2017: The Year That Was
Newsletter for January 2018

What a year 2017 has been! We started the year with a lot of trepidation about the impact of political risks, protectionism and the unquantifiable impact of changing focus in the US. But broadly we expected reasonable returns in a stable rate environment with an improving growth outlook. We closed the year with returns above our expectations in an environment of synchronized global growth recovery. As we evaluate the landscape for 2018, market optimism abounds, reflected in stretched valuations in some segments, but the narrowness of last year's rally presents opportunities to cherry pick companies with good cash flows still trading at attractive valuations. However, it may not be a smooth ride as volatility is likely to rear its head this year and the gap between risks associated with continuing policy uncertainty and optimism as reflected in valuation and low vols poses repricing risk in global financial markets. As investment managers, our key focus for 2018 would be to manage downside risk.

Review of what we said earlier

Before we elaborate on our 2018 Outlook, we thought it would be a good idea to look through what we have said and how things have evolved over the past year.

Peaking of the USD: We had an anti-consensus expectation that the US dollar is close to its top and as relative economic competitiveness catches up, it would reverse a trend which had been in play for nearly five years. Though this has turned out to be true, we have been surprised by the extent of the USD weakness.

Growth will improve: We entered the year with strong conviction on growth trends both in nominal and real terms and, as we elucidated in a previous newsletter, our belief that nominal GDP growth is a strong driver of equity market performance gave us conviction on our positive outlook. Again, as we expected, GDP growth in 2017 was strong across markets.

Deflation will recede: Our expectation was that as growth improves and spare capacity reduces, we would see a slow normalization of inflation numbers from ultra-low levels. This could lead to volatility as well as opportunities. We have been surprised how stubbornly low inflation has been despite a robust and synchronized growth recovery.

As the year unfolded, returns were strong and we saw emerging signs of strong growth recovery finally getting market attention. In our monthly newsletters we talked about some of the trends we gathered from our field trips, the key among them being a *recovering earnings cycle in Asia* and *cyclical rebound in China.* In the portfolio we added to our positions in China as valuations were attractive while earnings risk was receding.

In the middle of the year we talked about the narrowness of market returns, a theme which continued right through the year and, as we look forward to 2018, it presents interesting opportunities.

As ASEAN reached a milestone, we looked at where these economies are and what we gathered gives us a lot of confidence that we are potentially at the cusp of a multi-year boom as various countries in the grouping start investing to catch up with infrastructure deficits and meet the aspirations of the rising middle class in these economies. Combined with the saving surplus in China and their thrust to invest this as part of the Belt and Road initiatives, we can see Asia at the cusp of a self-funded growth phase.

As the year was drawing to a close, we started seeing a few excesses and risks which we wrote about. In our October newsletter “Storm Alert” we talked about the rising disconnect between weak earnings and rallying stock markets in India. Subsequently we highlighted the growing challenges to growth in the US as we enter the mature phase of this prolonged cycle and rounded the year by “learning from fallen angels” by looking at stocks which were once darlings and how over the long run some of them fell by the wayside.

Analysis of our 2017 Portfolio Performance

- 2017 was a strong year for us with portfolio net returns of 18.9%.
- The bond portfolio delivered about 13% USD return while the equity portfolio delivered about 33% for the full year.
- We ran the gross portfolio with a broadly equal exposure to fixed income and equities (before index hedging).
- Our net equity position post our index hedges was only averaging 30%. We continued our conservative stance of running a partly-hedged portfolio (both in terms of market risk and currency risk) which is visible in terms of the low monthly volatility of our returns, but this hedging obviously adds to our cost in a market like 2017. Our overall returns could have been higher if not for the hedges, but we stick by our principle that focus on capital preservation is key for compounding returns in the long run.

Some of the names which drove our equity portfolio performance for the year were Asian insurance behemoth AIA; Catcher Technology from Taiwan; HDFC Bank from India; consumer staple company WH Group; and Alibaba’s holding company in the US, Yahoo (now Altaba). Among the yield securities Ascendas Hospitality Trust delivered stellar returns and one of our long term holdings, Croesus Trust, got bought out at a premium. Among the fixed income securities, Standard Chartered coco’s delivered strong returns while Crown Resorts’ bond in Australia got a big boost on credit improvement and its floating rate nature.

Our Learnings from the Year

EM currencies tend to be pro-cyclical: In Emerging Markets, currencies tend to move in tandem with asset prices. Hence in a year like 2017 when we were relatively positive on asset prices, we had to be positive on currencies too. To be fair, we were relatively negative on the USD but we did not size up on this bet and continued to maintain a partial hedge in favour of USD for most of the year. This hurt us.

Reducing risk too soon: We started reducing risk from June onwards in terms of both the kind of stocks we stated favouring in our portfolio and the level of hedges we started carrying. This was a bit too soon given the continuation of the rally later in the year. Though this is an opportunity loss, we do recognise that most of our clients want us to manage both "return on capital and return of capital" and hence we are comfortable with this slightly conservative stance.

Outlook for 2018

Healthy but slower growth: Post the normalisation of growth in 2017, we feel that 2018 continues have momentum to be a good enough year for growth. With inflation potentially picking up, nominal GDP growth will probably maintain its trend from 2017. Though we are worried about the natural brakes on growth (inflation, interest rate, etc.), we do not expect them to kick in strongly in 2018; the earliest would be by the end of 2018.

Volatility and risks will increase: While the current growth and asset price rally matures and potentially inflects over the next 24 months, we do expect more volatility as global markets struggle to price assets correctly.

USD is not a one way trade: The sentiment on the USD has totally inflected in the last 12 months from uber bullishness in Jan 2017 to ultra bearishness in Jan 2018. Even if the long term trend line on the USD is weak, our view is that the USD will perform well against other currencies in 2018.

Inflation will finally start showing up: The fear of inflation over the past five years has echoes of the oft cited "cry wolf" story. The market has been expecting it for so long and has been proven wrong for so long that when it really does turn up it will shock markets. We do believe that the green shoots of inflation have already started showing up in 2017 and will gain strength in 2018. The corollary to this is that this will have an upward pressure on interest rates globally. If USD 10y rates do go past the 3% mark without a positive surprise on growth, asset prices globally will have a tough time. But this is probably a worry for 2019.

Asset valuation: Asset prices are not cheap anywhere. They are all between fair value and expensive, which means the margin of error in terms of predicting economic and corporate fundamentals has reduced. This warrants a level of caution in our investment process and increasing focus on hunting for mispriced opportunities. For the year 2018, security selection will likely play a bigger role over asset allocation.

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