Monthly Investor Letter

April 6th, 2018

About this note

ReDefine provides clients and business partners with a differentiated suite of services and products. The monthly note from our Asset Management division encapsulates, in a succinct manner, how our team is looking at the world and the practical implications of that approach. The note is designed to illuminate the process behind the implementation of investment decisions within ReDefine Wealth Management portfolios.

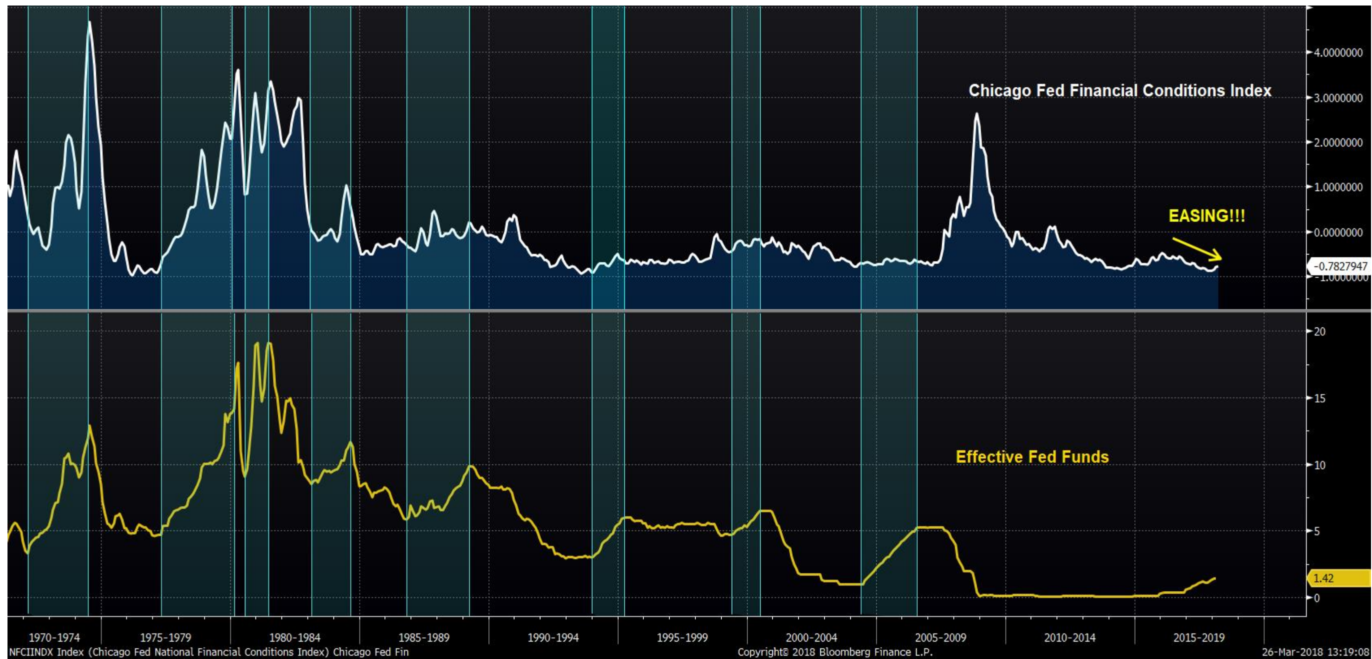
Investment Process

At ReDefine, our investment process consists of three main components. Firstly, we undertake a thorough analysis of the fundamental macro backdrop. We look at where our research differs substantially from consensus growth and inflation prognoses, region by region. We also look at distributions of risk around those expectations which might lead to a positive or negative surprise. Secondly, we look at flow of funds. We investigate who the key actors in the investment world are at any given point in time in each specific asset class. Thirdly our technical analysis is combined with the first two components to provide the basis for attractive reward versus risk investment opportunities. As part of the technical analysis we look at the liquidity characteristics of markets (or subsets of markets) to calibrate whether a defensive or offensive approach to risk is appropriate. Unexpected changes in liquidity characteristics can often turbo charge profits or losses and need to be considered carefully.

Fundamental Macro Backdrop

Central to our fundamental analysis has been an above-consensus outlook for both growth and inflation in the US and more especially Europe. To some extent, market analysts and investors had begun to catch up with our thinking which was then reflected in their trading biases as described in more detail below. All the same, the models we track continue to exhibit more strength in both key metrics than currently anticipated by either the US Federal Reserve or the European Central Bank (ECB). Encouraging the idea that this period of relative strength will continue is the yet-to-be assimilated impact of US tax cuts and spending programmes which will boost GDP through 2018 and 2019.

