HEALTH WEALTH CAREER

2018 THEMES AND OPPORTUNITIES

FROM QE TO QT

After almost a decade of monetary stimulus, the world's major central banks are starting to gradually pull back, led by the US Federal Reserve (the Fed). In response to low levels of unemployment and robust growth, the Fed recently announced a plan to gradually normalize its balance sheet over the coming years (referred to as quantitative tightening or QT). In November, the Bank of England (BoE) implemented its first rate hike since 2007 and the European Central Bank (ECB) has announced a reduction in the rate of asset purchases from January 2018. The pace and scale of the shift from quantitative easing (QE) to QT will be critically important for markets in 2018 and beyond.

PREPARING FOR LATE CYCLE DYNAMICS

The later stages of a credit cycle typically present a challenging environment for investors, offering lower returns and greater risks than the early or mid-cycle periods. Although we expect the current economic strength (evident across much of the global economy) to continue into 2018, we believe that investors should start considering the ways in which they might prepare portfolios for the risks and opportunities that the late stage of this credit cycle might present.

POLITICAL FRAGMENTATION

After 25 years of convergence toward the political center across the developed world, politics since the financial crisis have become increasingly divergent, with populists from both the left and the right of the political spectrum making significant advances. Symptoms of political fragmentation have manifested in the Brexit vote, elections across Europe, the election of Donald Trump and more recently in the Catalan bid for independence. Investors are likely to face an environment of heightened political uncertainty for some time.

STEWARDSHIP IN THE 21ST CENTURY

As the finance industry seeks to rebuild trust following the financial crisis, institutional investors increasingly need to recognize the importance of their role in acting as good stewards of the capital entrusted to them. This requires investors to have a clear set of beliefs in relation to environmental, social and corporate governance (ESG) issues as well as recognizing and managing systemic risks (such as climate change). An increasing number of investors will seek to reflect their values and to promote the social good when investing their assets.

Our investment themes are intended to highlight the forces that we believe will shape economic and market dynamics over the years ahead — some themes are focused on the next one to three years, whereas others would be expected to play out over the course of a decade or longer. We would therefore not expect our themes to change dramatically from one year to the next, but rather to evolve gradually to reflect important shifts in the investment landscape. Although we present them as discrete themes, in reality they are highly interdependent.

1 FROM QE TO QT

Against a strengthening economic backdrop, Janet Yellen[1] announced in September 2017 the Fed's intention to implement a gradual normalization of its balance sheet by slowly reducing the pace of reinvestment as assets mature.[2] This "unwinding" of the QE program will take place alongside a gradual normalization of interest rates. Other major central banks are also making tentative steps to withdraw stimulus as conditions improve — the ECB announced a downsizing of its asset purchase program and the BoE implemented its first rate hike since 2007. Having said that, the ECB and, in particular, the Bank of Japan (BoJ) are likely to remain in easing mode for some time, and central bankers will continue to adapt policy as conditions evolve.

We would therefore appear to be on the cusp of a shift in monetary policy — the end of an era in which central bank policy has been a significant tailwind for markets. The open question is whether and when policy might become an outright headwind for markets.

The implications of a gradual shift from easing to tightening will depend in large part on the speed and magnitude of central bank moves relative to market expectations (markets are currently discounting a very slow pace of policy normalization). Tightening policy at the appropriate pace is always challenging, as the taper tantrum in 2013 and the sell-off in early 2016 (following the Fed's first rate hike in December 2015) illustrated. However, so far central banks have navigated a challenging economic backdrop and managed investor expectations effectively. A shift away from QE need not end badly, but there is no historical precedent for unwinding an easing program of this magnitude, and assessing economic and market sensitivities to tighter conditions will be extremely difficult. We therefore expect a more volatile market environment than the unusual degree of stability that prevailed over 2017.

In light of this policy shift, we emphasize the following considerations:

- As central banks, led by the Fed, begin to reduce and unwind the scale of their bond buying programs, this is likely to place upward pressure on bond yields. This comes at a time when the sensitivity of assets to yield movements has increased.[3] From an absolute return perspective, floating rate assets or strategies with limited structural duration (such as private debt, absolute return fixed income or asset-backed securities) may be preferable to more traditional credit strategies that are tied to a benchmark.

1. Jerome Powell will take office as Chair of the Federal Reserve board when Janet Yellen's term expires in February 2018. Powell is widely expected to provide continuity with the existing approach to monetary policy, having voted with Yellen, and before that Bernanke, since he was appointed to the Fed board in 2012.
2. Starting in October 2017, the Fed will let up to US$10 billion of securities roll off the balance sheet each month by stopping reinvestment of maturing treasuries and mortgage backed securities. The scale of the roll-off will gradually increase over a period of 15 months, up to a level of US$400 billion per year. The balance sheet unwind is expected to take around five years.
3. This is a direct consequence of lower yields, since cash flows far in the future become a more important component of the present value of any asset when discounted at a lower rate.

