Capricorn Annual Letter

This is our 2019 outlook piece, the purpose of which is to provide our views and insights into the key questions affecting our decision making in client portfolios today.

As a reminder, we don't have a crystal ball and we don't make significant short or medium term timing decisions on markets that are volatile and unpredictable. However, we do invest probabilistically and we do have longer term thematic views that cut across asset classes which inform the way we invest portfolios for the longer term.

The main bulk of this letter addresses these key themes that drive our investment thinking for the coming year and beyond. The summary of our work can be described as:

1. Higher interest rates, in time, will depress future asset price returns, though in the short term we believe interest rates will remain roughly where they are.
2. There is an increasing risk of a recession in the US in the next 24 months. Global asset prices will likely react ahead of it occurring. Arguably they have already factored in a reasonable probability of one occurring.
3. Political risks are not likely to reduce anytime soon. This makes the kind of global co-ordinated response we saw in the last financial crisis less likely to occur with governments now more inwardly focussed than they have been for a long period of time.
4. China's slowdown, and associated macro issues will be a long term issue and consequently we are cautious on emerging market allocations on a longer term basis.
5. For long term investors Brexit uncertainty will result in attractive opportunities. We believe some are emerging already and we favour defensive assets which will be resilient whatever the outcome of Brexit.

Against this back-drop we see more challenging prospects for traditional asset classes. Our longer term expected returns for a 60/40 global equity/bond index would be in the mid-single digits versus high single digits over the past 20 years or so. In response to this challenge we encourage clients to 1) invest with the expectation that we will see more volatility going forward as a consequence of higher interest rates and slowly shrinking central bank balance sheets 2) embrace longer term alternative strategies which derive a return from a risk factor, illiquidity premia and/or manager skill that is uncorrelated to broader financial markets 3) invest with the knowledge that a recession while not imminent is probable, and structure portfolios with a sufficient margin of safety (in the form of retaining liquidity and holding non or lowly correlated assets) to exploit the ensuing panic when it happens.

In the below table we translate the above views into positioning across asset classes. As a reminder, each portfolio we manage is tailored to individual circumstances (regulatory, taxes, currency, liquidity needs, leverage requirements, etc.) and we don't have a generic portfolio or fund, however, we feel it is useful to have a model portfolio which acts as a reference point to demonstrate what we think. Our key skews are to hold cash over government bonds and increase allocations to specific niche strategies within private credit and alternatives, and to hold public equity at target weights.

Model Portfolio (for non-taxable, USD based client)

Asset Class	Long Term Strategic Allocation	2019 Tactical Allocation	Themes taken within asset classes
Cash / Money Markets	2%	15%	Cash interest rates are now equivalent to long term inflation rates and allow clients to preserve wealth in real terms and retain liquidity to exploit opportunities that result from ensuing volatility.
Government Bonds	13%	0%	There is no need to hold any bonds for a USD investor given the nominal difference to cash. This conclusion is different for GBP or EUR investors where yields are higher than cash.
Credit	20%	20%	Within Credit we are allocating to short duration funds and asset backed strategies focussing on: • Short Duration High Yield Bonds • Lower Middle Market Private Credit • Real Estate Backed Credit • Mortgages

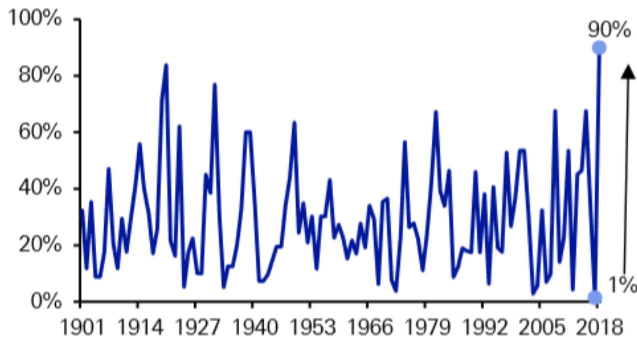
Asset Class	Long Term Strategic Allocation	2019 Tactical Allocation	Themes taken within asset classes
Absolute Return	10%	15%	We favour alternative strategies that earn returns that are lowly or uncorrelated to wider financial markets. These include: • Life Settlements • Catastrophe Reinsurance • Litigation Funding • Actively managed market neutral strategies, e.g. Merger Arbitrage, Low Net Long-Short Equity
Public Equities	30%	30%	We have a preference for US large cap stocks, Chinese technology stocks, are neutral on Emerging Markets and underweight Europe, UK and Japan due to structurally weak growth in these areas.
Private Equity	20%	15%	We are wary of the significant dry powder in the private equity industry and are avoiding the large buyout funds due to excessive competition for assets. Beyond this allocations are very much manager and opportunity dependent. We have a preference for: • Co-Investment Funds to reduce fees • Lower Middle Market Private Equity in developed markets which offer greater scope for operational improvements and strategic mergers • Venture Capital within our trusted partner network
Real Estate	5%	5%	We expect generic real estate to underperform against a slowing global growth backdrop and in time higher rates. However we like defensive assets, e.g. care homes, nurseries, waste management facilities, social / affordable housing given their economic resilience. Again our allocations are opportunistic.
Total	**100%**	**100%**	
Gross Long Term Expected Return	**6.5%**	**6.7%**	
Volatility	**10.3%**	**9.1%**	
Expected Sharpe (2% Risk Free Rate)	**0.43**	**0.50**	