Despite the tightening of interest rates in the US and incremental balance sheet reduction by the Federal Reserve, financial conditions have remained accommodative. This is due to strong equities, narrower credit spreads, flatter yield curves, a weak US dollar, and low historical volatility. Some of these metrics are beginning to change but as the chart below shows, we are a long way from the historical norm.



In Europe, rates remain firmly in negative interest rate territory (NIRP) whilst the ECB continues its bond-purchase program at least until September. The combination should result in far higher inflation outcomes than those expected by the ECB in their official forecasts. European PMIs (Purchasing Manager surveys) already point to bottlenecks in production and capacity constraints in some industries. Regionally, Germany stands out as being susceptible to inflationary pressures.

To be clear though, we see the developments in US and Europe as a late-cycle dynamic and our optimism is pragmatic and prone to revision as evidence either supports the current trend or begins to undershoot upwardly revised expectations.

Counterbalancing the current data (and the lead indicators we track embedded in our models) is a worrying geo-political backdrop. Trade tensions, tariffs and bi-lateral confrontation between US and both China and Russia constitute a material risk. Concurrently, the darlings of the Tech world seem determined to shoot themselves in the foot (Facebook, Tesla, Amazon). Extrapolated, these issues could begin to weigh on the otherwise optimistic global growth outlook.

The Portfolio Month in Review

We concluded in our March 2018 Monthly as follows: “Since behavioural biases in the markets have barely begun to adjust and only the most aggressive, active trading portfolios have made material adjustments to their investment profile, this period of heightened volatility is very much in its infancy. We anticipate an extended period of higher volatility to force the market to de-leverage. Higher volatility will generate much less attractive risk-adjusted returns and strategies that rely on long-only diversification as their sole source of defence will be challenged. We demonstrated how both volatility and correlation metrics have allowed excessive risk-taking…and we now expect that to unwind.”

ReDefine
Wealth Management

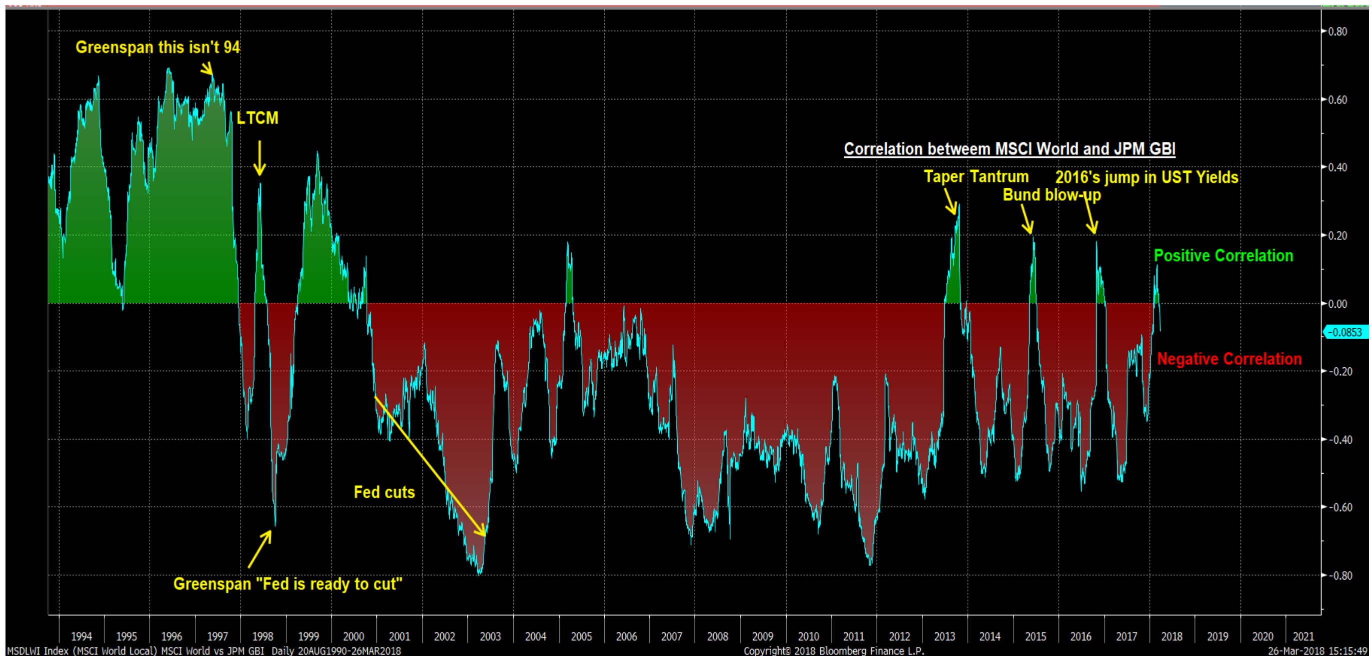
We are now very much in the process of unwinding some of the excesses we referred to.

