Defenseless Defensives

Some Thoughts on Portfolio Construction in a Period of Rising Rates and Increased Inflation Fears

The optimism that marked the first four weeks of 2018 seems to have evaporated over the past two. I want to send a brief note explaining what I think is driving the current volatility and why it is that I am comfortable with our current positioning.

As noted in our year-end communications, we have been encouraged by the prospects of global synchronized expansion and strong earnings growth. Our optimism was widely shared, which explains why the markets began 2018 with a strong bull run — the MSCI All World Country Index (MSCI ACWI) provided a total return of 7.33% through Friday, January 26, 2018. Reading the same economic and earnings reports that have been encouraging shareholders worldwide, investors in fixed income markets have begun to worry that the US Federal Reserve (Fed) will have to raise rates more quickly and more steeply than previously had been contemplated. On the morning of Monday, January 29, 2018, US Government 10-Year bonds traded through the 2.7% mark for the first time since April 2014. The rise in yields and inflationary expectations has spooked equity investors around the world, sparking a sell-off that has wiped out all of the gains in most global indices and sharply reduced those that it hasn't entirely erased. The MSCI ACWI's total return through last Friday, February 9, 2018, was -2.24%. The rise in yields and the sell-off in stocks represents, we believe, a return of volatility to equity markets that have been uncharacteristically calm over the past two years.

I feel that it is critical that the rise in interest rates be taken in context. For that, a brief review of recent history is in order. In December 2008, the Fed set the target range for the federal funds rate at 0.00% to 0.25%. This was the 11th and final cut to the target range since August 2007, when credit markets began to falter due to increasing defaults in the US subprime mortgage market. By late 2008, the US economy was reeling (as was the global economy) and the zero interest-rate policy (ZIRP) was adopted as an emergency measure. Central bankers around the world lowered rates in reaction to the crisis. Other emergency policies followed, in the form of "quantitative easing," in which the Fed and other central banks intervened in credit markets to keep rates low and to encourage investment in higher-risk investments. To some extent, at least, these policies had their intended effect, as stock markets recovered after devastating routs and economic activity began to revive and, more recently, to accelerate.

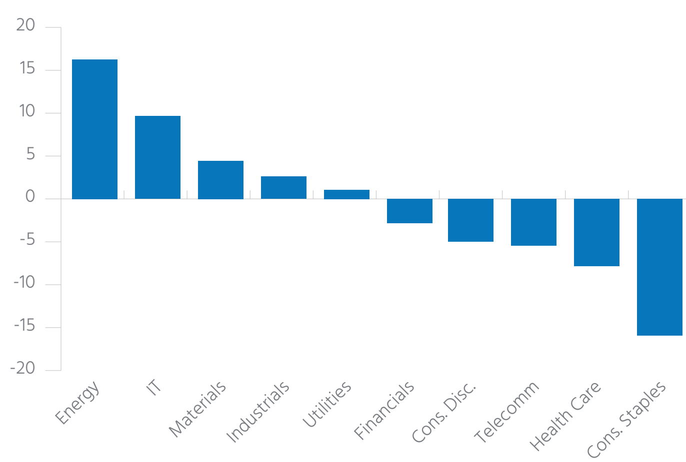
The Fed's ratcheting up of the federal funds rate that began in late 2015 represents, we feel, something akin to the gradual weaning of a patient from very, very powerful medicine. It's a requirement for full recovery and, in hindsight, the process might have started even sooner. Prior to the onset of the 2008 Financial Crisis, the federal funds rate stood at 5.25%. After the most recent hike, the fifth since December 2015, it is 1.25%-1.50%. The Fed has moved gingerly, not wishing to cut off the still weak recovery. At the same time, the Fed must shrink its bloated balance sheet, a process that's just started. The markets had, generally, applauded this gradualist approach. Inflation has moved up around the globe, but in most cases is still below targeted levels. The Fed's new chairman, Jerome Powell — sworn in as markets were selling off on February 5, 2018 — pledged in his remarks at his swearing-in ceremony that he and his colleagues would "support continued economic growth, a healthy job market, and price stability." I take the man at his word. No Fed chief wants to go down in history as the one who allowed inflation to reignite. There's a very good chance that the Fed will raise rates three or four times this year and as often again in 2019. The Bank of England last week signaled that it is likely to raise rates earlier than had been anticipated, maybe before summer. I expect the European Central Bank (ECB) will eventually be forced to tighten as well.