The rest of this document covers our views on a number of critical questions that we think face investors today, our responses to them and how we get to our allocation preferences above.

The year 2018 was a difficult one for investors.

The graphic below from Deutsche Bank (Fig 1) shows that 63 of the 70 asset classes they survey delivered a negative return (in USD terms) in 2018 which was the worst year going back to the inception of their dataset beginning in 1901.. This created a very difficult backdrop for most allocators and investors. However, 2018 can't be viewed in isolation. 2017 was almost the complete opposite in that 99% of assets delivered a positive return.

Figure 1: 90% of assets surveyed were negative in 2018



Source: Deutsche Bank. Note number of assets is 34 in 1901 versus 70 in 2018

Why was 2018 so difficult?

We believe too much time is spent delivering a narrative to explain what just happened in financial markets and the reality is you can take your pick from a whole host of factors that change from month to month or quarter to quarter. However, we feel the principal reason for such high correlation across asset performance is mainly down to the end of the era of easy money with the US short term interest rate finally exceeding inflation (as measured by core CPI) at the end of 2018. This easy money era created by governments post the financial crisis naturally encouraged risk seeking behaviour which led to high valuations across a number of asset classes (and also mania/speculative bubbles in some) which was likely to lead to future lower returns - it was just a matter of time.

However, we would encourage some healthy perspective. The S&P 500 total return in 2018 was down -4.4% (after dividends), and comes off the back of nine straight years of positive returns. The MSCI World Index in USD had a worse year at -8.9%, but it wasn't far behind in delivering 7 out of 9 years of positive returns. Like all good things, they come to an end eventually. The critical question is where we go from here.

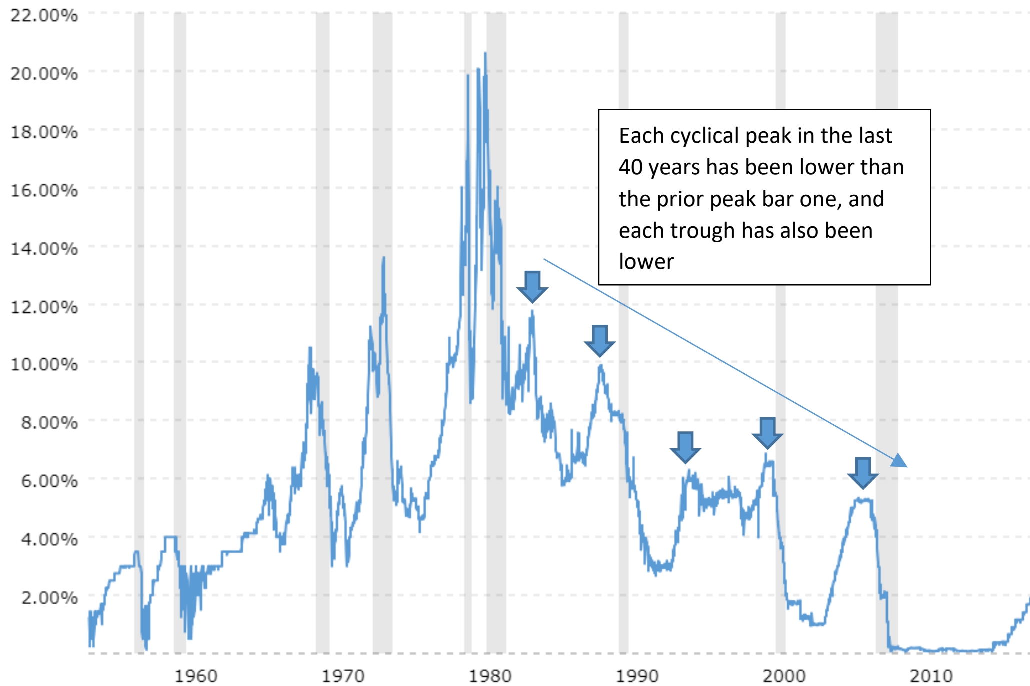
What are the key questions we are asking when looking ahead?

