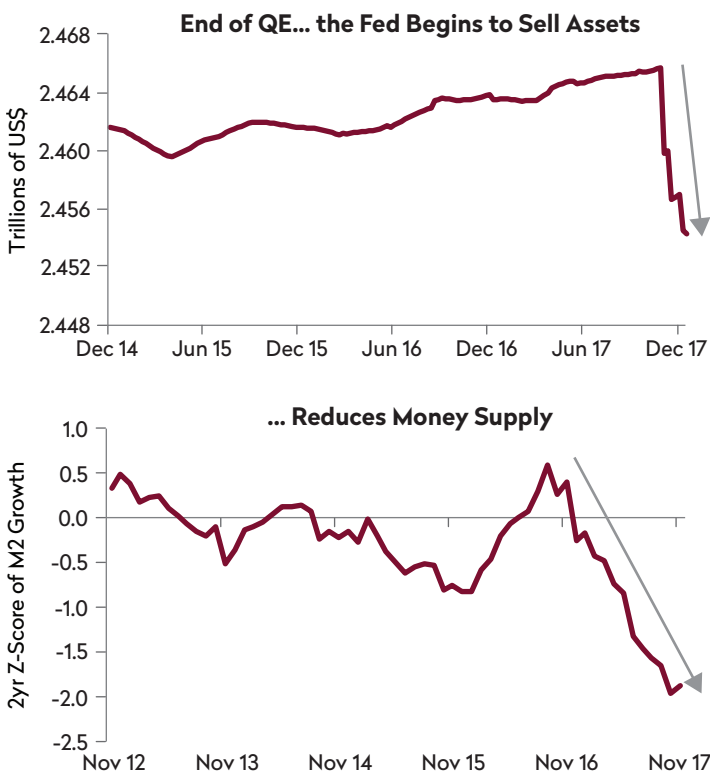


Real QE Ends... Bubble Sectors Come off the Boil

Quarter 4, 2017

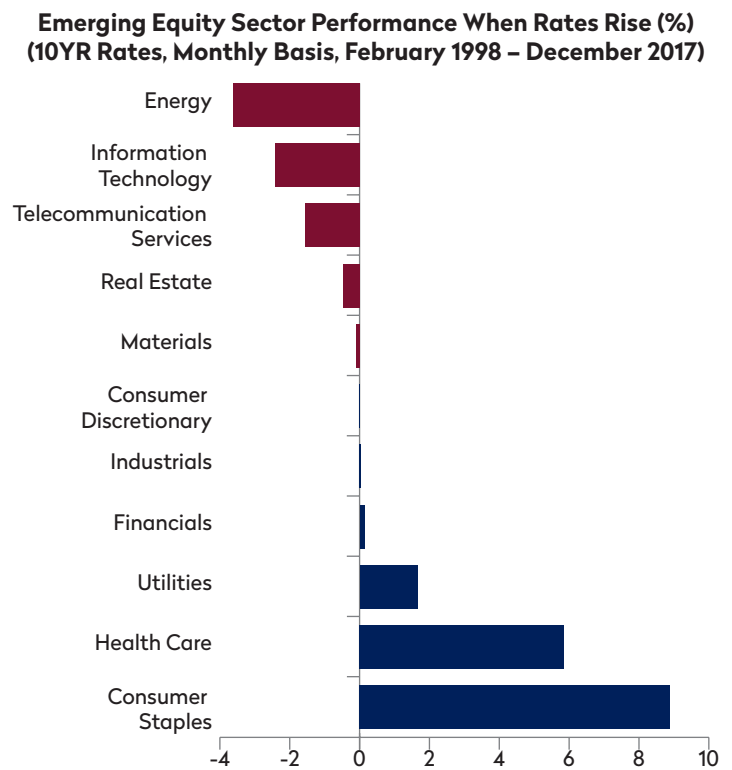
- November: US Central bank starts to reduce Treasury holdings
- US\$ Money supply growth continues to dip sharply in Q4
- Chinese Tech hits a bump in the road; coincidence?

Exhibit 1: The Fed Jabs the Brake



Source: US Federal Reserve.

Exhibit 2: Past Sector Performance in a Tightening Cycle



Source: Rothko Investment Strategies, MSCI, Factset.

A contracting Fed balance sheet, falling money supply growth and fully valued equity markets shout to us that defensive value approaches should be favored to capture a continuation but partially hedge for the inevitable market volatility. We have noted over the past few years the rising inflationary pressures in the US and the risks of a retraction of US\$ liquidity on bubble sectors and poor quality stocks in EM. These concerns have now started to be realised and should be a wakeup call for investors in bubble sectors, as inflationary pressures increased in the US. November saw the start of the Fed's announced action to reduce the size of its balance sheet (see Exhibit 1, upper), initially by \$10bn per month, while also raising short term rates in December. In addition, we note that US\$ money supply continues to sharply slow (see Exhibit 1, lower). These three monetary factors ratchet up the risk of a correction

in specific areas, and historically Tech has been one of the worst effected (see Exhibit 2).

A conundrum for defensive value approaches has been "what to do with Tech"? It is overvalued on conventional measures but the sector appears to have "decoupled" from market correlations relative to other sectors and this has caused speculation that Tech may yet prove to be defensive as well as being a "bull market outperformer". We note that, in the past, when there have been fewer dollars in the global economy, intrinsic value has counted for more. That has resulted in bubble sectors and poor quality names suffering higher volatility and correcting more sharply. Tech has historically been one of those sectors (see Exhibit 2). As a true value manager Rothko does not hold overvalued stocks such as Tencent or Baidu.

Side-Step the Tech Conundrum

We believe Income orientation will prove to be a key driver of defensiveness, when it is needed and we note that Rothko is an income oriented defensive approach, conceived to capture the majority of the upside but to defend on the downside.

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Disclosure

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