- Equity markets will also be affected by the speed and scale of tightening, but the market impact might differ substantially across stocks and sectors. Defensive sectors and high yield stocks that have been treated by some investors as "bond proxies" could be particularly exposed to a rising yield environment. Although we continue to advocate equity portfolios with a diverse mix of style exposures, investors with a significant bias to low volatility equity (especially where this is captured via an index-based approach[4]) might wish to review the extent to which their equity portfolio is exposed to a rising yield environment.

- A gradual withdrawal of liquidity by central banks (following a period in which policy has been aggressively stimulative) may lead to increased bond market volatility, creating both risks and opportunities for investors. In particular, investors making use of leverage — for example, within pension scheme liability-hedging portfolios — should understand the impact that a sudden sharp rise in yields would have on collateral positions (especially if this leads to a sell-off in equities and credit at the same time). Conversely, oscillations in bond yields could create opportunities for investors utilizing trigger-based strategies.

- Equity and bond markets have delivered exceptional returns in the post-crisis period, while also benefiting from a diversification effect due to their negative correlation.[5] The shift toward a tightening bias threatens both of these characteristics on a forward-looking basis. Investors should be prepared for an environment of lower returns from equities and bonds as well as the possibility that the diversification effect could disappear, with equity and bond returns becoming positively correlated (as has been the case for long stretches in history). This is an important consideration for investors making use of leverage (for example, risk parity strategies) and suggests that portfolios dominated by passive equity and bond exposure offer an unattractive prospective risk/reward profile.

4. Active low volatility strategies are better-placed than naïve index strategies due to their ability to evolve their approach to take account of risks such as interest rate sensitivity.

5. In fact, equity and bond returns have exhibited a negative correlation for most of the period since the early 2000s. This reflects the fact that in an environment of low inflation, markets have been driven to a large extent by shifts in growth expectations. In periods of stronger than expected growth, equities have typically performed strongly and bonds have fallen, and vice versa — hence the negative correlation.

2 PREPARING FOR LATE CYCLE DYNAMICS

Credit cycles typically move through three distinct phases: (i) early cycle, in which risk premia are high but falling, risk appetite is low but rising and monetary policy is stimulative; (ii) mid-cycle, in which risk premia are moderate, risk appetite is recovering and monetary policy remains supportive; and (iii) late cycle, in which risk premia compress and risk appetite becomes excessive, before central banks tighten liquidity, causing risk premia to expand and risk appetite to fall.

We believe that the US is now approaching the late stage of the credit cycle, as the economy is growing strongly, unemployment is very low, credit spreads have hit pre-crisis lows, leverage is rising and equity markets are moving into expensive territory. Europe and Japan are more comfortably in the mid-cycle, whereas many emerging economies look to be at a relatively early stage in their credit cycles. The late-cycle environment tends to be a more challenging period for investment returns, so the extent to which the US starts to see inflationary pressures emerge — thus prompting more aggressive action from the Fed — will be an important factor over the course of 2018 and 2019.

As cyclical conditions evolve across the global economy, we believe the following issues warrant discussion:

- Investors should be wary of reaching for yield, especially in credit markets offering historically low levels of compensation for default risk. In particular, we view investment grade credit and high yield as unattractive, with current yields and spread levels offering relatively little upside. Similarly, investors should ensure that they are able to achieve a sufficient level of compensation for illiquidity and complexity when accessing less liquid parts of the credit markets. More generally, investors should ensure that the risks inherent within their strategy remain appropriate given their tolerance for risk.

- Reduced levels of liquidity in markets (driven to a large extent by post-crisis banking regulations) may increase the magnitude of any sell-off in markets, as illustrated by the Flash Crash in 2014 and the market falls in early 2016. In addition, an increasing volume of assets is now managed in a way that could increase “gap risk” in markets — the potential for large and sudden falls in asset prices in a short space of time.[6] In particular, risk parity, volatility control and trend-following strategies (as well as ETFs that provide "short volatility" exposure) could all amplify a market sell-off.[7] A reversal of retail flows into high yield exchange-traded funds under a spread-widening scenario might also contribute to instability in credit markets. As well as reinforcing the importance of stress-testing and appropriate position-sizing, periods of market stress may also create opportunities for investors who are willing and able to behave in a contrarian manner. This supports the case for flexible and dynamic strategies that may be able to capitalize on opportunities and provide some element of downside protection.