The purpose of this section is to focus our efforts on thinking about the key drivers that will shape our investment strategy going forward.

Q1. What is the short and longer term path for interest rates?

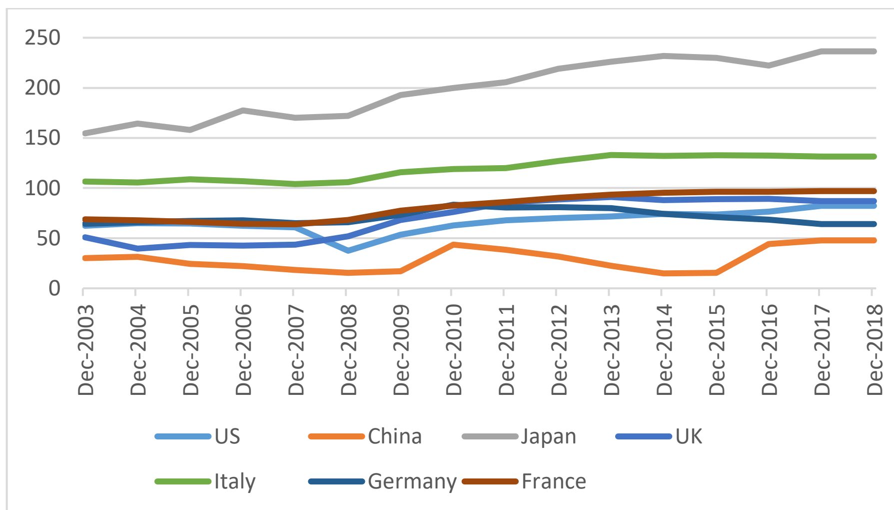
This is such a critical question as it drives valuations of all cash yielding investments. Interest rates move in both longer term cycles (40+ years), and shorter term cycles (5-10 years which reflect so called business cycles that most of us are more familiar with). Most developed markets have been in a long-term interest rate reducing cycle since the late 1970s/early 1980s as demonstrated by the US interest rate declining from a peak of c. 20% down to 0% in 2008 (Fig. 2). This recent 40 year cycle ended in 2016/2017 as the Federal Reserve started increasing rates and reducing its balance sheet and other central banks followed. We believe this long term cycle is now changing, with interest rates heading higher globally, but the pace at which this happens will be slow due to the high leverage levels across most large economies as demonstrated by the absence of a decline in leverage over the last 10 years in government debt levels (Fig. 3).

Figure 2: The US Federal Reserve Policy Rate has been in a secular declining cycle since the late 1970s



Source: St Louis Fed

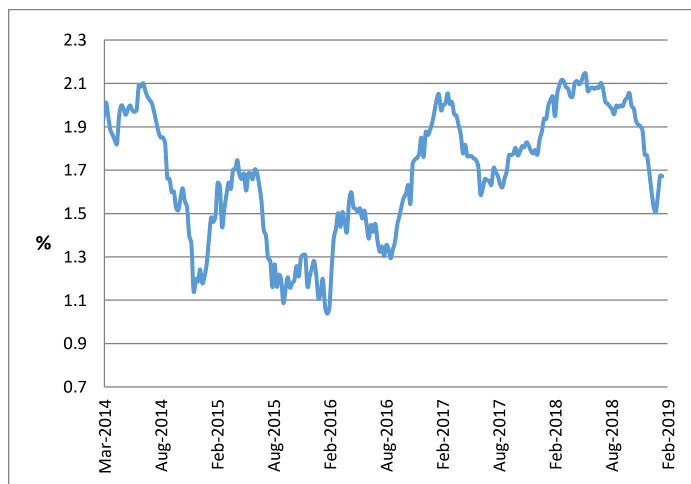
Figure 3: Government debt as a % of GDP has risen since 2008 for most large countries



