ROTHKO

MONDRIAN INVESTMENT PARTNERS LIMITED

The Great $7.2tn Sucking Sound

Quarter 2, 2018

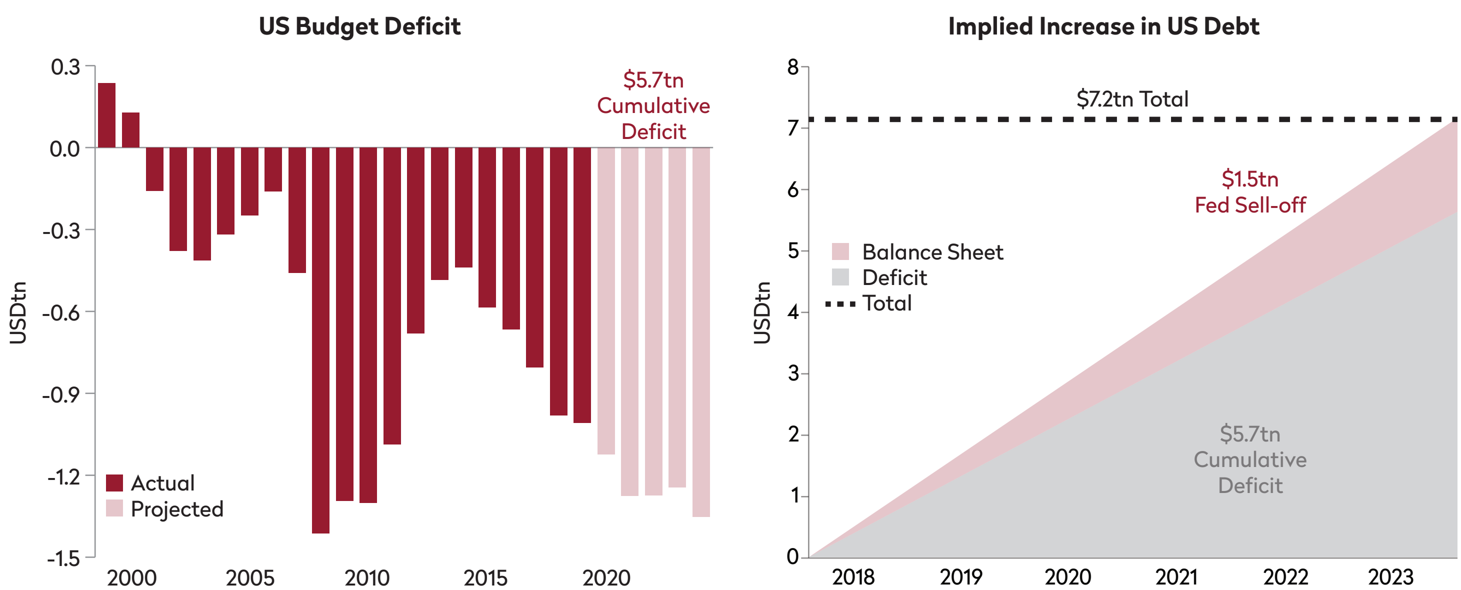
- **The Fed calls in the US$7.2tn loan to the weakest international markets**
- **US$ liquidity recedes: defensive styles remain key**
- **Factors with appealing names: Beware they could be liquidity death traps**
- **Canary in the coal mine: China's FX reserves, maybe A-shares weren't such a great idea**

The Fed's attitude to US$ monetary policy and potential damage to foreign markets has tended to be opaque but considered. This makes sense. While the US economy is paramount to the Fed, damage to export markets and foreign investments have arguably had a nasty habit of coming full circle.

The current Fed policy has broken with past norms and appears reckless in this regard. With an extra $7.2tn of funding being demanded by the US Authorities over the next 5 years (see Exhibit 1), someone will have to go without. This is a big number made up of the additional $5.7tn to finance the US budget deficit, at the same time as the Fed will be mopping up $1.5tn through asset sales. The result will be a sustained decrease in US$ liquidity.

The combined impact of this is likely to be felt hardest by the weakest borrowers and some of those borrowers will be emerging markets. We believe this puts a greater onus on fundamentally driven, defensive investing.

Exhibit 1: The Fed Demands $7.2tn Back



Source: The Federal Reserve, Rothko Investment Strategies.

