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Thesis Market Commentary

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Is there a price to pay for following the herd?

Index tracking – investing in collective investment schemes that simply aim to mirror the holdings and performance of an index – is on an inexorable path forward. To the end of last year, according to research firm Morningstar, $130.7bn left actively managed US equity funds whilst $240bn flowed into products tracking US equity indices, and it is estimated that exchange traded funds (index trackers) now account for nearly half of all trading in US stocks.

So what is the problem with this I hear you say? It is reasonably well documented that the average active US equity manager actually underperforms the broad US market (as measured by the S&P500) over time despite charging high fees after selling their potential to outperform. So why wouldn't an investor instead want to simply obtain the (on average better) performance of the index for a lower cost.

Yet as index tracking has grown in popularity, so have the concerns about the inadvertent risks they could be creating in markets or to investors. Witness the on-going rise in the S&P500 as it continues to reach new all-time highs. With so much money going into index tracking products, these in turn will be investing the majority of this into the largest stocks in the index which will be bought irrespective of the prices at which their shares are trading. 2015 famously saw the year of the FANG stocks – Facebook, Amazon, Netflix and Google (now Alphabet) – where without the contribution of their share price rises, the S&P500 index would not actually have made a gain for the year. Three of these four companies were among the top five largest companies in the index, and although it is not disputed that these companies and their disruptive business practices are doing well, without so much money flowing into index tracking products, would their share prices have been so well supported. Or maybe investors bought the index knowing they would pick up exposure to these companies among the top 5 holdings. Anyway, one debate about index tracking products is that nobody quite knows the cause and effect relationship yet between the money flowing into these products and their underlying holdings which get bought on a price indiscriminate basis.

Where perhaps an answer becomes a little clearer is among tracking products that presently exist to allow investors to get exposure to more niche asset classes than the broad US equity market. iShares for example offer an exchange traded fund which aims to track the performance of an emerging market bond index. It has performed pretty well over the last 12 months in terms of performance (+6.5% in USD to 30 Sep) whilst in terms of size it has grown by 400% from around US$100m at the beginning of the year to over US$500m at present. Some of this of course is the performance, but it still amounts to nearly US$400m of inflow.

Next we look at the top holdings in this index, the largest of which is a US dollar denominated bond issued by the Russian Federation with a coupon of 7.5% maturing in March 2030 and rated BB+ by S&P. Their definition of this rating states that issues have "significant speculative characteristics" and "while such obligations will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposure to adverse conditions."

US/Russia credit spread

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Now, in rational terms, the way investors are typically willing to accept this extra 'speculative' risk is through a higher return than something with less or perceivably negligible risk, something such as the treasury bond of an AAA rated government; and the question investors need to ask themselves is what premium they require over and above this for them to buy and hold this bond. At present, on a gross redemption yield basis this is around 3% per annum greater for the average of all the emerging market sovereign bonds in the JPMorgan emerging market bond index than a 10-year US treasury bond. But this Russian Federation bond – which at 1.5% is the largest in the index - trades at only around a 0.4% gross redemption yield premium to the 10 year US treasury. Moreover, this holding along with the other Russian Federation issues which together account for nearly 5% of the index, all only trade on an average 0.4% premium. Undoubtedly Russia could be classed as among the 'safer' of the emerging market nations represented in the index, especially so versus the highest yielding constituents such as Argentina and Turkey, but does it sound sensible lending to Putin's government to only receive 0.4% per annum extra return versus the US?

Any active manager would be questioned by both colleagues and investors on such a decision, especially if their intention is to buy and hold rather than 'pass the parcel' with this perceivably risky trade. Index tracking funds however HAVE TO BUY the bonds in the index with new money that they receive and hold them, so around US$6m of this iShares ETF's inflows would have gone into this Russian Federation bond this year. This doesn't sound as much when we note that there were US$21bn issued. When, however we then consider all the other index tracking products feeding into this bond, one of which - the iShares Emerging Market Bond ETF (London) currently with over $8 billion of assets; up from less than $4 billion a year ago – also holds the same Russia bond as its top holding, then one can work out the scale of demand created.