- If the monetary policy punchbowl is removed faster than expected and bond yields rise materially, companies that have been supported by ultra-loose policy may face challenges in refinancing their debt. A rise in default rates, while painful for existing credit portfolios, could create opportunities for strategies that are positioned to allocate capital to distressed assets. Long/short credit strategies, multi-strategy hedge funds and more adventurous multi-asset credit strategies may offer some exposure to such opportunities, as will distressed-oriented private debt and equity strategies for investors with a meaningful tolerance for illiquidity.

- Conversely, if central banks are able to reduce monetary stimulus without upsetting markets, emerging markets (both equity and debt) are likely to benefit from a combination of early cycle dynamics, relatively cheap currencies and strong global growth. Under our central scenario, we expect emerging market equities to outperform developed market equities, perhaps for some time.

6. The classic example of gapping markets is 19 October 1987 ("Black Monday"), when the Dow Jones Industrial Average fell by more than 20% in a single day. It has been argued that a key contributor to this event was the use of portfolio insurance strategies that mechanically sold equities when markets fell.

7. This is not to say that investors should avoid all such strategy types. We have had material concerns about volatility control strategies for some time but continue to believe that trend-following strategies make sense as part of a diversified hedge fund portfolio.

3 POLITICAL FRAGMENTATION

Over the period since the early 1980s, there has been widespread convergence — across large parts of the developed world — toward neoliberal policies, broadly centered on free trade, free markets and reduced state intervention (de-regulation). In recent years, we have witnessed a backlash against the mainstream ("establishment") politicians and parties that have upheld this consensus, resulting in the rise of populism[8] across large parts of the western world. Disenchantment with the neoliberal consensus has been attributed, in large part, to high levels of immigration, rising inequality and stagnant real earnings in many developed economies over the last 30 years.

This fragmentation of the liberal free market consensus creates an environment in which political uncertainty is heightened, with a higher probability of substantial shifts in policy. These political developments come at a time when global trade has been relatively weak since the financial crisis, albeit the recent trend has been more positive. There is therefore a risk that isolationism and protectionist trade policies (or "deglobalization") will upset the current synchronized upswing in global growth.

In the face of these political uncertainties, we highlight the following issues as relevant for investors:

- The more extreme outcomes arising from populist policies could include trade and currency wars. Such scenarios, though unlikely, would be highly disruptive to markets, so stress-testing portfolios against large equity, bond and currency movements will be important in assessing portfolio risk exposures. Investors who might struggle to tolerate large market movements may wish to consider approaches to managing their downside risk exposure, including outright de-risking, defensive tilts or explicit hedges.[9]

- The increasingly widespread perception that QE has disproportionately benefited the wealthiest in society via asset-price inflation is likely to have two important implications. First, governments are more likely to relax fiscal targets (or, in the US, to consider outright fiscal stimulus) to appease voters. Second, in the event of an economic downturn, a populist response could involve a combination of fiscal and monetary stimulus — "QE for the people" — designed to put money directly in the hands of people to stimulate demand. Although

8. Populism typically draws a contrast between "the people" and a group of privileged elites. Populists can fall anywhere on the traditional left-right political spectrum. Although "populist" is often used as a term of disparagement, we use it here simply to refer to political groups that have grown in importance by adopting popular policies (such as controls on immigration or seeking to address inequality) that run counter to the mainstream center-left or center-right positions.

9. Defensive tilts could include reducing equity exposure in favor of defensive hedge funds, senior private debt or real assets with contractual income streams. Explicit hedges could include a wide range of option strategies designed to reduce an investor's exposure to an equity market sell-off.

the nature and impact of any fiscal stimulus are difficult to predict in advance, they are likely to strengthen inflationary forces within the economic system. In the context of a world in which inflation has been largely unproblematic over the last 30 years (at least in most developed economies), investors with inflation-linked return objectives should review the extent to which their portfolios are protected against higher inflation outcomes.

- As illustrated by the performance of sterling following the Brexit vote, political surprises create the potential for large currency moves. Protectionism and trade tensions could also lead to currency volatility. This increases the importance of a clear policy on hedging currency risk and may also create opportunities for strategies that can make use of currency as a source of alpha.

- A fragmenting political consensus, fueled by a rise in populist resentment of elites, might also become more openly hostile toward corporate profits and monopoly power. Over time, this could lead to a reversal in the multi-decade trend favoring capital over labor (as a percentage of GDP), leading to downward pressure on profit margins. Similarly, more empowered regulators might seek to take action on aggressive taxation policies and the dominance of large tech firms. Such actions need not be unambiguously bad for equity or credit investors — it is quite possible that intelligent regulatory interventions might help reduce the risk of more extreme political outcomes — but they clearly do create some tail risks for certain stocks and sectors of the market.