Source: Bloomberg

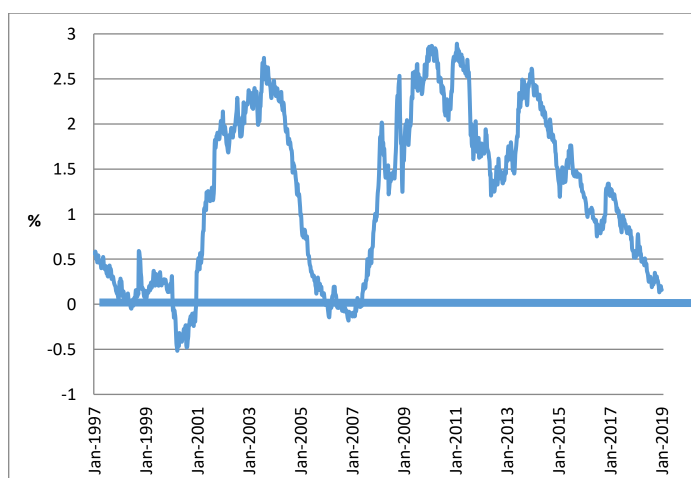
While the longer term rate cycle is in the process of turning higher, on a short term basis the market environment indicates that current policy rates will likely remain close to where they are. We see weak growth limiting the ability of the ECB, BoJ and BoE to raise rates. The US has been on the most aggressive path higher and here we think a slowdown in the pace of rate rises is likely. Our reasoning is best illustrated by the charts below.

Figure 4: US 5 year break-even inflation rates (a market expectation for US inflation for the next 5 years) has fallen sharply in recent months



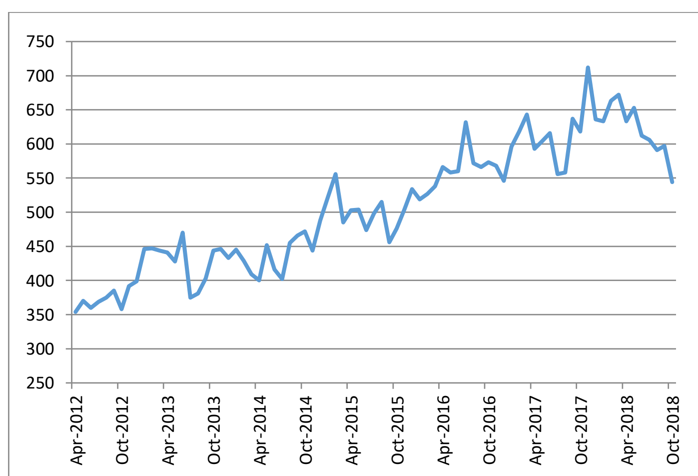
The sharp contraction in medium term inflation expectations from a 5 year high to 2 year low highlights the absence of inflation expectations. Even the 5- year high was only hovering around the Fed's long term target.

Figure 5: US 10 year yield less US 2 year yield is a cause for concern as inverted curves precede recessionary environments



The shape of the yield curve offers us clues to what the market expects the future to hold. Here the market is saying that further increases in rates are unlikely, hence the "flat" interest rate curve. Previously, inverted curves (i.e. when the difference goes below zero) which held for several months preceded future recessions.

Figure 6: US new home sales (Thousands, SAAR) have fallen sharply in recent months



Source: Fig 4-6 all Bloomberg

Higher interest rates have taken their toll on US housing via rising mortgage costs resulting in a recent sharp reduction in US housing activity, a key driver of US growth.

How could we be wrong about rates?

Across most of the developed world (especially the US) unemployment remains low, and there remains significant fiscal stimulus coming from the Trump administration which remains quite determined to oversee a period of strong economic growth, low unemployment and a strong stock market. We have to acknowledge the risk that workers are able to negotiate higher wage increases (already at the highest in a decade at 3% YoY in the US), and that there may be higher rates as a result of an increasing supply of Treasuries to fund the infrastructure spend Trump desires. These factors could drive up inflation expectations especially in the US. For these reasons we still continue to shy away from long duration fixed income assets in portfolios, and because the interest rate curve is so flat we will continue to allocate to the shorter end of the maturity curve within fixed income allocations.

Our view is that a combination of a -20% peak to trough stock market decline, weak US housing, and a recent fall in inflation expectations will drive a pause before the US Fed moves to any further tightening. We also see limited scope for other central banks (ECB, BoJ, etc.) to withdraw liquidity and raise rates quickly as global growth expectations have declined. So, in conclusion, we don't see a material risk for higher rates in the near term, though some individual countries see borrowing costs spike due to idiosyncratic issues (e.g. UK, Italy). In the longer term though, the rates path is up across most developed market countries.

