recent rally.
- In terms of other currencies, we continue to be optimistic on Norway. The Norwegian krone has depreciated in recent weeks following the fall in the oil price, but we expect a reversal and have taken advantage of current weakness to add to our positions. The Mexican peso has weakened against the US dollar, but we have managed to structure trades to take advantage of Mexican peso strength against other currencies. Specifically, we have been long the Mexican peso against the New Zealand dollar, Swedish krona, Israeli shekel and Polish zloty. These trades have contributed 2.8% to performance year-to-date for GAM Star Global Rates. We will continue to trade the Mexican peso in the forthcoming months. We are currently cautious on, and therefore short, sterling, the euro, Canadian dollar, Korean won and Polish zloty.
- For much of this year, we have been running short positions in the yen, constituting approximately 15% of the fund. When USD / JPY reached 109 in October, we felt it had moved enough and we closed most of the position. Following this, the rate fell to 105.5 and we considered when to re-establish the position. However, shortly after the Bank of Japan announced a further round of QE and the yen fell significantly (USD / JPY reached 118). Unfortunately, we had not re-established the position to take advantage of the rapid yen depreciation. These yen moves highlight the dangers of trying to be too tactical in the face of a powerful medium-term story. We want to avoid this situation with our more general bullish dollar view.
- The strength of the South Korean won has impacted negatively on the profits of large Korean exporters, including Hyundai, whose share price has fallen considerably compared to its Japanese rival, Toyota. The Korean government may intervene but we believe it will first wait to see how the economy plays out. For example, inflation in Korea has been on a downward trajectory and is now just above 1%, and some of the recent economic indicators have been soft. If economic data continues to soften, there will be more impetus for the government to try to weaken the won.
- On interest rates, we retain a small bearish bias. If we review the last five US rate hike cycles, the market has typically underestimated, by approximately 1%, the extent to which the Fed needs to hike interest rates. Based on our view, we have established some small front-end yield curve steepener and short positions in the US, which we may add to in the future. In the UK, we believe the yield curve has flattened too much and we have therefore placed steepening positions, both outright and against other markets. We do not have significant exposure to emerging market rates. As the US economy strengthens and quantitative easing by the Fed comes to an end, we are being selective in terms of opportunities. Our favoured trade continues to be forward-starting swaps in Mexico, both outright and against the US.
- We are currently monitoring movements in German Bunds and US Treasuries, following the large increase in spread between Bunds against Treasuries over the last three years. Given these extreme levels, going long US Treasuries versus Bunds is optically attractive, but we believe that given the divergence in the respective economies it is still too early for this trade. We would wish to see further euro weakness and the subsequent impact of activity before entering this trade in a meaningful way.

Past performance is not indicative of future performance. Performance is provided net of fees.

Discretionary Fund Management

Charles Hepworth
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GAM Star Global Equity, GAM Star Growth, GAM Star Balanced, GAM Star Cautious, GAM Star Defensive

- Following the outperformance of our five risk-rated strategies in 2013, this year has proved more difficult, with the models typically trading 1–2% behind their respective IMA averages for the year to-date. GAM Star Global Equity has the largest performance differential, but the peer group is quite esoteric, spanning long only global technology funds to global smaller company funds, and holds a number of exposures that we do not include in the fund's portfolio – hence the apparent discrepancy.
- Looking at the underlying allocations across all our models, we remain positioned with a marginal underweight to UK equities. This has proved the correct allocation decision, as the UK market has not moved materially ahead this year, while displaying elevated volatility. This is despite earnings coming in modestly ahead of expectations throughout the year.
- We view US valuations as reasonably stretched. Our US managers have not performed as we would have expected them to this year, and our modest underweight position has also detracted. While we see pockets of value in the US, implementing broad-brush asset allocations, using, for example ETFs, which attempt to replicate the entire index, are unlikely to continue to do as well in 2015 as they have done this year.
- European equities have also proved a detractor for us this year, although one of our managers is currently rebounding strongly from the intra-month October decline, which is helping to close the underperformance gap. We are currently positioned overweight Europe on valuation grounds and are looking for other promising managers within the sector for inclusion in our line-up.
- On Japan, our currency-hedged overweight position has been very beneficial for performance this year, rebounding strongly from the market's April lows. In Asia, following the spring rotation, our managers have broadly tracked the market recovery, although overall fund selection has been negative. Our overweight position in the region has helped to balance the negative impact.
- One of our leading positions over the year has been the emerging markets. However, the region has not bounced back from the September / October decline as strongly as developed markets, raising doubts about whether the market could recover. At current levels, we are considering trimming our exposure and reducing our overweight.
- Looking at the global equity basket, our managers have underperformed this year to varying degrees compared to the broad MSCI World index. Our specialist technology manager suffered during the sector rotation of April / May, but has since been making progress in recouping performance.
- We are positioned overweight to absolute return compared to our peer group. Returns across the manager spectrum have been mixed but overall flat to negative on the year. One of our stronger managers suffered a significant loss in October, but has bounced back swiftly as the long Nikkei positions within the fund rallied strongly following the extension of QE by the Bank of Japan. The fund has a higher level of volatility than we would typically tolerate, but the strong performance coming from the Japanese exposures currently justifies its inclusion.
- In fixed income, fund selection has proved positive for us. We have sold out of a government bond manager following a number of departures in the team and as their short, short-dated positions proved a continuous drag on performance. We hold both local currency and dollar-denominated emerging market debt managers in the book. Currently, the hard currency manager is proving the stronger performer as one would expect from the rapid short-term appreciation of the US dollar. Our credit opportunities manager continues to deliver steady positive performance with low volatility. A recent addition to the book has been a US-based mortgage-backed securities manager, who brings an additional element of diversification to the line-up.
- Since March to-date, 10 out of the 26 managers on our books have outperformed. Looking since June, this increases to 11, and from October, 13 have outperformed. While this trend is positive, we are actively working to hone our line-up to deliver a significantly greater level of outperformance to our clients. Absolute return remains the proxy position for our underweight exposure to fixed income. Europe and Japan are our strongest regional overweights, representing markets where we see the most value.