River Valley Asset Management

2019: The Year That Was
Newsletter for January 2020

2019 was a very strong year across asset classes. The one and only fundamental driver was dropping interest rates and a sharp increase in liquidity. Also, some of the risks of 2018 – Brexit, U.S.-China trade war, EM currencies, etc. - played out. Like always things did not turn out as bad as the market thinks when its mood is at its depressed worst.

There were plenty of negatives in 2019 but they were ignored as the fading of geopolitical negatives and a dropping rate environment overwhelmed these negatives. We will deal with these points later.

A Review of What We Said During The Year

Below is a brief review of what we said in our newsletter of January 2019 under "Outlook for 2019". Of the five points we made then four have come true and the last one has been neutral.

USD strength to peak out: The USD appreciated against its trade weighted basket by a negligible 0.22% in 2019, i.e. it was basically flat. This was partly a result the peaking out of interest rates, which we had foreseen. This trade (flattening out of USD strength) potentially has more legs especially as the growth differential between the U.S. and the rest of the world again starts to expand.

Trade uncertainty to taper off: This became worse before peaking off in August. Since then the incremental news has become marginally positive. Also, the world has realised that even with the high tariff imposed by the U.S. and China on each other, the actual impact on growth was not life-changing. An interesting factoid is that through all this rhetoric of global trade problems, international trade in 2019 is expected to show a positive growth number.

Rate cycle to peak out: This has come true, and how! Just a mere twelve months have been enough for the rate outlook to do a complete U-turn. U.S. 10-year rates which peaked in November 2018 at over 3.2% are now below 1.9%, having touched 1.5% in August 2019. Though one of our core theses for the past seven years has been "lower for longer" rates, even we were shocked by the sharpness of this move. Also, though our long term view still holds, the sentiment is so one-sided on this trade that there is a genuine risk of a counter trend rally of 40-60 bps upwards.

Political uncertainty in some markets to create opportunities: This was our prediction where nothing much happened. The markets with general elections (India, Indonesia, etc.) saw not much volatility related to the election cycle. The one market where the political cycle created opportunities and then returns was the U.K. We had a clear exposure to this market.

Lower starting valuation to give margin of error: This was one of the starkest points at the beginning of 2019. Given the sharp selloff in December 2018, we started 2019 with very cheap valuations. Our contention at that time was that this created a high probability of above average asset returns over the medium term - we just did not realise that a lot of that would happen in 2019 itself.

Analysis of Our 2019 Portfolio Performance

2019 was a good year for returns across asset classes. A sharp drop in risk free rates helped the fixed income markets. On the other hand a drop/ flattening out in geopolitical risks helped equity markets. Consequently our portfolio had a strong year being up nearly 14% in gross terms.

Breaking down our performance shows that we carried an average gross exposure of about 122% and a net exposure of about 90%. Our average equity exposure was 68% and our average debt exposure of about 54%. We carried a 30% in index hedge position (buy buying index put options) through most of the year.

Though all our asset baskets (equity growth, equity yield and bonds) gave strong return, the equity growth basket has more to do. Both our yield focused baskets (bonds and equity yield) did exceedingly well. Our equity growth basket was held down a bit by our slightly higher focus on value and hence a marginally higher bias towards cyclical growth. Globally as the underperformance of value against growth reached historic proportions, this held back our equity growth portfolio to some extent.

The biggest negative contributors to our portfolio were our hedges (as expected). This is a reversal of 2018 when our hedges were our strongest contributors. Our hedges lost us 2.3% in 2019.

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Our Learnings From The Year

The power of liquidity: Strong liquidity can overwhelm other factors when pricing assets. The prime example is the U.S. market where a year with zero earnings growth has been the strongest year for total returns since 1997 and the fifth best in the last fifty years. Part of this can be explained by the drop in 2018 but a large part is simply to do with very easy liquidity globally and the perception of this situation continuing in the foreseeable future.

Value as style works only when there is growth: Till global growth makes a genuine recovery pure value plays do not work. Not only does the market not re-rate them up, but their earnings also become weak and could start dropping. In such an environment secular growth gets continuously bid up. This is clearly happening in the tech space, both in public and (especially in) private markets.

Outlook For 2020

USD strength to start reversing: This is a continuation of the trend we mentioned last year. World GDP growth will start moving away from U.S. GDP growth. World GDP historically has been growing at about 1-2% higher than U.S. GDP growth. In Q1 2019, however, this fell to only 0.28%. We expect this trend to go back to the long term range of 1-2%. This will have repercussions on the currency markets.

Interest rate convergence will continue: We have been proponents of "lower for longer" as far as interest rates are concerned since 2012. Last year we wrote "We are all Japanese now", elaborating this point. We believe this trend will continue, though because of the very sharp rate drop of 2019 there could be a counter trend rally in rates in 2020. Also, this convergence of rates is one of the reasons for the potential end in outperformance of the USD.

Focus a lot more on earnings this year: As mentioned earlier, last year's rally in most markets was primarily driven by a valuation re-rating. This year the earnings have to show up, or else returns will become volatile.

Green shoots of cyclical recovery: We will see the green shoots of cyclical recovery across the world. A large part of the corporate world has seen a cyclical downturn of some sort for the past 3-5 years. This has created its own positives in terms of supply discipline, pent up demand, improved balance sheets, etc. As some of the positives from these factors start showing up, the market will start looking at such stocks and companies. This will be especially true in sectors/ countries where the long term secular demand is still not in question. Here EMs stand out well, especially markets with secular growth stories like India and Indonesia.

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Structural growth trends will continue to be sought after: Asian megatrends like insurance, travel, sports, e-commerce, infrastructure, etc. will remain interesting. Global trends like 5G adoption, electric vehicles, premiumisation of consumer staples, turnaround in infrastructure spend, migration of manufacturing from China to ASEAN, etc. will continue to work.

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