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INVESTMENT MANAGEMENT

It's a MAD* World

*Mutually Assured Destruction

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"When people run in circles
It's a very very mad world
Mad world."

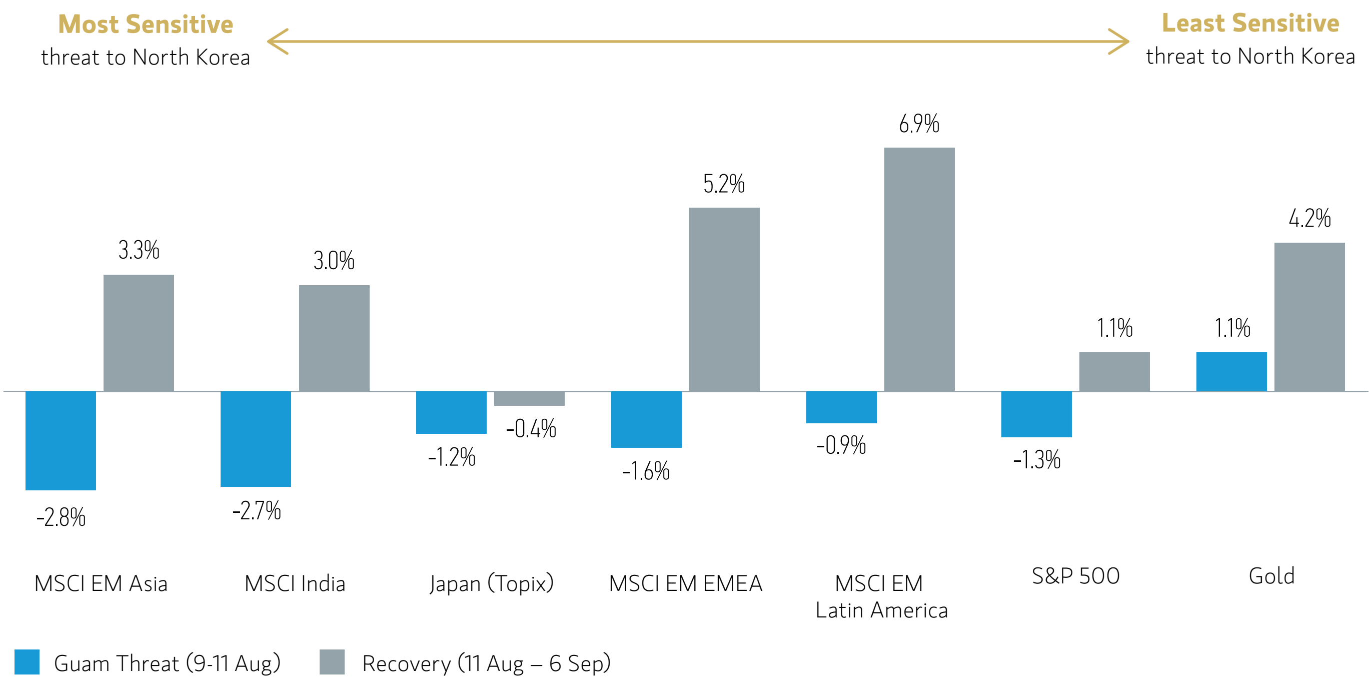
— Mad World, Tears for Fears, 1982

Hurricanes, floods, fires and earthquakes are enough for the planet to bear. Add in heavy legislative agendas, potential tightening by central banks and spiralling tensions between the U.S. and North Korea, and the net effect for investors is an increased number of potential "event risks." The world seems to be going mad as the nuclear standoff revives the Cold War concept of mutually assured destruction (MAD).

Our positive view throughout 2017 has been supported by healthy global economic data and, until recently, accommodative central bank policy. Other reasons for optimism have included low global market volatility, favourable conditions for capital investment and consumer spending, the latter having been bolstered by low energy prices. These fundamental drivers remain strong—so strong, in fact, that they could prompt central banks to start monetary tightening, following the U.S. Federal Reserve's (Fed) lead — and the bond markets seem to be factoring that in. But the positive backdrop is complicated by the geopolitical risks, which argue for moving into safe-haven assets.