Now, if the flow of money into tracking products and some of their holdings is roughly equal to the opposite of flows out of active funds, then the market pricing should be in equilibrium, however the fact that this bond has risen so significantly in price suggests demand is outstripping supply due to the likely buying across all iShares ETFs, and across all other providers of index tracking products higher still. This constant flow of money into (in this case) emerging market bond ETFs creates a constant buy order for particular bonds, regardless of whether these bonds offer fundamental value and regardless of price. And it is this constant buying in what is still a rather illiquid security that pushes the price up past fundamental value.

Going back to our starting point then, there is clearly a lot of thought and research needing to be done about the potential impact index tracking products could be having on different markets. Most numbers about percentage ownership of a market or index by tracking products are pretty rough cut, but are certainly still increasing so this 'momentum' effect could continue for some time to come. Quite where the fulcrum point for security pricing is between the indiscriminate passive buyer and the active price discoverer also needs to be thought about. Certainly for the latter, the more prices may get distorted by passive buyers there should eventually be more opportunity for their selection ability and so the two strategies can sit side by side.

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News and views

Global equity indices continued their advance as corporate earnings news proved largely supportive and the global economy continues its synchronised recovery, as evidenced by robust data across regions. Those gains have been broadly based, from both a regional and sector perspective, albeit Japan's Nikkei was the standout performer with a month that included a 16-day winning streak, finishing with a gain of +8.1% and propelling the index to a new 21-year high.

Indices	Value as at 31/10/2017	% Change on month	% Change year to date	% Change on 12 months
FTSE 100 Share	7493.08	1.64%	4.90%	7.75%
FTSE All Share	4117.69	1.67%	6.31%	9.28%
S&P 500	2575.26	2.22%	15.03%	21.12%
Dow Jones	23377.24	4.34%	18.29%	28.85%
Euro Stoxx 50 EUR	3673.95	2.20%	11.65%	20.25%
Nikkei 225	22011.61	8.13%	15.16%	26.32%
MSCI Emerging Markets	1119.08	3.45%	29.78%	23.64%
UK Treasury 4.25% 2027	127.50	0.10%	-1.66%	-1.76%
Sterling/US$	1.33	-0.91%	7.91%	8.55%
Sterling/Euro	1.14	0.42%	-2.60%	2.18%

Source: Bloomberg

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Speculation over who would be chosen as the next chair of the US Federal Reserve (Fed) was a key theme throughout the month, with Republican Jerome Powell nominated by Trump just after month-end. Powell has served under both Yellen and former Fed chairman Ben Bernanke during his five years on the Fed's board. His public statements and voting record on the Federal Open Market Committee (FOMC) have so far been consistent with chair Yellen's agenda of normalising monetary policy. Market reaction to the news was muted, given broad expectations that Powell would be the pick, in addition to the continuity and experience he brings. Though Powell would be the first Fed leader in nearly four decades without an economics degree, he is well regarded inside the central bank and would be expected to bring a crucial ability to build consensus.

UK

The initial estimate of third quarter GDP delivered a small, but still welcome, upside surprise versus the market consensus. The 0.4% increase between July and September continues to show the dominant services sector, which makes up around three-quarters of the economy is still supporting growth. Whilst we acknowledge that sentiment towards the UK's longer-term trade prospects is inevitably coloured by the perceived rate of progress in the Brexit negotiations, we continue to monitor consumer activity very closely for any signs of deterioration. With the Bank of England credit conditions survey pointing to much tighter supply for household credit over the coming quarter, particularly for unsecured debt, and with the run of positive surprises from the UK retail sales data suggesting a relapse, we remain cautious on activity levels going forward. Household spending has played a key role in supporting the overall economy in the wake of the 2016 Brexit vote, and with real incomes suppressed by rising inflation, growth in consumer credit has been an important prop to consumption. We are also paying close attention to the labour market for any change in the now familiar pattern of historically low levels of unemployment combined with still-sluggish wage growth. Any upward pressure on wage growth could continue to stimulate household spending.