Q2. What is the prospect of a US recession in the next 12-24 months?

There are several warning signs flashing that concern us that the US is heading toward a recession at some point in the next 12-24 months. These include:

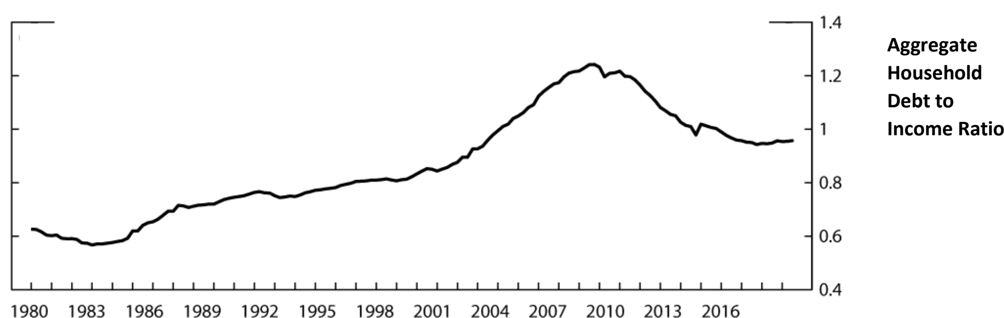
1. A flat yield curve
2. Tightening financial conditions (higher borrowing costs/credit spreads, increased equity market volatility)
3. Equity multiple contraction implying lower earnings growth
4. Declines in global PMI indices
5. Weak performance of cyclical stocks such as financials and commodity stocks

The equity markets have already made the call that a slowdown is going to happen – *remember equities always move ahead of the fundamentals* - so the -20% decline we just experienced in Q4 already moved the market to a point where a slowdown in 2019 was largely priced in. The next key question is whether or not the slowdown turns into a full blown recession in 2019/2020 where equities and other risk assets move to a more severe level of underperformance.

Offsetting the above we observe:

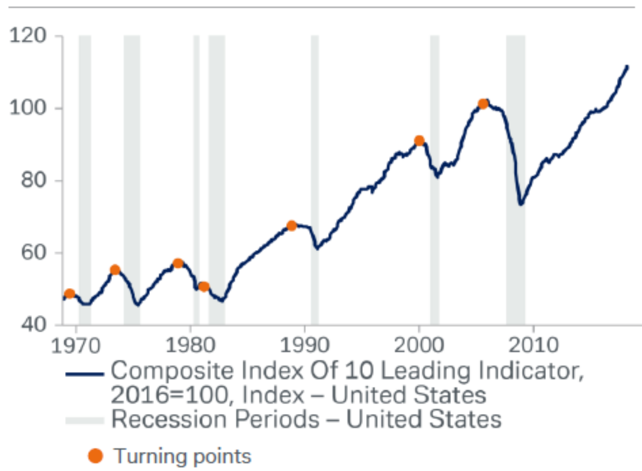
1. Significantly lower consumer leverage since the financial crisis (Fig. 7)
2. Still healthy US leading indicators (Fig. 8)
3. US still operating well below prior capacity utilisation peaks (Fig. 9)
4. A healthier and recapitalized banking system

Figure 7: The US consumer has decreased leverage post crisis



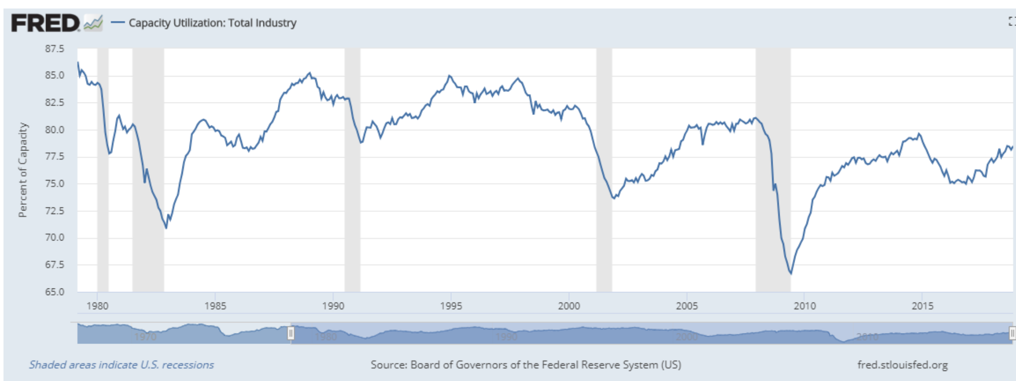
Source: Federal Reserve

Figure 8: US economy still has some room to run, with recessions not occurring until 15 months after a peak in leading indicators



