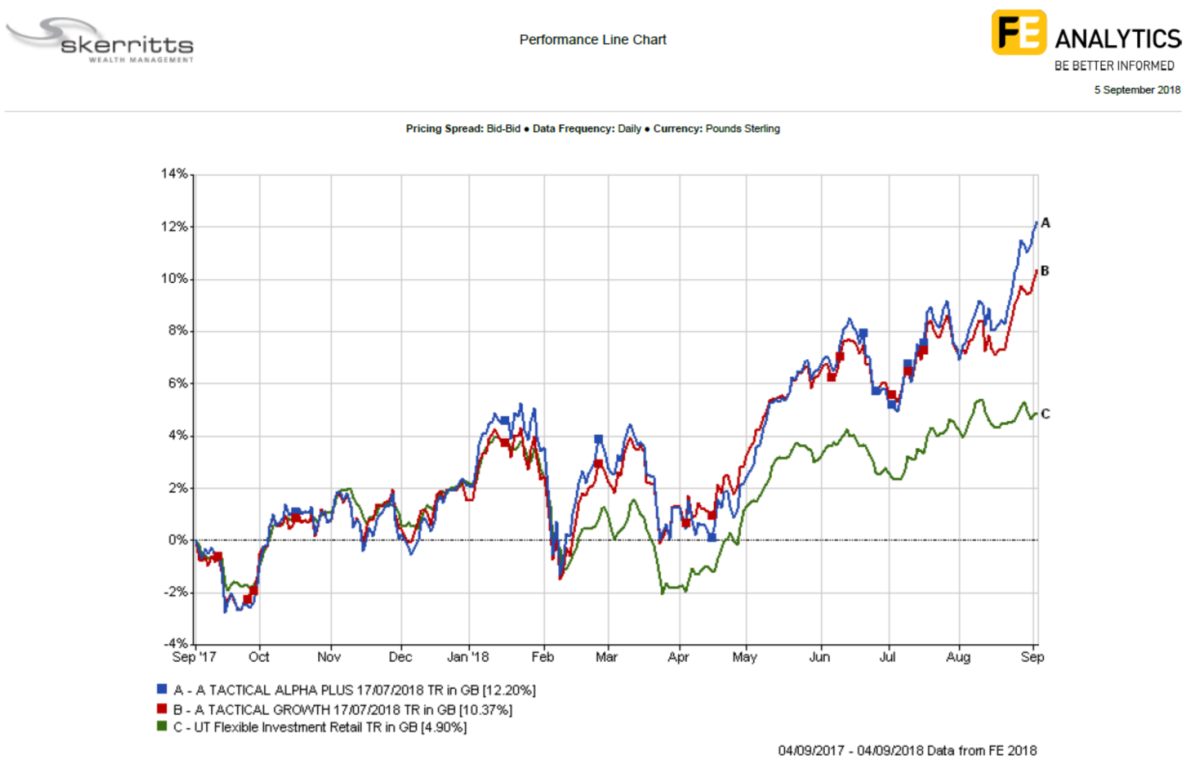
SKERRITTS VIEW – SEPTEMBER 2018

The Themes That Keep Giving:

We were pleased to see our range of funds and model portfolios continue to nudge new highs last week, whilst remaining fully aware that things don't keep going up forever. We have repeatedly explained over recent years how we view the world thematically rather than geographically, and this approach seems to be rewarding our investors well.

A quick glance at the past 12 months' performance of our Tactical Alpha Plus and Tactical Growth portfolios (chart below) shows that our key themes of cyber security, robotics and automation, artificial intelligence, digitalisation, healthcare innovation and luxury brands are **each** showing returns **in excess of 20%** over the year.



Compare this to the performance of the more widely used geographic asset allocation strategies used by most investment managers and it is easy to spot why we pursue the strategy that we do. The Japanese sector is up 9%, the FTSE 100 is up just over 7%, while Asia excluding Japan and Europe excluding UK are each below 5% and emerging markets are negative [Source: FE Analytics]. That is not to say that our thematic approach avoids any of these areas per se (far from it); rather, our geographic allocation is a by-product of the themes that we have identified as relevant in the world we live in today.

The World We Live In Today:

So, what is the world we live in today, and how different is it from the past? In many ways, it's totally different, yet nothing has changed. It was eye-catching that a recent survey claims that only 6% of the UK population works 9 to 5 nowadays, yet the vast majority of those who want to work, do. It's just that they do it in a different way from previously. And this is true of much of today…the world is still inhabited by people who eat, drink, laugh, cry, relax, stress and generally go about their daily lives in a similar way to their predecessors, but they do so differently. And it's these things that make all our lives different that we aim to invest in, because we find it better to invest in the future and in what people want instead of more dated essentials.

Long Cycles Are Made Up Of Mini Cycles:

Across the decades, cycles come and go, and because they are cycles there are often similarities to be drawn. These can be extremely useful in trying to identify potential outcomes and consequences. Throughout the year, for example, we have the calendar year itself which consists of the four seasons, which break down into months, then weeks, then days and so on. Although there are similarities, no two summers are exactly the same, no two winters repeat precisely, and months come and go with many differences between them. Having said this, we all have general expectations of summer which are different from winter, and prepare accordingly.

Economic cycles are similar. You can often look at one set of circumstances and recognise a relationship with a period from the past. At the moment, we are looking very closely at the late 1990s for clues as to what the current late cycle may bring.