Q1 provided poor or negative returns in all major, broad equity indices with substantial volatility. The table below shows YTD returns in Equities for the major indices for a USD-based, unhedged investor as of Close of Business 4th April.

Standard | Movers | Volatility | Ratios | Futures | Δ AVAT | 10D | %Chg YTD | USD

1) Americas	RMI	2Day	Value	Net Chg	%Chg	Time	10D Vol	30D Vol	%Ytd	%YtdCur
11) DOW JONES			24264.30	+230.94	+0.96%	21:50 c	31.27	21.78	-1.84%	-1.84%
12) S&P 500			2644.69 d	+30.24	+1.16%	21:50 c	31.46	20.93	-1.08%	-1.08%
13) NASDAQ			7042.11	+100.83	+1.45%	22:16 c	37.60	24.41	+2.01%	+2.01%
14) S&P/TSX Comp			15164.37 d	-16.39	-0.11%	21:43 c	14.66	11.15	-6.45%	-7.90%
15) S&P/BMV IPC			47457.46 d	+773.40	+1.66%	21:16 c	20.84	14.33	-3.84%	+4.41%
16) IBOVESPA			84359.69 d	-263.77	-0.31%	21:22 c	15.20	13.86	+10.42%	+9.83%
2) EMEA										
21) Euro Stoxx 50			3340.35 d	-6.58	-0.20%	22:03 c	15.35	13.84	-4.67%	-2.48%
22) FTSE 100			7034.01 d	+3.55	+0.05%	04/04 c	12.98	11.55	-8.50%	-4.63%
23) CAC 40			5141.80 d	-10.32	-0.20%	17:05 c	13.32	12.96	-3.21%	-0.99%
24) DAX			11957.90 d	-44.55	-0.37%	04/04 c	18.72	17.04	-7.43%	-5.30%
25) IBEX 35			9513.30 d	-36.30	-0.38%	16:38 c	13.43	12.20	-5.28%	-3.11%
26) FTSE MIB			22442.78 d	-67.55	-0.30%	16:35 c	14.58	15.37	+2.70%	+5.06%
27) OMX STKH30			1494.65	-14.15	-0.94%	16:35 c	19.46	16.78	-5.22%	-7.65%
28) SWISS MKT			8553.69 d	-77.24	-0.89%	21:06 c	17.78	15.43	-8.83%	-7.54%
3) Asia/Pacific										
31) NIKKEI			21319.55 d	+27.26	+0.13%	04/04 c	32.72	23.38	-6.35%	-1.16%
32) HANG SENG			29518.69 d	-661.41	-2.19%	04/04 c	22.31	21.49	-1.34%	-1.78%
33) CSI 300			3854.86 d	-7.62	-0.20%	04/04 c	20.77	15.91	-4.37%	-1.28%
34) S&P/ASX 200			5761.35	+9.43	+0.16%	04/04 c	12.33	10.86	-5.01%	-6.12%

Correlations also changed, meaning fixed income failed to act as a counterbalance to equity losses over the Quarter as a whole.



ReDefine
WEALTH MANAGEMENT

As we enter Q2 there is some evidence that market participants have been unsettled by their recent experience and behaviour is beginning to change as we will discuss in more detail below.