4 STEWARDSHIP IN THE 21ST CENTURY

Ideas of stewardship and fiduciary duty have evolved over the course of history, with the basic concept of a fiduciary being rooted in the Latin term "fiducia" — meaning trust or confidence. In a post-crisis world, in which trust in the financial system is at a low ebb, we have in recent years seen an increasing recognition of the importance of institutional investors' role as stewards of capital as well as a wider discussion around the role of finance in promoting the social good.

In particular, there has been a clear trend in the treatment of fiduciary duty to increasingly recognize the importance of ESG issues. We see this as a positive development, having explicitly stated for many years our belief that an engaged and sustainable investment approach (in particular, one that recognizes the importance of ESG issues and takes a long-term perspective) is likely to help create and preserve long-term investment capital.

With legal opinions and regulators converging toward a view that consideration of ESG issues is consistent (or, at the very least, not in conflict) with fiduciary duty,[10] it is incumbent on investors to have a clear policy in relation to ESG issues and to ensure that their strategy and underlying managers are consistent with that policy.

For long-term asset owners, the critical components of a sustainable investment approach can be considered at three levels:

- Asset owners should have a clear set of **beliefs** setting out their view on: (i) the impact of ESG factors on risk/return outcomes; (ii) the importance of stewardship and engagement activity; and (iii) any investor-specific factors that might affect their approach. Investors should also determine which collaborative industry initiatives can help them address related issues in a resource-effective manner.

- At the strategy level, asset owners should ensure that their strategic **asset allocation** is consistent with their beliefs and policy. Beyond this basic requirement for consistency, investors should also be clear on the extent to which systemic risks (in particular, climate change) are likely to impact the risk/return characteristics of their portfolio. It seems likely that regulators and beneficiaries will increasingly view the absence of any consideration of the impact of climate change as a dereliction of fiduciary duty (though this will vary by region).

- At the portfolio level, asset owners should ensure that their **underlying managers** integrate appropriate consideration of ESG issues within their investment processes and take their stewardship responsibilities seriously (this applies equally to active and passive managers).

10. For example, The Pensions Regulator in the UK updated its DB and DC good practice investment guidance in 2017, documenting that: trustees are expected to assess the financial materiality of ESG factors; stewardship activities are part of a scheme's investment governance; and ESG issues are consistent with the fiduciary duties of trustees. This is consistent with the approach taken in Europe by the EU IORP 2016 update, which states that pension scheme risk assessments should include "risks related to climate change, use of resources, the environment, social risks and stranded asset risk".

Moving beyond sustainability and ESG considerations, there is a wider debate taking place concerning what has been described as a "crisis of capitalism."[11] As touched on under our "fragmentation" theme, this discussion typically revolves around issues of rising inequality, the rent extraction of elites, corporate and investor short-termism, and insufficient consideration of social and environmental externalities.

Although it is far from clear where this debate will lead, what does seem clear is that politicians and policymakers (reacting to a loss of public trust in finance and capitalism) will seek to find ways to align corporate behavior more closely with social well-being. This will apply as much to the investment industry as to any other part of the economy and will require all parts of the investment chain to be able to demonstrate their value to society in order to maintain a "social license to operate." A recent example would be the 2017 recommendations of the Financial Stability Board's Task Force on Climate Related Financial Disclosure,[12] which provide a framework for companies and investors (including pension funds) to disclose to shareholders, clients and beneficiaries how they are managing climate related risks and opportunities.

Stewardship in the 21st century is closely aligned to the growing industry focus on sustainability, ESG integration and impact investing, but also relates to issues of transparency and fairness in the terms of trade between asset owners and asset managers. We recently set out our views on asset manager fees in our paper "Investment Management Fees: Seeking Fairness and Alignment"[13] and will continue to contribute to this debate over the course of 2018.

11. https://www.ft.com/content/9dbce496-b5ae-11e7-a398-73d59db9e399
12. https://www.fsb-tcfd.org/
13. http://www.mercer.com/content/dam/mercer/attachments/private/nurture-cycle/gl-2017-wealth-investment-management-fees-seeking-fairness-and-alignment.pdf-mercer.pdf

TAKING ACTION

The ideas outlined in this paper represent our observations on the challenges, opportunities and drivers of change present in the current investment environment. We provide these ideas with the aim of provoking discussion, but the appropriate response at an investor-level will be heavily influenced by the specific beliefs, objectives and constraints of each investor. We look forward to helping investors adapt their strategies as new risks and opportunities arise over the course of 2018.

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