2016: A Review; 2017: A Preview
Newsletter for January 2017

2016 was an interesting year. It had more than its share of "world changing events", but life went on. Financial markets continued to find reasons to panic and to get euphoric but at the end of the day returns were healthy and clearly more than what most participants expected at the beginning of the year. Some asset classes rebounded off a poor 2015 while some continued the positive trend of the past few years, though I dare say here that the returns would have been poor for most asset classes if the post Trump rally in developed markets had not happened.

A Review of What We Said

We write out our thoughts in our monthly thought pieces and that would be a useful starting point for the post-mortem of 2016.

Our first two write-ups were probably the most relevant in driving our portfolio performance and activity in 2016. Here we would like to highlight some of the most pertinent points we made through our newsletters in 2016.

- **Keep calm:** The title of our January 2016 write-up was "It's not as bad as we think and it wasn't as good as we thought". This newsletter was written during the China-induced panic of December-January (which continued into February), and was instrumental in us keeping our heads during those negative months. We quoted extensively from a Howard Marks' Oaktree Capital newsletter to help calm down our investors and ourselves too. The one comforting fact at that time was very cheap valuations. Our belief has firmly been that valuations at extremes are always a good guide to future returns. ***This helped us gain confidence in increasing our leverage to the maximum since the inception of our fund.***
- **The commodity cycle was already sowing the seeds of self-correction:** Our February 2016 newsletter was titled "Crude Cacophony: Facing the Facts in the Oil Market". This was written when crude had just come off its sub USD 30 per barrel bottom. We realised that the seeds of crude's price normalisation were being laid during its worst price points. We think this story still has legs and can be played in various ways in 2017 too. Also, this broad chain of thought is true not only for crude but also for the overall commodity cycle.
- **Secular stories in China:** Another interesting newsletter (September 2016) was titled "China Consumer: From Penetration to Premiumization". We mention this as it is the theme on which we hold our best performing stock for 2016 – WH Group. We continue to like this stock and hope it will remain a part of our core long term holdings.
- **USD strength maturing:** The final newsletter from 2016 that we want to highlight was titled "The Pounding of the Pound" (October 2016). This for the first time touched on an investment theme we have started dipping our toes into and could become more relevant from the latter

part of this year. The theme is our view that USD strength is in its final legs and would reverse or at least flatten out soon.

What We Got Right in 2016

We got a few macro trends right.

- China will not blow up
- US rates will rise less and slower than the market expects
- Growth globally will remain anaemic and will get bid up

However we now feel marginally less confident about each of these points.

At the margin, risks in China have increased in 2016 as it sticks to its leverage-led growth model and slows down from the reform track.

US rates went up only once in 2017 but the trajectory could marginally accelerate into 2017. Though the long term reasons why rates have a natural cap will kick in before the end of 2017, the current momentum is healthy.

Finally, global growth remained poor but now seems to be bottoming out.

Hence our three underlying macro calls for 2016 remain true for 2017 too but with less conviction.

Other than getting some stocks and bonds right, our ratcheting up of overall exposure (and thus leverage) helped in building up performance.

Finally, keeping our duration low helped in protecting our portfolio during the yield spike up in the last three months of 2016.

Our Learnings in 2016

- Our biggest error of 2016 was not selling early enough in one bond where we had clearly lost faith. Sometimes good and timely execution is as important as getting the fundamentals and valuation right.
- The second mistake was our relatively low exposure to US markets that was an opportunity loss for us. But given its higher valuation and our lower familiarity with bottom up fundamentals, we will remain slow in adding to this market.

Our Calls for 2017

- **From deleveraging to fiscal expansion in developed markets:** There is potentially a slow turn around in trend line especially in the US and, probably by the end of the year, also in Europe. This could have a strong impact on demand for non-consumer cyclicals globally. This is a space which is already seeing some sort of supply discipline in the past few years and hence could be an interesting source of opportunities.

- **Peaking of the USD:** Though we believe the USD strength still has legs, our view is that the USD will peak sometime this year. Though the DXY is still 15% below its 30-year high, it has already moved up 35% from its bottom of 2011. The relative loss of competitiveness for the US because of this move is strong and the pain will start to show up. Hence one of our strategies is to slowly reduce our currency hedges over 2017.
- **EM's balancing act of exchange rate, growth and interest rate will become more difficult to manage:** Most emerging markets have been trying to balance all three of these parameters but they have to realise that they have to give up on one of them. Hence we believe that some countries will let their currencies further weaken and some will raise rates and take a risk with slightly lower growth (or depend on other growth drivers).
- **Deflation will slowly recede from our list of concerns:** As spare capacity in the world slowly starts to reduce (in the developed world through reducing unemployment numbers and in the emerging world through industrial capacity rationalisation), we will slowly see a normalisation of inflation numbers from the ultra-low levels of the past few years. This creates a different set of opportunities which we will be looking at to make money. On the other hand this will create risks and volatility in financial markets which have not been seen since 2008.
- **Growth will improve:** We do believe that growth will trend up in 2017, both in real and nominal terms. In our June 2016 newsletter we had mentioned that nominal growth rate improvement is an underappreciated driver of stock market performance. We continue to believe so and this is one of the supports of our relatively positive outlook on returns in 2017. Our only concern is that some of this improvement has already been priced in and hence we need to be selective about what we buy.

Conclusion

Our full year expectation in terms of total global asset returns from 2017 is not very dissimilar from what was achieved in 2016. Though some risks have increased, new opportunity sets are opening up. Markets are not as cheap as twelve months ago, but growth visibility has markedly improved. Our long term view of low interest rates and low growth broadly still remains, though we are coming off rock bottom levels as both these parameters head up in 2017.

The risks for 2017 are primarily related to political push leading to further unwinding of global rules of trade and business. This would include protectionism, tariff barriers (by the US), unwinding of trade blocks (NAFTA, EU), hindrance in cross border flow of capital and labour, etc. Political risks remain in places like EU (French elections), the US (how Trump manages a fractured mandate) and some emerging markets.

In conclusion, though 2017 will have its own share of risks, the broad investment environment remains positive.

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