It is vitally important to an understanding of today's financial markets to put these rate hikes in perspective. What we're experiencing here is a return to a more normalized interest rate and economic environment after years of below-trend growth. It's true that ZIRP and quantitative easing have led to some excesses (the art market, Bitcoin…), but none of the data I've looked at supports the contention that we are late in an economic cycle and in a position such that the Fed will be forced to raise rates to the extent that the expansion comes to an end. Frankly, I'd be worried if the central bankers weren't concerned about inflation. But they are; and the markets will — through weeks like the last two — keep them focused.

Historically, markets have been volatile in response to central bank tightening — usually there are those who feel that the bankers are behind the curve and another contingent who feel that they're prematurely reining in animal spirits. I believe that economies around the world are in good shape, that earnings will grow and that markets have room to run. I also believe, as a colleague likes to say, that there's not a straight path up the mountain. Rates will almost certainly rise over the next few years, and the markets will almost certainly react with increased volatility in the classic tug-of-war between bulls and bears. In my view, there will be a transition in the market as long bond yields go higher – markets will need to adjust, which might result in lower multiples. In this tug-of-war, I believe earnings growth will act as a counterweight to multiple compression.

I want to stress that I am a bottom-up stock picker, not a macro-driven investor. Still, I have looked at some data regarding previous periods of Fed tightening, and I feel that our portfolios are well positioned for the current economic environment. Credit Suisse has done some work that indicates that, during past periods of Fed tightening, stocks that many would consider "defensive" have actually performed quite poorly. In fact, Consumer Staples and Health Care have been the worst performing sectors, on average, in previous tightening cycles (see Exhibit 1).

Exhibit 1: Global Sector Average Relative Performance During Fed Tightening %



Sources: Credit Suisse as of December 31, 2017.

It is not surprising to me, then, that year-to-date, the MSCI All World Consumer Staples subindex has underperformed the MSCI ACWI, generating a total return of -5.37% (see Exhibit 2).

As we've explained in prior investor communications, our view on the Consumer Staples sector is that many of the companies in the group have seen their share prices rise because they were viewed as bond proxies even as their business fundamentals deteriorated. Many global Consumer Staples companies have been losing share to local competitors, have priced aggressively to meet financial targets and have suffered from perceived lesser product quality advantage in brand name products.

Exhibit 2: YTD MSCI ACWI Subindices Performance

	Currency	Price Change	Total Return	Difference
MSCI ACWI Consumer Staples Index	USD	-5.46%	-5.37%	-3.14%
MSCI ACWI	USD	-2.36%	-2.24%	—
MSCI ACWI Financials Index	USD	-0.70%	-0.56%	1.68%
MSCI ACWI Information Technology Index	USD	-0.87%	-0.75%	1.49%

Source: Bloomberg from December 29, 2017 to February 9, 2018.

For just under two years now, we have been underlining the point that valuation matters. We've adjusted our holdings in response to fundamental changes at the companies we invest in, always concerned not just with quality, but also with value. If you overpay for quality, you could well end up garnering bond-like returns. We aim to compound our clients' wealth at a reasonable rate of return over the course of the cycle. I don't believe we can do so by sticking with supposedly safe companies despite meaningful changes in the fundamentals at those companies and in the economic environment in which they operate.

Exhibit 3: Global Staples — Absolute P/E Valuations x

Sources: Thomson One, IBES, Morgan Stanley Research from January 7, 1994 to February 2, 2018.

In closing, I'd like to emphasize that I believe that we've found many companies that are likely to perform well over the next three to five years, including many in the Financials and Information Technology sectors, two sectors in which GQG is overweight versus the index. Financials as a group are notable as being likely beneficiaries from the return to a more normal interest rate environment. A skeptic will point to Exhibit 1 and note that Financials have performed poorly in Fed tightening periods. I'd counter that we've never before been in a cycle like the current one. We are in uncharted territory. Bank balance sheets are strong; lending activity and trading activity are likely to rise. I therefore feel quite comfortable owning Financials in our portfolios. Our IT holdings represent investments in fast-growing industry leaders, many selling at surprisingly low multiples considering the strength of recent growth and near-term prospects. The seas may get choppy, but I believe the 'GQG ship' is well-outfitted to reach our destination.

Sincerely,

Rajiv Jain

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