DISPLAY 1

Dr. Strangelove moments: "How markets stopped worrying about the bomb"



Source: Bloomberg, MSCI Emerging Markets Asia Index, MSCI India Index, Tokyo Stock Price Index (TOPIX), MSCI Emerging Markets EMEA Index, MSCI Emerging Markets Latin America Index, S&P 500 Index, Gold Bullion, London Bullion Market US dollars per troy ounce – from the ICE Benchmark Administration (IBA) data as of 31 August 2017. The performance of these indices is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See disclosure section for index definitions.

North Korea: MAD?

The tension between the U.S. and North Korea appears to be getting worse, building up a pattern where a missile test by North Korea triggers a reaction from the U.S., and markets fall. When neither side says anything for a few days, investors relax and the market rebounds. Then the cycle repeats. There is no clear resolution because neither side is willing to compromise.

North Koreans clearly consider their nuclear weapons to be a core asset. They repeatedly cite other nations that gave up their nuclear capability, like Libya and Iraq, and were subsequently invaded. Whether their concerns are purely defensive or whether they intend to use their nuclear capabilities to gain leverage over South Korea is an open question that is hotly debated by Korea experts. But it is clear they do not intend to abandon their nuclear programme, considering it to be their one "ace in the hole".

For the U.S., allowing a state as unpredictable as North Korea the ability to potentially reach the continental U.S. with a nuclear-armed warhead is unacceptable.

We expect the standoff to escalate further before it is resolved. One of the U.S. strategies is to impose drastic sanctions on North Korea to bring them to their knees, but both China and the UN have already tightened sanctions, with no apparent effect. As Russian President Vladimir Putin said recently, North Koreans "will eat grass but will not give up the [nuclear] programme."[1]

Markets: Hell no, we won't glow

The markets are unusually sensitive when it comes to nuclear issues, even non-military ones like the Fukushima meltdown in 2011. Although markets tend to stabilise when there is no news, each escalation in the North Korea crisis leads to renewed nervousness. This up and down movement is the definition of volatility, so investors need to prepare for it.

When put under pressure, both President Trump and Supreme Leader Kim tend to double down rather than pull back, so whilst actual military conflict is still unlikely, we believe there is a higher probability of the two sides pushing each other ever closer to military conflict.

[1] http://www.businessinsider.com/ap-putin-north-korea-will-eat-grass-before-giving-up-nukes-2017-9

Eventually the threat of MAD may force a resolution, but neither of the key protagonists really seems willing to compromise at this stage.

As a result, the odds have shortened and investors are getting nervous. We expect volatility to persist until a resolution is found—and when it comes, we could get a very rapid rebound in the market, particularly if the underlying economy is solid. But for now, the confluence of factors pushing volatility up in the short term makes us cautious about assets that are sensitive to this particular risk.

It is possible to correlate the periods of tension with North Korea to the prices of assets. For example, when North Korea threatened to strike Guam, most regional indices fell, notably the MSCI Emerging Market Asia Index and the MSCI India Index. The MSCI Emerging Markets Latin America Index, on the other hand, was relatively insulated, as was the U.S. Subsequently, EMEA and Latin America Emerging Markets rebounded most strongly whilst, at the other extreme Japan failed to rebound. Gold performed well as a hedge *(Display 1).*

Industrial metals and copper also seem to have defensive characteristics in this kind of environment. They are heavily used in military applications, and all the sabre rattling is making nations around the world reconsider, and increase, defence spending.

Trump: Expect the unexpected

The U.S. president is coming under increasing pressure from different directions: The Russian investigation is distracting from his agenda, and disarray within his own Republican Party seems to be causing him to act even more unpredictably. As a result, we wouldn't be surprised to see further unexpected policy decisions, particularly in foreign, trade and military policy where his power is less constrained by congressional oversight. The likelihood of unexpected, market-moving events is rising.

