News & Views

September 2016

For Professional Clients and, in Switzerland, Qualified Investors

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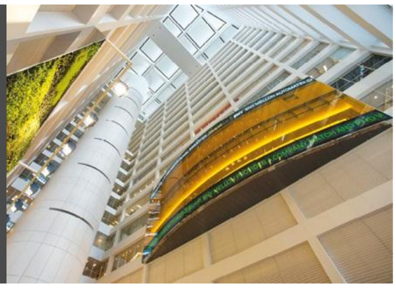

WHAT IS GLOBAL REAL RETURN'S NEXT MOVE?

The ineffectiveness of quantitative easing is becoming clear so investors should re-evaluate their positioning, says Aron Pataki portfolio manager at BNY Mellon boutique, Newton.

The Newton Real Return team is poised to re-position the strategy in anticipation of a shift from quantitative easing (QE) initiatives towards fiscal stimulus, says Aron Pataki, portfolio manager of the Dublin-domiciled Global Real Return Fund.

Over recent months, Pataki says, the market has come around to the team's thinking about the inefficacy of QE and its apparent failure to jumpstart global growth since the financial crisis.

"If you flood the world with copious US dollar liquidity, it has an impact on both demand and supply. This is something policymakers did not consider prior to implementing QE. Some of the dollar liquidity created in the US leaked out and went into different areas, including emerging markets, which allowed companies to build out more capacity," he adds.

According to the team, there has been insufficient demand to absorb this capacity which means companies are losing pricing power. Says Pataki: "This coupled with rapid technological change and increased completion, leads us to believe a deflationary rather than inflationary environment is more likely going forward."

Shifting sands

So there is a wider acknowledgement of the unintended consequences of QE and intimation from certain circles that there could be a move from using monetary policy to attempt to manipulate the economy towards more fiscal spending, particularly on infrastructure projects. However, in some countries the hurdle rate for additional stimulus is high, says Pataki.

In the US for example, to go from expectations for a rate hike to more stimulus (of whatever nature) in a short space of time would not be particularly palatable. "For this reason we think we have longer to wait before we need to move our positioning in US assets to reflect a journey towards looser monetary policy."

Pataki predicts central bank-sponsored fiscal policy would have a different impact on risk assets compared with QE, which served to push down bond yields, support equity prices and push up valuations, in his opinion.

"If increased fiscal spend is the next step in supportive policy we think infrastructure spending in targeted areas will increase. This means within the equity market there could be some pockets that benefit more than others – construction, building and materials firms, for example."

The Real Return strategy has between 2.2% and 2.6% in infrastructure (the exact figure depends on which currency and share class is held) and around 1% in renewables. It also holds around 6% in utilities and infrastructure related securities and nearly 5% in industrials.[1]

So far the allocation to construction and materials is small, although the strategy does have allocation to REITs.

In the second half of last year the team de-risked the strategy by reducing gross exposure to equities, increasing direct equity hedging and doubling the duration from two years to around four at the fund level. These steps proved helpful in the first seven months of 2016 when volatility was marked and the strategy demonstrated strong capital preservation compared to the broader market.

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[1] Source: Newton, as at 30 June 2016

More recently, the team has also taken advantage of significant market moves to tactically trade its exposure to long-duration (primarily US) government bonds and add to some short-dated US Treasuries for cash management purposes.

Pataki says: "Although we are not currently concerned that inflation is a significant risk, the recent implementation of some put options on the US long bond future and similar positions on the euro-bund future should, we believe, offer protection should inflationary concerns materialise further out.

What next?

Pataki says the team is cognisant that with the slight recovery in the oil price and the potential for further 0.25% rate rise in the US before the end of the year the deflationary theme might have muted impact on the remainder of 2016.

The team's view remains that long duration assets will do well over the longer term. In the government bond allocation within the strategy the duration is around 10 years but the team has recently trimmed exposure to the US long bond due to the increasing rhetoric from the Federal Reserve surrounding intentions for a rate hike. It has also reduced exposure to five-year Treasuries. The team is positive on conventional government bonds particularly in countries such as Australia and New Zealand where there is room for further rate cuts – this tends to benefit long duration assets.

Corporate bond exposure within the strategy's return seeking core is between 3.1% and 3.4% as the team believes this is one asset class that could see a lot of volatility.

Going gold

The team maintains an allocation of around 12% to gold through a gold ETC and gold mining equities. "Holding gold miners provides you with geared exposure to the price of gold to the tune of one to three. To get the same exposure through physical gold only you would tie up a lot of cash, the equivalent exposure without miners would require us to hold almost 20% in a gold ETC. After a strong run we trimmed some of our larger cap gold miners because overall exposure had drifted up to 7% in May. We took it back to 6% in June and reallocated some of the proceeds into physical gold to take some of the gearing out," explains Pataki.

"We hold gold because it is a good hedge against policy errors and tail events. We think it makes sense to hold a real asset that cannot be printed or debased. The team is bullish on the gold price because fiat money can be devalued at the whims of central bankers and policymakers."

Asset allocation (% weight)

	EUR	USD
Cash and cash equivalents	6.8	9.0
Equities	44.2	43.4
Convertibles	0.8	1.1
Govt bonds	28.0	26.1
Corp bonds	3.1	3.1
Index linked bonds	2.3	2.4
Floating rate notes	0.0	0.0
Covered and called bonds	0.0	0.0
Infrastructure	2.2	2.3
Renewables	1.1	1.1
Precious metals	11.5	11.5
Derivatives	-0.1	-0.1

Source: Newton, as at 30 June 2016

Equities by sector (% weight)

	EUR	USD
Pharmaceuticals & biotechnology	9.3	9.2
Media	5.7	5.6
Tobacco	4.1	4.1
Software & computer services	3.9	3.9
Electricity	3.5	3.5
Gas, water & multiutilities	3.2	2.8
Support services	2.6	2.5
Chemicals	1.9	1.8
Mobile telecommunications	1.4	1.4
Food & drug retailers	1.3	1.3
General retailers	1.1	1.1
Aerospace & defense	1.1	1.1
Household goods	1.0	1.0
Real estate investment trusts	0.9	0.9
Health care equipment & services	0.7	0.7
Electronic & electrical equipment	0.7	0.7
Fixed line telecommunications	0.7	0.7
Travel & leisure	0.5	0.5
Technology hardware & equipment	0.3	0.3
Real estate investment & services	0.3	0.2
Construction & Materials	0.1	0.1

Source: Newton, as at 30 June 2016

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