Fixed Income

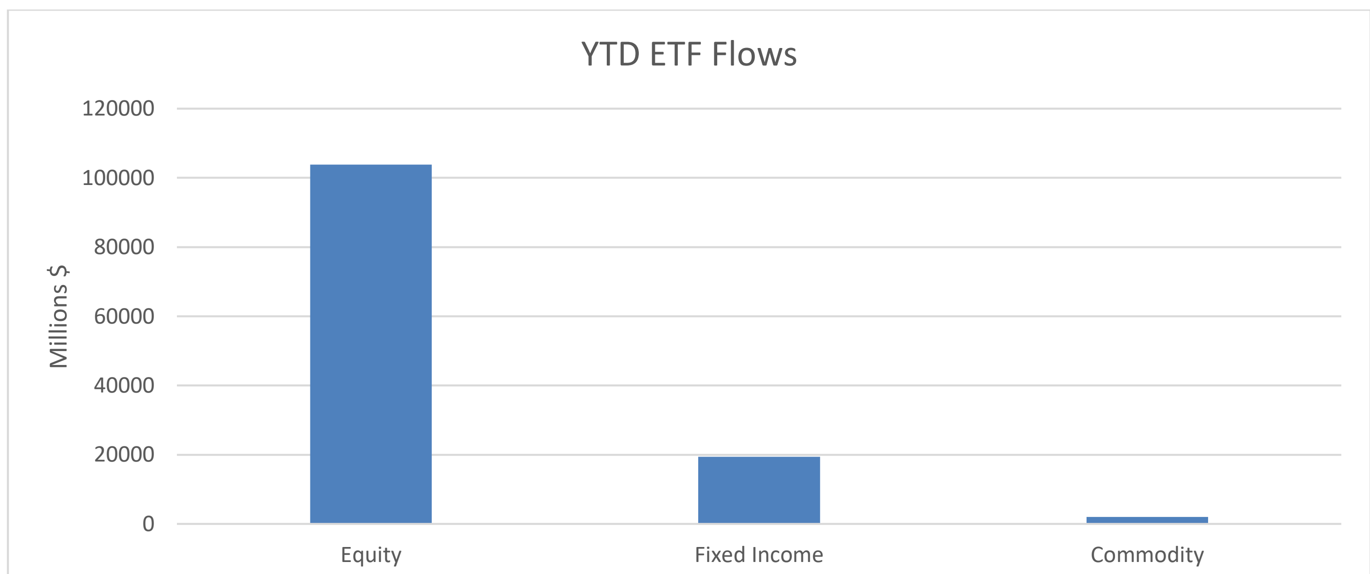
Our premise for Fixed Income (as outlined in February's inaugural Monthly) is that US bonds below 3% are yielding too little fundamentally speaking. Nevertheless, when 10-year US Treasury yields reached 2.95% and 3.20% on the 30-year there were compelling flow-of-funds and technical reasons to expect a rally in bond prices. The outcome in March validated this conclusion and we are now looking for a set-up which provides a suitable risk-reward profile to establish a short position in US bonds. We will also greatly reduce the duration of the fixed income that we do own. Whilst it is our contention that both bonds and equities remain vulnerable to further deleveraging, the poor performance of equities at the time of writing encourages us to think we will achieve more attractive re-entry points for our bearish fixed income outlook.

Equity

We have been exiting European equities since the beginning of February. The European equity complex remains over-owned and flow has started to reverse from the region's principle markets. We expect substantial further declines in European equities in the early part of April. Thereafter we will reassess our outlook using our three-pronged process.

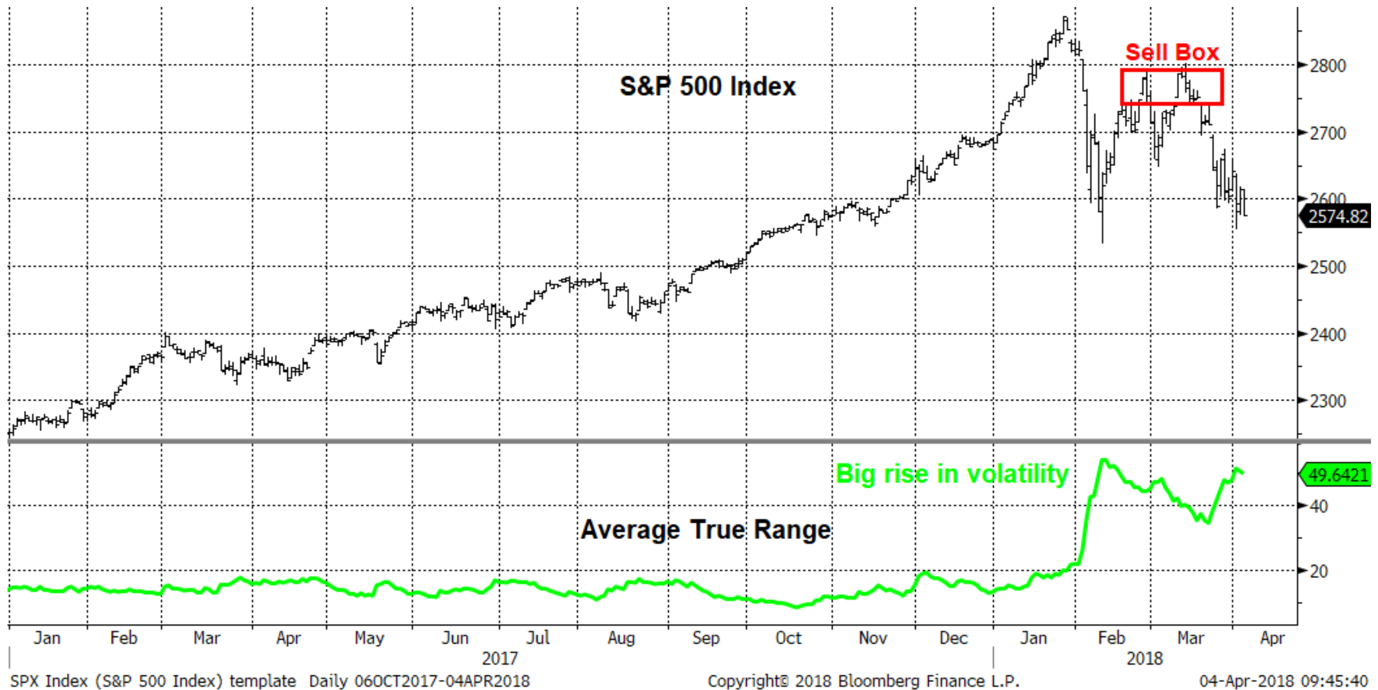
The US equity market, meanwhile, is exhibiting much more vulnerability after a month of chronic over-trading by both retail and institutional investors. Using data-aggregating ETF flow, it is apparent that the enormous wave of buying in January and subsequent "first-dip" buying in February and March has left the best part of $100 billion worth of global equity purchases not only off-side but with deteriorating average entry prices. This makes for a potent risk.