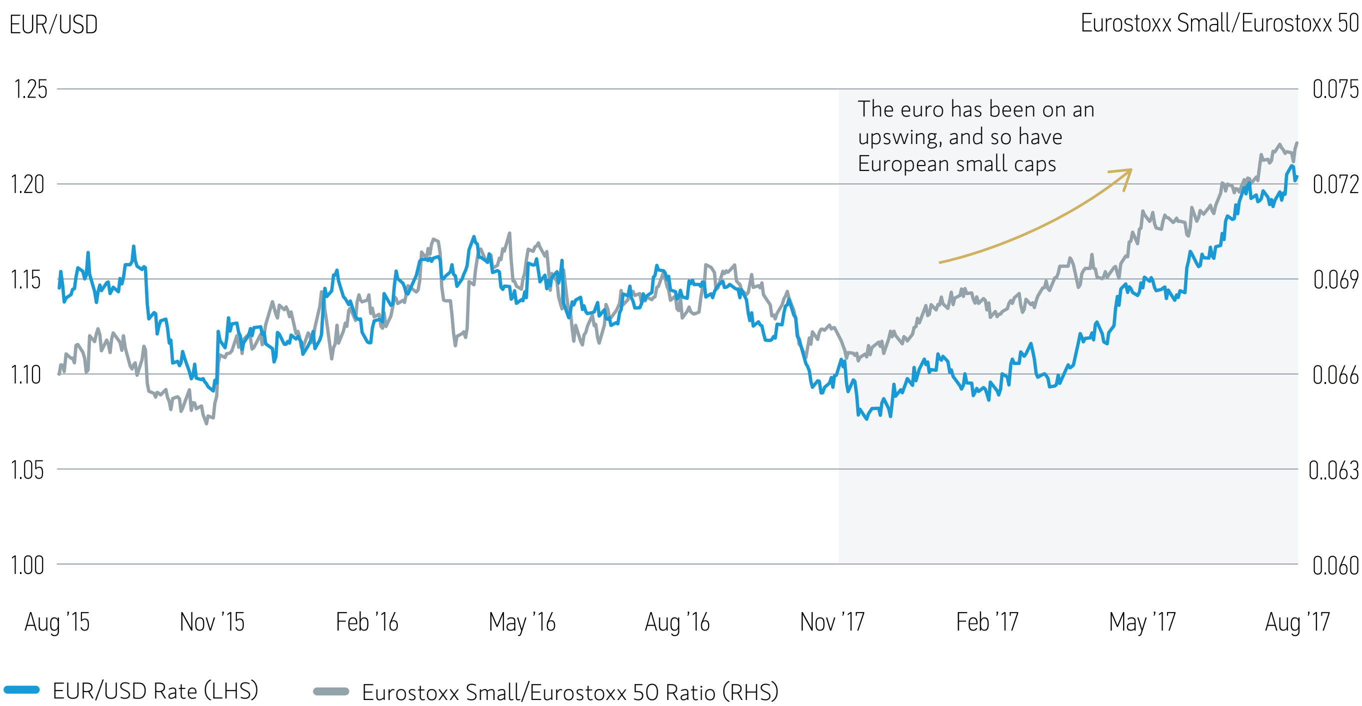
Tightening: Another wild card

Our outlook throughout 2017 has been positive, largely due to the strengthening economy, but that's a factor that can turn negative as central banks begin to tighten monetary policy in an effort to prevent overheating and inflation. As we have commented in previous outlooks, for a while, modest central bank tightening was considered good news. It had been seen as a vote of confidence in the economy, particularly in the U.S., whereas now tightening could be viewed as a negative.

