Elgin asset management

investment commentary monthly

Monthly Commentary 3rd January 2017

If one thing 2016 taught us was to expect the unexpected. Here are some of those unexpected events that most investors were unable to predict in 2016.

- Oil prices plunged to a 12-year low in February reaching a price close to $26 a barrel. By the end of the year oil ended up gaining 45% to more than $53 a barrel.
- US equities as measured by the Dow Jones Industrial Average touched a low for the year at 15,660. Trump's victory ignited a rally that carried it to all-time highs.
- Britain's vote to leave the European Union and terror attacks shocked European markets. The fact that the Stoxx Europe 600 index dropped "only" 1.4% for the year is good news. The loss could have been much worse. In the days following the U.K.'s referendum in June, the index hit its nadir, down almost 16% on the year. Since then, it has rebounded, adding nearly 17%. Similarly, Britain's FTSE ended the year up 13%, while Sterling dropped more than 16% versus the USD..
- The 10-year US Treasury yield fell to 1.36% in July, an all-time low. By the end of the year it was back to 2.45% (bond prices move inversely to yields) signaling the probable end of the 30-year bull market in government bonds.

2016 was definitely not a trader's year. The high volatility and sharp reversals in most asset classes left many traders licking their wounds. Fortunately, we did not fall into this trap despite the fact that many of our clients asked us to reduce their equity exposure or even liquidate their portfolios after believing that the uncertainty leading of the UK referendum and US elections would lead to markets collapsing in 2016.

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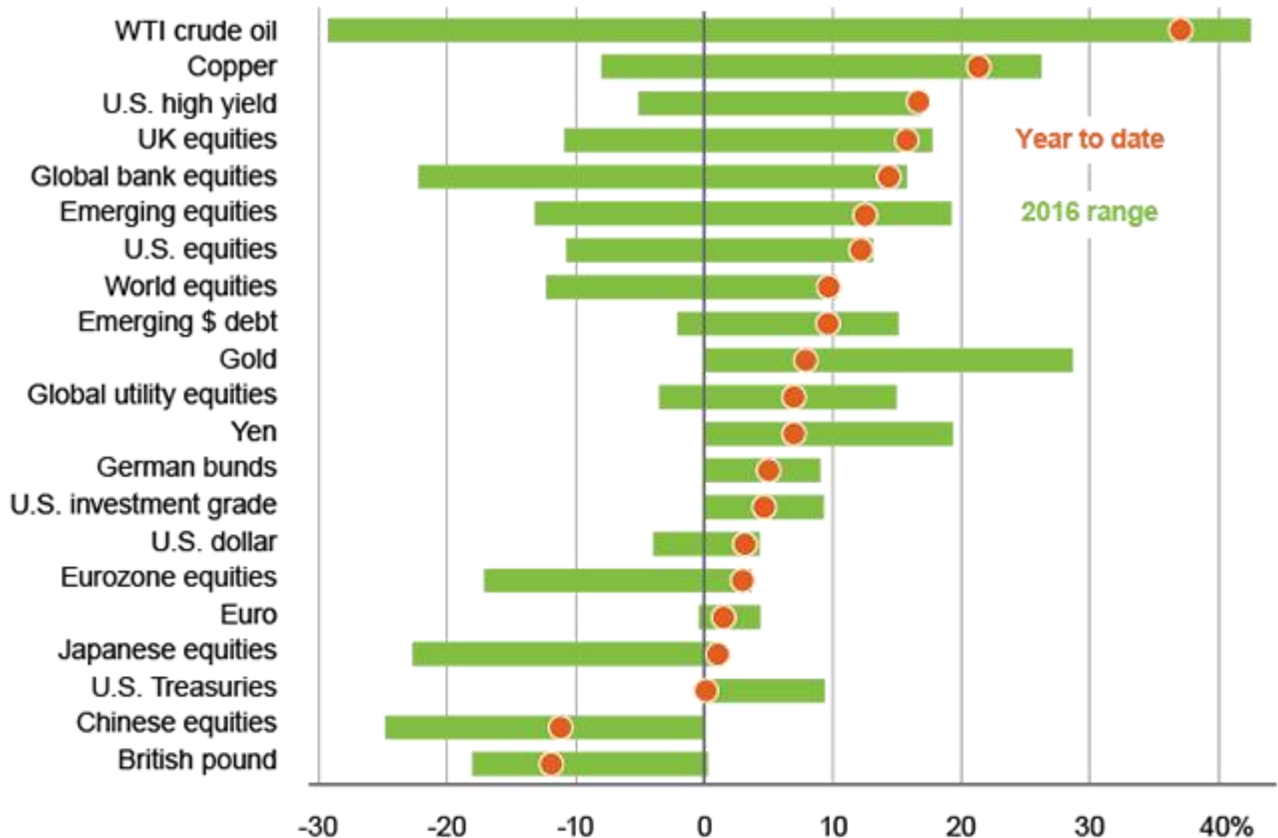
Markets' twists and turns