Source: Deutsche Bank

Figure 9: Capacity utilisation is still below historical peaks prior to previous recessions



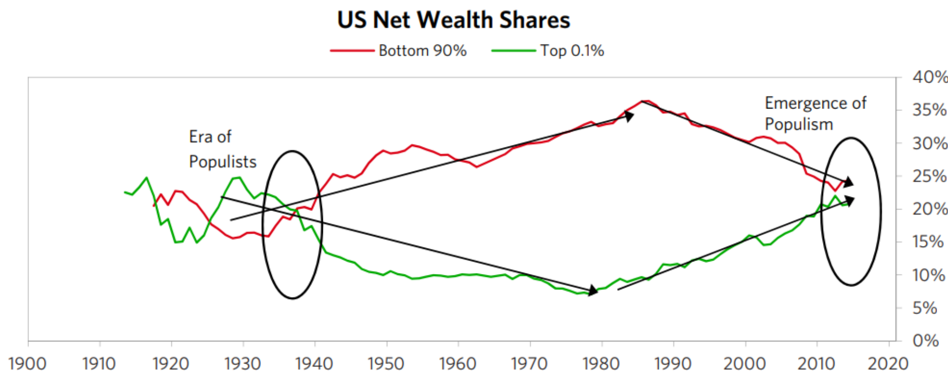
Source: St Louis Fed

Our best estimate is that with these mitigating factors we would put the probability of a recession in the 40-50% range in the next 24 months. We are very focussed on the yield curve, and given it has a strong tendency to predict recessions were it to invert our probability of a recession would move to higher than 50%. To stress why we think this is important a flat yield curve essentially drives risk aversion and acts as an incentive to not invest – why take a long term bet if you get the same compensation for a short term bet? If the US were to dip into a recession we don't see how Europe would not follow.

Q3. Will we see an abatement in geo-political risk?

There are many different expert opinions on this point but we believe the main driver of higher geo-political risk is down to an increasing inequality gap between different earnings cohorts in the developed markets. Fig. 10 below demonstrates this by comparing how much wealth is held by the Top 0.1% of US the population versus the bottom 90%. This shows that today we have reached a point where the share of wealth held by these groups is the same as it was in the 1935-40 period, which was an era of very high instability.

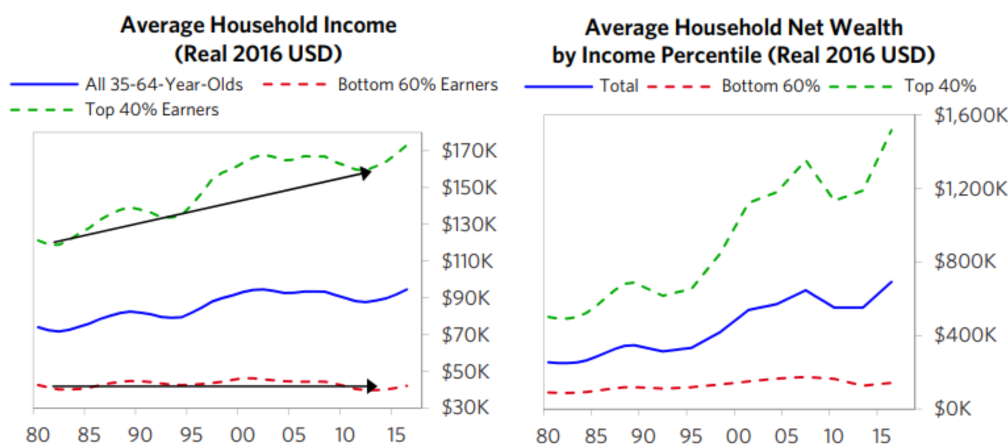
Figure 10: The distribution of wealth share between the Top 0.1% and Bottom 90% of US population is at the same point as in the 1935-1940 period



Source: Bridgewater

To give a broader picture Fig. 11 below shows how the wealth picture has changed for the top 40% of earners and the bottom 60% in the US over the last 40 years, as well as what the average looks like. It highlights a worrying trend that all income growth can be attributed to the Top 40%. We believe this stagnant (or declining) real wage for the lower 60% cohort across the US (and a similar pattern applies for parts of Europe) has driven much of the political risk we see today – manifesting itself in the form of the rise of right or left wing populist governments and increases in protectionist policies. Bridgewater have written an excellent piece on this (link here) with other interesting data and related points on this topic.