In the U.S., bond yields have been dropping again. There is a great deal of

DISPLAY 2

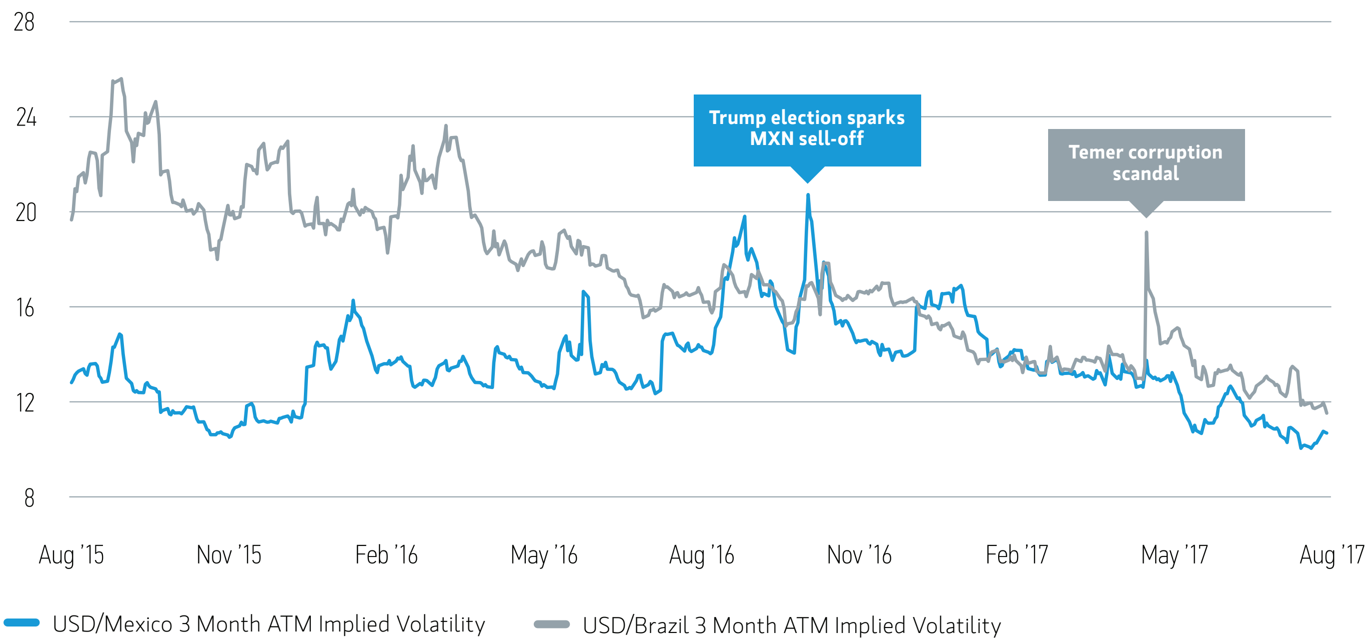
European small caps outperform when the euro strengthens



EURO STOXX 50 Index, EURO STOXX Small Index. See disclosure section for index definitions. Currency performance based on euro – US dollar. Performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

DISPLAY 3

Amid global tensions, volatility has been falling in Latin America



US dollar/Mexican peso 3-month at-the month (ATM) implied volatility, US dollar/Brazilian real 3-month ATM implied volatility. **Past performance is no guarantee of future results.**

scepticism that the Fed is actually going to raise rates in December, although the Fed has said nothing to justify such scepticism. If it does in fact raise rates, the market may be surprised, which could trigger additional volatility.

Adding to the uncertainty is how the Fed will go about it: Which part of its balance sheet will it reduce? Typically, tightening entails selling short-term instruments, pushing short yields higher and flattening the yield curve. But because the Fed has a lot of long-dated bills in its inventory, it might reduce those instead, driving up yields in the long end of the curve. A flatter yield curve is therefore not a certainty.

If tightening were to result in a steeper yield curve, that could have implications for equities. Corporations have issued debt to buy stock over the last several years. Higher longer-dated bond rates would reduce the incentive for stock buybacks, thereby removing one of the supports for equities.

Hurricanes: Lifting inflation?

The U.S. is one of several countries that have been experiencing weather-related disasters with hurricanes Harvey, Irma and Maria, representing an exceptionally catastrophic hurricane season. Harvey, in particular, inflicted damage to assets in the oil and gas sector, pushing up gasoline prices. Any uptick in inflation – even if driven by temporary forces – would tip the scales toward raising interest rates, particularly if the Fed is already tightening.