Blackrock's illustration below shows the large trading ranges (in green) and the YTD prices to December 14 (red dots). It reflects this topsy-turvy year quite accurately.

2016 Asset Performance in Local Currency



Sources: BlackRock Investment Institute and Thomson Reuters, December 2016.
Notes: The data are as of Dec. 14. Commodity prices are based on the spot price of the underlying commodity. U.S. Treasuries and German bunds performance are based on the total return of Datastream 10-year Benchmark Indexes. U.S. high yield and investment grade performance are based on the total return of Bloomberg Barclays indexes. Emerging market debt performance is based on the total return of the J.P. Morgan EMBI Diversified Index. Equities' performance are based on the total return of local currency MSCI indexes, except for the performance of emerging markets (which are in U.S. dollars) and Chinese equities (which use the Shanghai A Share price index). The performance of currencies is based on J.P. Morgan nominal trade-weighted indexes.

The yearend value of so many indices is a deceitful measure of the path taken by so many of them from the beginning of 2016. Most managers had a very difficult time making sense of the often-violent market swings, and the fact that a sizeable majority of managers under-performed the indices shows how difficult it was to navigate the markets.

Indeed, many of the top long-only fund managers that we use were whipsawed to such an extent that they did not match their benchmarks. This phenomenon was also evident in the alternative space where many hedge fund managers also had a torrid time. While we have been monitoring each manager closely, and we are going to make some changes where we feel they are due, it would be unfair to many top managers to judge them purely on 2016 performance. As such, we shall keep the funds for which we have high conviction in both their managers' skills and processes. A past example of this conviction is the M&G Optimal Fund that had a very subpar 2015 (down almost 2%), but which we kept in all client portfolios. It came back with an almost 7% gain in what was a very challenging fixed-income market, managing to beat almost all of its peers.

What's in store for 2017?

Developed-market equities are entering 2017 with a full head of steam. Buying efforts have been broad-based, and prices have been lifted by the rotation of money out of the safe-haven Treasury market. At the same time, consumer and business confidence have reached historic highs. Trump's election has been driving most of this euphoria. We are concerned that the markets have been banking on good things happening without knowing any specific details—or costs—of the policies that will presumably be enacted.

The question is, can the economic fundamentals rise to meet the optimism and high expectations? Some factors may spoil this euphoria:

- The adverse impact of a stronger dollar, which could crimp earnings prospects for U.S. multinationals and lower sales prospects for exporters.
- Political and economic uncertainty in Europe resulting from Brexit negotiations, the migrant crisis, banking problems in Italy, elections in major countries and a pushback on restructuring efforts in Greece.
- A less cooperative than expected US Congress (a lot of pro-growth hope is resting on the view that proposals will pass Congress easily).

- A spike in long-term rates stemming from a view that the Fed is behind the inflation growth curve and will be forced to raise the fed funds rate faster, and more than expected.

On the balance, the above negative scenarios are not our base case. Nevertheless, unexpected events like the above need to be considered. That is why a diversified portfolio, which consists of high quality funds including alternatives, bonds and equities can provide stability to a portfolio and reduce volatility. Going into 2017 this stability will be our main goal.

The Elgin Analyst Team

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