Figure 11: US Real Earnings and Net Wealth by Income Percentile



Source: Bridgewater

The implications of this on investments is not conclusive with no study proving either way if increasing or reducing income inequality is good or bad for stocks, bonds or property markets. However, we think it is a major global issue and as a result don't think political risk is going away anytime soon. Our best assessment is that the current situation could drive higher taxes on higher earners, more protectionist policies and could contribute to more inflation via higher fiscal spending. We also note that this failure to increase real wages across the population has also contributed to the above situation of an inability to reduce debt globally. Governments, especially in Europe, continue to run large debt to GDP balances and any attempt to decrease it via fiscal tightening (i.e. eroding living standards further) has been met with fierce resistance by the local populations (see recent riots in France and Italy). Consequently we see geo-political risk as adding to risk premia across asset classes.

Q4. What are the implications of China's growth slowdown?

Directional exposure to China/EM is a small part of our portfolios, but the Chinese economy and the actions that their government take are extremely influential on sentiment and ultimately global asset prices. We rely very much on our expert network of managers to give us insight into China. Our current takeaways are:

1. China is slowing down. A number of indicators are of concern to us including falling Money Supply (Fig. 12) and declining PMIs (Fig. 13) which reflect a difficult macro environment. Some of this is down to the imposition of US tariffs, however, there are longer term structural issues in China related to their need to rebalance their economy to a more stable and sustainable growth path.

2. China remains highly motivated to avoid a hard landing and will continue to take measures to avoid this. A combination of a weakening Chinese currency, interest rate cuts, reduction in bank capital requirements and other stimulus measures including tax cuts (lower income tax, higher VAT rebates, etc.) are all being pushed through the system to offset the recent impact of tariffs and weak market sentiment.

Figure 12: China Money Supply (M1) has fallen very sharply in recent months

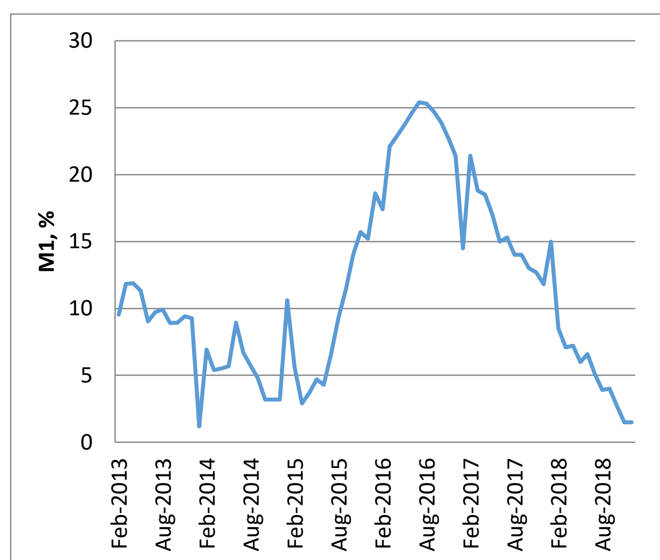
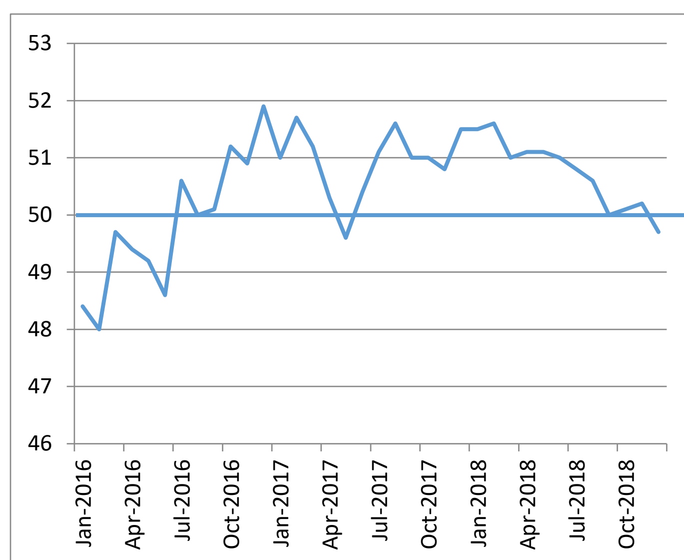


Figure 13: China Composite Manufacturing PMI has fallen into contraction territory



We believe it is important to separate stocks from the economy as one is forward looking relative to the other. While China concerns us the Chinese equity market is trading at low valuations relative to developed market counterparts. A slowdown is very much reflected in the recent -30% correction in the main China stock indices. Such a correction is nothing out of the ordinary for this market (-40% corrections experienced in 2010/11 and 2015/16) and were followed by strong recoveries.