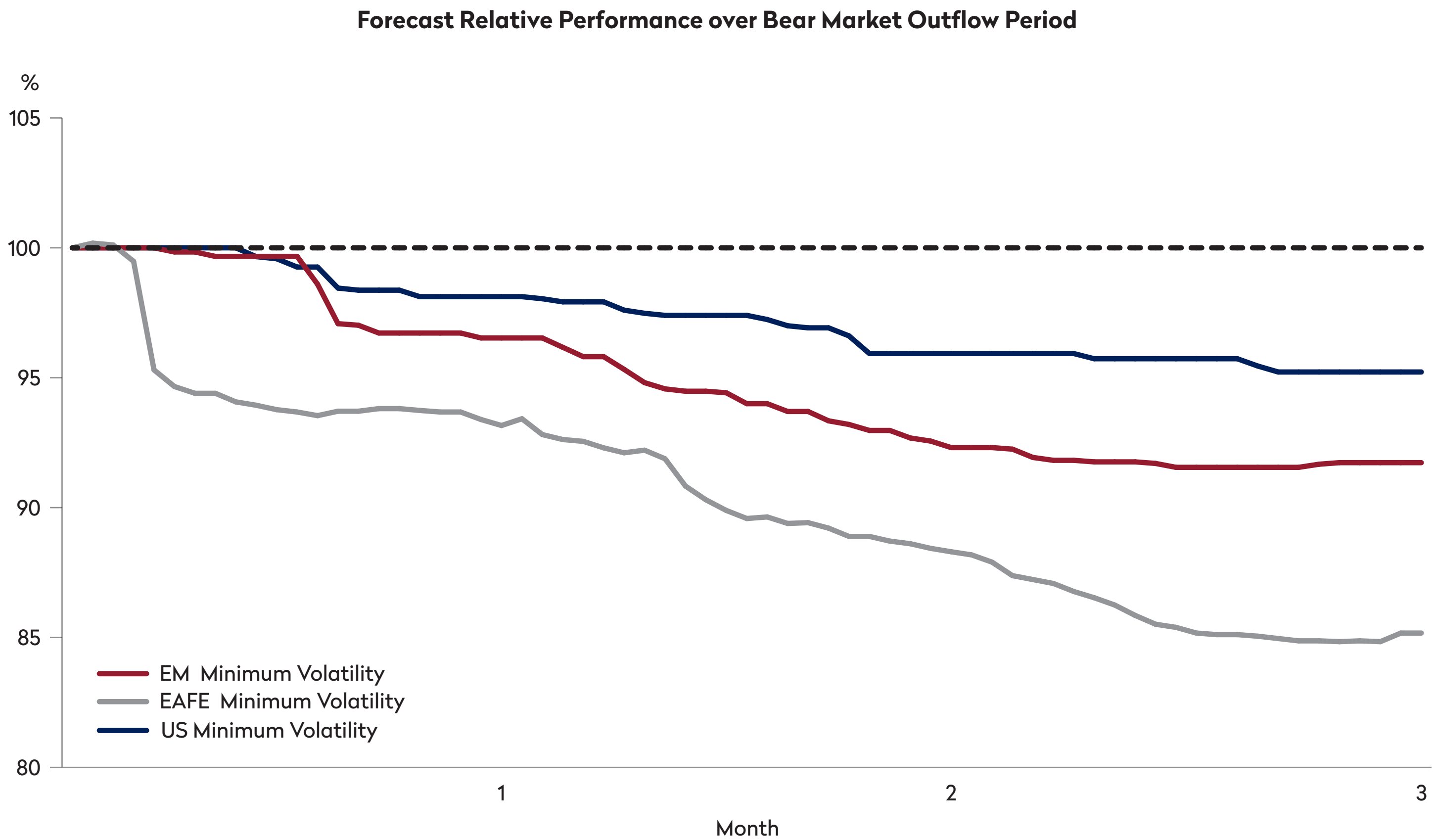
The Great Factor Debasing: What is Defensive?

The shift to passivity appears to have distorted factor investing, boosting factor returns at the expense of building dangerous liquidity risks. We believe that factor strategies may have been debased by these distortions and note that financial alchemy has never ended well.

As one example, Min Vol strategies have shot to prominence in a period of historically low rates and low market volatility. They are often overweight to relatively illiquid names and have no proven record in times of significant market declines. We note that the returns of many of these strategies are influenced by huge passive flows, which means they are now exposed to a sharp deterioration in sentiment, crowded trades and a rush for the exits (see Exhibit 2). This is like the tail wagging the dog, where flows are responsible for altering the return characteristics of underlying factors, thereby debasing the factors themselves and most likely factor strategies that tap them.

Rothko is different. We do not believe in factors, we do not use factors. Our modelling framework is focussed on fundamentals and more specifically future income potential. This deep view of defensive value investing is prudent and we believe will allow us to avoid stocks identified as defensive only through price correlations.