The chart below shows net ETF buying in Equities and Bonds globally up to the last week of March.



ReDefine
WEALTH MANAGEMENT

Volatility is rising and investors are getting whipsawed.



When we reached our sell target for SPX of 2,750 in the middle of March, our strategy was to begin reducing equity exposure given our expectations of a higher-volatility regime. This leaves us in a strong position to benefit from any further disorderly bouts of equity-selling. The fact that the technology sector (the most important driver of 2017's gains) is leading the market lower is highly suggestive of a change of behavioural bias and we intend to use this regime shift as an opportunity to further reduce exposure and possibly introduce a short position.

FX:

With our bias for a stronger USD still in the background, we have been looking for opportunities to enter long USD positions where the risk-reward seems appropriate. Thus far we have restricted ourselves to UUP (dollar currency basket) and a position that was short the Euro specifically. We exited the short-Euro position after being stopped out but remain in UUP. We will continue to look for suitable levels to increase this position

ReDefine
Wealth Management

If DXY can break satisfactorily above 91 or EURUSD fall below 1.22 we will look to broaden our USD long positions.

Gold

Gold is beginning to exhibit some modest strength independent of its anti-USD role. In a heightened-risk environment where bonds fail to act as a hedge for falling equities (as described above), it is certainly possible that some an allocation to precious metals could have a powerful effect. A break above the recent highs of $1,360 and above €1,110 could give bullion the tailwind of momentum buying. For now, the jury is out but we will be watching developments carefully.

ReDefine
WEALTH MANAGEMENT

Gold vs. the US dollar is up against long-term resistance here.

Interestingly, vs. the Euro it is already showing signs of breaking higher.

Conclusion

April promises to continue to provide interesting trading opportunities around our three key biases: short bonds, short equities and long US dollar. The latter is the least compelling at the moment, as the USD's fortunes are being tossed between fundamental and technical factors.

Of the other two, our expectation is for further equity weakness early in the month to provide the opportunity to introduce a fixed income short position at attractive levels.

The chronic over-trading of equities, a change in mood in the technology sector and a behavioural change from greed (fear of missing out a.k.a. FOMO) to fear of losses or dissipating profits all stack up to suggest this period of comparatively higher volatility will persist for the time being. That said, markets are prone to exhaust themselves. When we have sufficient evidence that weak-handed positions have been substantially washed out there will be an opportunity to weight our analysis more heavily towards its fundamental drivers as a way to produce alpha in the portfolio.

ReDefine Asset Management

Disclosure
The information presented in this report are the opinion of Redefine Wealth Management ("RWM"). This material is based upon information RWM believes to be reliable. The information provided, while not guaranteed as to accuracy or completeness, has been obtained from sources believed to be reliable, and is subject to change without notice and may or may not be updated. RWM does not accept any responsibility to update any opinion, analyses or other information contained in the material. This material is for your general information only and is not an offer or solicitation to buy or sell any security. You should not consider the contents of this report as financial or other advice.
It is RWM's policy to have written investment advisory agreements. An investment advisory relationship between RWM and any entity or person will commence upon execution of the advisory agreement. RWM will not provide advice or enter into an advisory relationship until a written advisory contract is signed by the client.
Past Performance is No Guarantee of Future Results.