Until we get clarity around China it is likely to feature as a small part of portfolios and just within equity allocations. We skew our allocations in China to the Tech sector which has depreciated significantly in price, trades at a significant discount to US counterparts and is less affected by tariffs given the domestic nature of the stocks. Should there be some kind of stabilisation in the Chinese economy we believe these stocks have significant room to appreciate.

Q5. How do we assess the impact of Brexit and what does it mean for our strategy?

Rising above the media circus around Brexit is not an easy task for investors. However, a few basic truths now appear clear.

1. There is no parliamentary majority that can be assembled for leaving the EU with a specific deal.
2. There is, however, a clear majority for preventing the UK leaving with no deal.
3. This leaves the only logical alternatives as:
    a. a second referendum – which the PM has ruled out, but may still be forced into,
    b. a General Election – a wholly unpalatable risk for the Conservative Party (given the current parliamentary arithmetic), or
    c. a delay in the hope of forging consensus after further talks.

The protection offered to Prime Minister May ("PM") by the Fixed Term Parliament Act of 2011, her inherent caution, and dogged determination to deliver Brexit in some form leads us to share the (now widespread) view that the most likely scenario is an extension to Article 50 beyond March 29th (as discussed by the Chancellor with business leaders after the no confidence vote) leading to further rounds of talks with the EU. The complexity of the PM's position is increased not just by the warring factions within her own party, but the refusal of the Labour party to engage in constructive dialogue until "no deal" is taken off the table (something the PM sees as a critical negotiating tool).

On balance, our central case (60%) is that some sort of watered-down Brexit is eventually negotiated and signed off by parliament over the next 6-12 months. However, there is risk on both sides of the distribution – it may become clear that another vote is the only way to remove the log-jam (30% probability); rather less likely is that attitudes harden over the next 6-8 weeks and the UK exits with no deal (10% probability).

So what does this mean for investors? Like all markets in times of uncertainty, those with a deep understanding of the local dynamics embrace the opportunity, while the "tourists" withdraw entirely and wait for a more certain backdrop before re-engaging. The closest parallel we see to a bad Brexit outcome is the early 1990s recession after Britain crashed out of the European Exchange Rate Mechanism ("ERM") in September 1992 – initially very painful as interest rates and unemployment rose sharply, but actually quite short-lived with GDP growth in 1993 (+2.5%) and 1994 (+3.9%) returning to trend and ushering in a period of economic growth which continued through the first Blair administration until the dot com crash of 2001.

Nevertheless, in our conversations with global investors (particularly US private equity GPs) the UK is often referred to as "uninvestable" until Brexit has been resolved. We think this is a mistake. Some of the most sophisticated domestic UK investors we interact with actually see in this dislocation a significant opportunity to purchase assets at discounted prices. While we would not advocate an over-weight to the UK or GBP in general, we do think there are pockets of interest in defensive sectors which have been over-sold (e.g. waste management facilities, storage units, social/lower cost homes etc). We have been working hard to identify a number of specialist managers (mainly in the real estate / infrastructure space) who can play these themes and have the requisite experience to exploit the volatility we foresee in the coming months. Said another way we are looking to invest in assets that are resolute to both any short term pain from Brexit and can benefit from longer term positive structural themes.

Conclusions

So, to reiterate our conclusions, we believe that:

1. Higher interest rates, in time, will depress future asset price returns, though in the short term we believe interest rates will remain roughly where they are.
2. An increasing risk of a recession in the US in the next 24 months. Global asset prices will likely react ahead of it occurring. Arguably they have already factored in a significant probability of one occurring.
3. Political risks are not likely to reduce anytime soon. This makes the kind of global co-ordinated response we saw in the last financial crisis less likely to occur with governments now more inwardly focussed.
4. China's slowdown, and associated macro issues will be a long term issue and consequently we are cautious on emerging market allocations on a longer term basis.
5. For long term investors Brexit uncertainty will result in attractive opportunities. We believe some are emerging already and we favour defensive assets which will be resilient whatever the outcome of Brexit.

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