This makes us look at Treasury Inflation Protected Securities (TIPS). Embedded inflation expectations are still quite low, but if inflation trends back to normal levels for the pace of global economic growth we are now experiencing, inflation-sensitive assets could trade lower.

Europe: Small caps prosper from euro strength

Although European Central Bank President Mario Draghi has been trying very hard not to mention the word "taper," the euro has nevertheless strengthened significantly on expectations of potential tightening. This is bad news for European exporters, who form a big part of the European large-cap market. Smaller European companies, being far less export-driven, benefit from growth, without being affected by the stronger euro *(Display 2).*

As expected Chancellor Angela Merkel secured her fourth term in power, but with a weaker mandate than had been expected. In particular, the relative success the Alternative für Deutschland (AfD) party, not only raises questions about Germany's relationship with the rest of the European Union, but also creates challenges for Merkel in the Bundestag when building a coalition, as does the SDP's decision to sit in opposition. In the UK, we think it likely that Prime Minister Theresa May will continue on her "soft Brexit" course, but potential opposition by euro sceptics could turn this into a tricky political issue.

Europe, Middle East and Africa (EMEA) Emerging Markets: A mixed bag

We have been negative on EMEA Emerging Markets, mainly because they are dominated by Russia and South Africa. The region is not a coherent unit, however, and really should be looked at as three separate pieces: Russia is oil-dependent; South Africa depends on commodities; and Central Europe depends on growth in Germany and the rest of Europe.

Breaking these out, we find that the Eastern European nations are generally doing well. With Europe growing, there is going to be more demand for goods and services from Central Europe to supply that growth. A lot of the supply chain for Germany comes from Poland, for example.

While positioning in Central and Eastern Europe makes sense to us, political and oil concerns still caution against going into Russia. South Africa continues to have political difficulties, but commodity prices are rising meaningfully.

Latin America: A defensive play in a MAD world?

Latin America is not immune to global tensions. Yet, during the Guam threat, their market suffered only modest losses compared to their counterparts in Asian emerging markets *(Display 1)*. In a turnaround from the beginning of the Trump administration, volatility is now starting to decline in Mexico and Brazil *(Display 3)*. In the current geopolitical risk framework, the region may actually be defensive.

China & Japan: Delicate circumstances

China met its government growth objective in the first half of the year. It now has the luxury of pulling back on stimulus as part of its careful deleveraging. People tend to get nervous when growth slows in China, but it is important to distinguish between a natural economic slowdown and one that is manufactured by government policy.

On the geopolitical front, President Trump has been pressuring China enormously to take drastic measures with respect to North Korea. Yet, there is a limit to what China can do: Sanctions strong enough to be truly effective would trigger a major refugee crisis for China, since the Yalu River separating the two countries is relatively easy to cross.

Japan has had more than one North Korean missile fly over them. Even though their performance has been decent, exposure to Japanese equities is relatively risky given that it would be an obvious target for North Korea.

Anticipating risk events: It's what we do

With the risk from North Korea looming larger, it is interesting that the VIX[2], at 12%, hasn't gone up as much as might be expected. We think part of the reason is that investors don't quite know how to price in this volatility.

This particular risk event is extremely unlikely to materialise, but also extremely negative if it does happen, which means that taking a weighted average of the really bad case and the good case doesn't give a satisfactory position. We, therefore, think it prudent to reduce exposures to volatility and higher-risk areas and put in defensive positions where possible. As we cut back on equities, which tend to have high durations, we have increased durations modestly on the bond side to balance this out.

There seems to be a lot of mad running in circles in the political world recently, driving event risks in the markets. These risks are not equivalent across regions and sectors, which allows us to anticipate risk events and actively adjust asset allocations accordingly.

When some of these issues, like North Korea, are resolved, we expect these risks to turn into opportunities. We will be watching closely and ready to readjust our portfolios.

[2] This index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See disclosure section for index definitions. Source: Bloomberg, data as of 30 May 2017. The VIX is the Chicago Board Options Exchange (CBOE) Volatility Index ®, (VIX ®) a key measure of expected volatility using S&P 500 stock index option prices.

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