Exhibit 2: Min Vol – Expected Drawdown from Crowded Trades



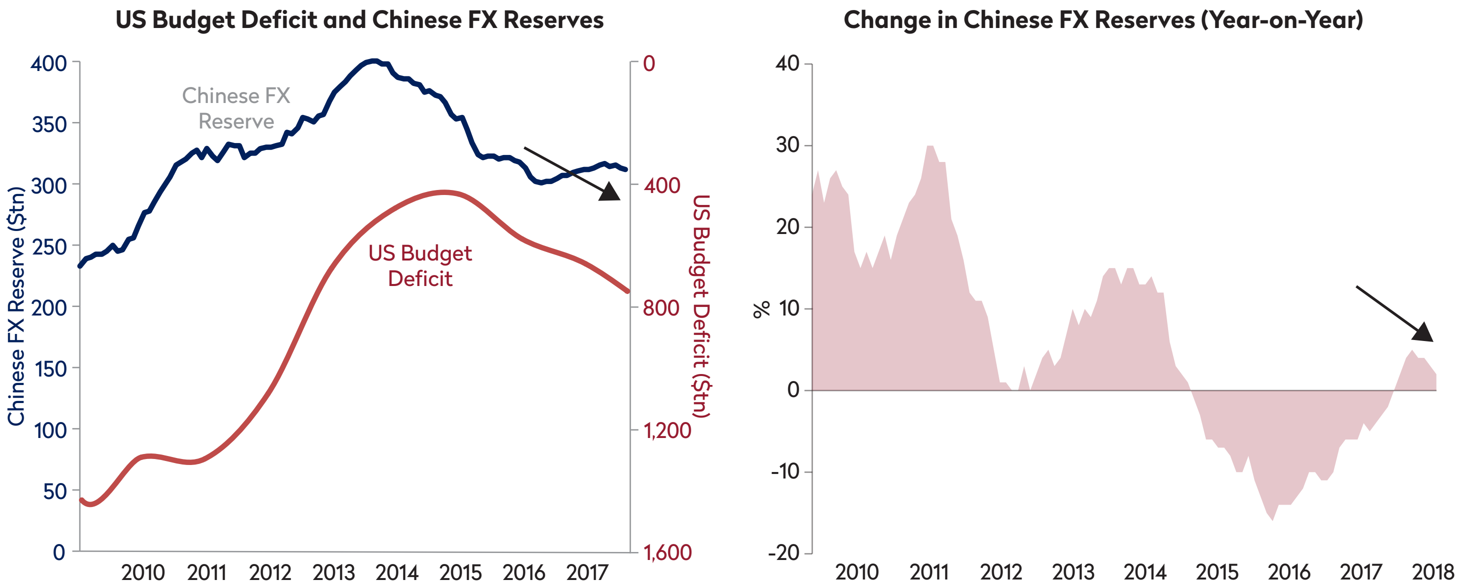
Notes: Forecast relative returns using the worst observed outflow from a Minimum Volatility strategy and modelling the impact this would have had during a bear market. The worst outflow experience (22% of AUM in a three month period) was seen in the iShares Edge Min Vol EAFE ETF. This percentage was multiplied into the other strategies to determine a worst case outflow and this flow was provided to our "Capital-Flow-Impact" model, which was calibrated to forecast outflow impact in bear months only. A bear market is a month with a market return of less than -3%.

Canary in the Coal Mine: China's FX Reserves

China A-shares investors should keep a close eye on changes in China's FX reserves. They have provided a pressure gauge of financial stress in China and of the willingness of the Chinese state to tighten capital controls, officially or unofficially. While reserves appear to have stabilised (Exhibit 3, right), investors should be wary. We note the link between US monetary policy and Chinese liquidity conditions (Exhibit 3, left) which increases our concern.

Rothko remains out of China A-shares for now as we believe it remains prudent to take a defensive stance and avoid the risk of capital controls. As the "economic nationalism" narrative plays out in US policy making, we believe there is a heightened risk to Chinese equity markets of falling liquidity and the temptation to place official or stealthy capital controls on investors.

Exhibit 3: Chinese FX Reserves



Source: The Federal Reserve, Rothko Investment Strategies.

Artificial Intelligence Guided Defensiveness

Emerging markets will continue to follow a "saw toothed" growth path and EM remains a critical strategic allocation for those that want to grow their capital but as pressures crank up, defensive investment characteristics have become even more important. But what is defensive anymore? The shift to passivity has debased defensive factor investing, boosting short run returns at the expense of building dangerous liquidity risks. We can only conclude that these styles have become unreliable, even dangerous.

Rothko is different. We do not believe in factors, we do not use factors. We believe this will allow us to avoid the pent up risks now apparent in factor investing. Our Artificial Intelligence driven approach has a consistent focus on fundamentally driven, income oriented value and we have seen these characteristics produce consistent defensiveness since our inception in 2013. We conclude that there is no substitute for fundamentally driven stock selection and pragmatic risk management... just don't trust a human to do it.

Disclosure

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