Is 2018 1998 In Disguise?:

In a previous article, we had already noticed how much events of 1998 were acting as a blueprint for what we're seeing in 2018. Freakishly (or was it?), the last time that France won the World Cup was in 1998, before, of course, they lifted the trophy again this year. Now, we've had the collapse of the Turkish Lira which has echoes of the Thai Baht devaluation in 1997 that led to the Asian currency crisis that followed in 1998. This ultimately had a major part to play in Russia defaulting on its debt in 1998, which in turn led to the collapse of the Long Term Capital Management hedge fund (ironic name) which consequently nearly led to the collapse of the banking system, such was the amount that US banks had at risk to LTCM. The market plunged in 1998 by 20% or so, but it was the very reason for the US Central Bank to cut rates aggressively which subsequently led to the 68% surge in the stock market that represented the final market blow-off before ultimately we witnessed the horrendous three year bear market that began in March 2000 and ended some 40% lower in July 2003.

Fast forward to today and see the similarities. It is virtually unknown for contagion across emerging markets ***not*** to occur when a major one falters – but it rarely happens immediately. Is it coincidence that Argentina have had to raise their interest rates 60% just a couple of weeks or so after the Turkish situation appeared to be getting out of control? What happens in Emerging Europe, Latin America or Asia rarely stays contained in that region. It is not coincidental either that this recent turbulence has occurred against the backdrop of a stronger US Dollar, because most EM debt is paid in Dollars. There are numerous debt repayments due in the second half of 2018 from countries seen as "emerging" which could cause problems. Add the fuel of an inflammatory trade war to the mix and it doesn't take a leap of imagination to see a deteriorating emerging market picture beginning to affect the developed markets too (globalisation has made the world more connected).

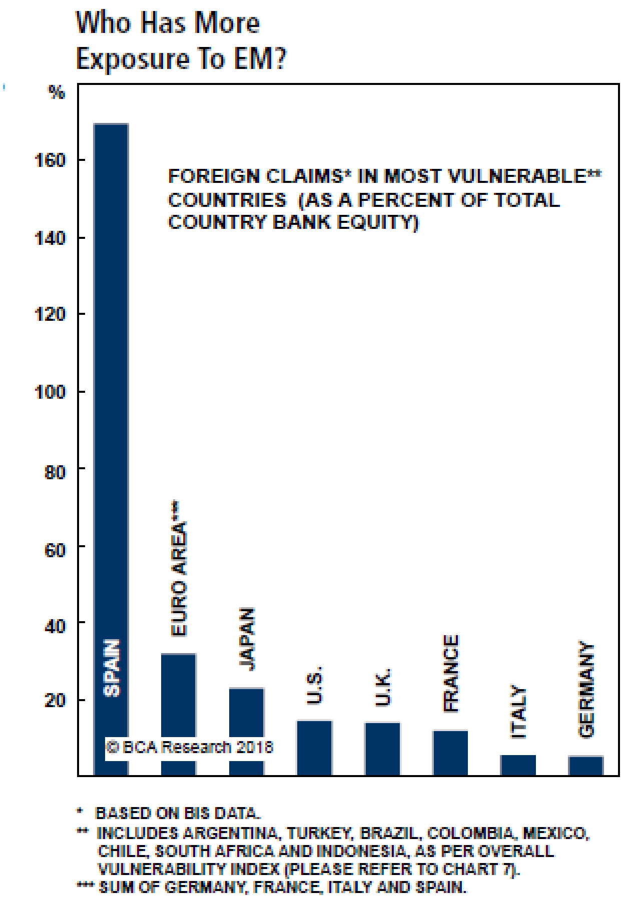
The chart below [**Who Has More Exposure To EM**? Source: BCA Research] illustrates the inter-connected nature quite clearly. Spanish banks are by far the most susceptible to an emerging market crisis, but could the Spanish banking system be seen to stand alone in terms of effect? The European banks are still in rehab following the Financial Crisis that was slower to pass through Europe than the rest of the world and it is inconceivable that other European banks are not exposed to Spanish ones. Dominos could start falling quite quickly.

The silver lining to all of this though is what the Fed is likely to do. They are very aware of the pain that a strong Dollar inflicts on a teetering emerging world, and a certain US President is tweeting his concerns about a strong Dollar on a nigh weekly basis. In the event that we were to see a sharply deteriorating situation for the emerging markets that looked as though it was going to seep into the developed world, it is highly likely that the Federal Reserve would indicate that they were not going to go ahead with the future rate rises that everyone has assumed they will announce, which would be precisely the blue touch paper that sets off the end of bull-run rally a la 1999 which equity investors would not want to miss.

Which Is Why We Invest Thematically:

All of which is precisely the reason that we like to invest thematically. If we don't like emerging markets, we won't invest in them. We don't. If we don't like the UK market until Brexit has become more defined, we won't invest in it just because we live here. We don't. If we can identify themes that have a multi-year raison d'etre it makes far more sense to us that we invest in these.

And if history can teach us anything, it is that markets don't peak until around 6 months before the next recession. We're edging towards the next recession every day by the very nature of cycles, but are we 6 months from the next one in the US and Europe? It doesn't feel like it, which means that markets have got a bit further to go yet before we go into defensive mode, albeit they may take a breather in the coming weeks.



Of course, events could happen very quickly which would cause us to change our minds. Which is also the reason that we run our funds and models on a tactical basis rather than adhering to benchmarks that could act as a straitjacket in times of crisis – for it is at times of crisis that you need every possible tool in the box to help see you through it.

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