US

Confidence in the outlook for the US economy was boosted when third quarter growth came in higher than expected, alongside robust corporate earnings particularly from the technology sector. GDP rose at an annual rate of 3%, with the heartbeat of the US economy, the consumer, alive and well as consumer spending grew at a solid +2.4%, as the tightening labour market underpinned confidence. The US also appears to be receiving a significant tailwind from faster growth abroad, as net trade and inventories both made significant contributions to growth which slightly flatters the headline rate. The strong showing made a December rise in interest rates by +25bp to a range of 1.25% to 1.50% even more likely, with the probability now fully priced in by the futures market. The November Fed statement reaffirmed expectations, delivering another confident assessment of the US economic outlook and making no changes to its inflation projections.

Eurozone

Eurozone activity data continue to impress, and the forward-looking indicators hint at a further acceleration into year end. The macroeconomic momentum helped the region's equity markets gain around 2%, even as political factors returned to the fore. The aftermath of Catalonia's unofficial independence referendum caused some short-lived volatility and resulted in the Spanish authorities triggering Article 155 of the Constitution and assuming direct control of the region. Elsewhere, elections in Austria saw victory for the centre-right/Christian democratic ÖVP. Mr Kurz, 31, will become Europe's youngest leader after becoming foreign minister at the age of 27. He has run his campaign with a promise of change, being tough on immigration, easy on taxes and widely Eurosceptic. On the monetary policy front, the European Central Bank (ECB) is beginning to acknowledge the robust and sustainable uptick in the economy as it took the first steps towards exiting quantitative easing (QE). While the QE programme has been extended for nine months, the flow of monthly purchases has been reduced to €30 billion from January to September 2018.

Japan

Prime Minister Shinzo Abe and his ruling Liberal Democratic Party gained the most votes in Japan's snap elections. "Abenomics" has been judged a success by the electorate in driving down unemployment and supporting the economic upturn. The large victory has enabled equity investors to form a view on the likely continuation of both monetary and fiscal policies. This more stable backdrop was matched by a significant pick up in net purchases of Japanese equities by foreign investors, with strong earnings prospects and Japan's political stability helping to maintain upward momentum, with the Nikkei 225 index reaching a 21-year high. The Bank of Japan maintained its policy stance, holding short-term rates at -0.1% and 10-year bond yields at zero. In contrast to other central banks, it has no plans to rein back the stimulus measures.

Emerging markets

It was a positive month for emerging equity markets as they extended their year-to-date gains on the back of ongoing strength in global growth. Asia led the advance with Korea and Taiwan among the best-performing markets, with technology stocks registering strong gains. India also posted a robust return as the government announced plans for a major recapitalisation for state-controlled banks. Outside of Asia, equity performance varied, with gains in Chile and Hungary being

offset by losses in Colombia, Mexico and Russia. In China, President Xi consolidated his power at the 19th party congress. He hinted at moving away from a pure focus on numerical growth targets to qualitative measures when formulating policy, with greater emphasis on reforms aimed at distributing wealth more evenly. GDP data for the third quarter showed that growth slowed modestly, in line with expectations, to +6.8% year on year. The tightening in credit conditions is slowing growth in new construction, property sales and house prices.

Fixed income

It was a positive month for bond markets with corporate bonds in general outperforming government bonds. Within the corporate bond market, high yield bonds outperformed investment grade. Shortly after month end, the well flagged Bank of England Monetary Policy Committee voted 7-2 (Cunliffe and Ramsden dissenting for rates on hold) to raise policy rates for the first time since July 2007. The 25bp increase to 0.5% was expected, but the dovish rhetoric suggests a definitive lack of urgency to raise rates again. Focus will now shift to the upcoming Budget on 22 November and any fiscal implications that may stem from it.

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