2018: The Year That Was

Newsletter for January 2019

2018 was another action-packed year for asset prices globally. But unlike 2017, it was exciting for all the wrong reasons. Asset prices absorbed a host of negatives: rising rates, reducing global liquidity, increasing trade uncertainty, etc. Hence, we saw a sharp correction in asset prices post April. For example our portfolio had no month where it fell more than 1.3% over the 27-month period from February 2016 to April 2018. But it had three such months over the 8-month period May to December 2018. Similarly, the Asia Pacific ex-Japan index had only one month of over 2% drop from February 2016 to January 2018 – a 24-month period. But in the following eleven months, it had five months with a drop of over 2%. This has taken out the one-sided optimism that prevailed across markets at the beginning of 2018 and has created large swathes of value across geographies and assets. Clearly 2019 starts with a much better medium-term return outlook than 2018 did. Though the risks in the short term look high, we are excited by the opportunity set that we see.

A Review Of What We Said During The Year

Before delving into our future outlook for 2019 it would be informative to reflect on what we said in the past twelve months and how we fared.

We achieved a high hit rate on our stock/sector calls: We made five sector/ stock calls in the past twelve months. We stated with a warning note on the "Fallen Angels" (our January 2018 newsletter) where we highlighted the risks in the much-loved stocks on the tech sector and compared them to the fallen angels of the past. In particular we highlighted Apple, Alphabet, Facebook, Amazon, Tencent and Alibaba. Except Amazon, which is up 28% for the year, the other stocks fell between 1-25% in 2018. Our other sector calls were on Cement in Asean (in Indonesia in particular) and global Tobacco stocks. The first call turned our right but the Tobacco call turned out to be too early. Our two stock calls were BOC Aviation and Cromwell Reit. The first has worked out well and the latter is a recent call and is already looking good.

We had a positive bias on the USD: We realised that after the weak performance of the USD in 2017 the sentiment had become one-sided and hence we increased our currency hedges at the beginning of the year. At one point our unhedged currency exposure was the least it has been for a long time. This view has broadly played out and we are in more neutral territory now.

We expected slower growth and flattening interest rates by year end: We talked about this in detail in the second part of our April 2018 newsletter where we reiterated our "lower for longer" long-term view on global growth and interest rates. Now the market has come around to that view too, but in April 2018 there was expectation that the 10y rates would reach 4% + by the end of 2019. We however continue to believe in our thesis of "lower for longer".

We expected inflation to start moving up: This is one call we did not get completely right. We had expected the higher growth of the past few years and the ample liquidity to manifest to rising inflation rates across most markets, hence our significant exposure to banks across markets in our portfolio. This did not come true (except in a few markets) and banks become one of the drags on our performance in 2018.

We forecast risks from a nascent trade war: We mentioned the risks from a trade war in our June 2018 newsletter and tried to make the portfolio immune to this risk. This risk came true; however, we underestimated the magnitude and duration of the impact from this event.

Analysis Of Our 2018 Portfolio Performance

Though we started the year with a stronger focus on asset preservation than any of the previous three years, we were not immune to the correction in asset prices in 2018. Our portfolio was down 5.1% on a gross basis in 2018. This is vis-à-vis the Asian equity index being down 14%, S&P down 6.25%, the global high yield bond index down about 2% and the Asian high yield bond index down 3.2%. Though this is a good relative performance, it was a tough year in terms of absolute performance.

A simple break down of this performance shows that we carried at an average a gross exposure of 113% (i.e. a 13% leverage) and an index put related hedge of just over 30%. Our bond portfolio was up 2% for the year in USD (post currency hedges) and our equity portfolio was down 8% post impact of currency hedges and index put option hedges. Nearly 80% of our exposure remained in Asia. Though the index puts helped, they were not enough to mitigate the full impact of the 14% correction in Asian equity markets.

Our biggest negative contributors were BAT Plc, Genting Malaysia, WH Group, Pandora and Prudential Plc. We continue to believe in three of these five stocks and expect to get good returns from them. Our best contributors were BOC Aviation, Yuexiu Transport, Infosys, LIC Housing Finance and Astra International, with the last two giving all their returns in the last quarter.

Of the 21 bonds that we held through various times in the year, all except three were up or flat on a total return basis. Our low duration and high coupon helped give over 2% return in an environment where all bond indices are strongly down.

Our Learnings From The Year

Do not under estimate volatility: Even though we were expecting 2018 to be a lot more volatile than 2017, the level of volatility has surprised us. This was especially true in the fourth quarter with December 2018 being extremely volatile. The risk with volatility for investors is that the chance of making mistakes increases exponentially. Such market moves test ones investment convictions and make it imperative that we have a clear focus on the long-term value of every business we have exposure to. They also increase our hedging costs and put our hedging strategy under pressure.

Markets are cheap but take your time: As markets started becoming cheaper across geographies it was important to be patient. Jumping in at the first sign of value could be expensive. Our best value buys (like Astra and LIC Housing Finance) happened right when investors had totally given up on these companies. Our task was to separate the short-term risks from the long-term value and then be able buy these companies. This remains true even today. Hence as we have slowly ratcheted up our total portfolio exposure, we are still far from the peak we reached in the beginning of 2016.

Outlook For 2019

Our outlook for 2019 includes a few points that are continuations from 2018 and some that are reversals.

USD strength to peak out: This USD weakening trend started in Q4 2018 as the interest rate outlook on the USD started to taper off. The differential between rates in most countries vis-à-vis the USD is the lowest in a long time. The trend has run out of steam as the US settles into a lower growth rate. The risk on this is that we actually have a sharp global growth slowdown in 2019 because of policy missteps or geo-politics.

Trade uncertainty to taper off: As both the US and China start facing the costs of the trade war, the urgency to sort this issue increases. This will not happen in a linear fashion but twelve months from now we will most likely be less worried about trade-related issues compared to today.

Rate cycle to peak out: The US rate cycle is in the last leg of its upward trajectory of the past few years. Combining this with the reduction in liquidity was one of the primary reasons for the asset price correction of 2018. This negative will not be the same in 2019. Hence some of our yield stocks could again become of interest to the market.

Political uncertainty in some markets to create opportunities: In our immediate neighbourhood, India, Indonesia and Thailand will be holding national elections in 2019. This will create volatility and uncertainty. But this will also increase the opportunity set to buy some good assets.

Lower starting valuation to give margin of error: As mentioned earlier, valuation has become a lot more supportive of medium term returns compared to the beginning of 2018. Though valuation is not a good predictor of returns in the short term, in the long term it is a powerful tool. Hence we have slowly been ratcheting up our gross exposure over the past two months.

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