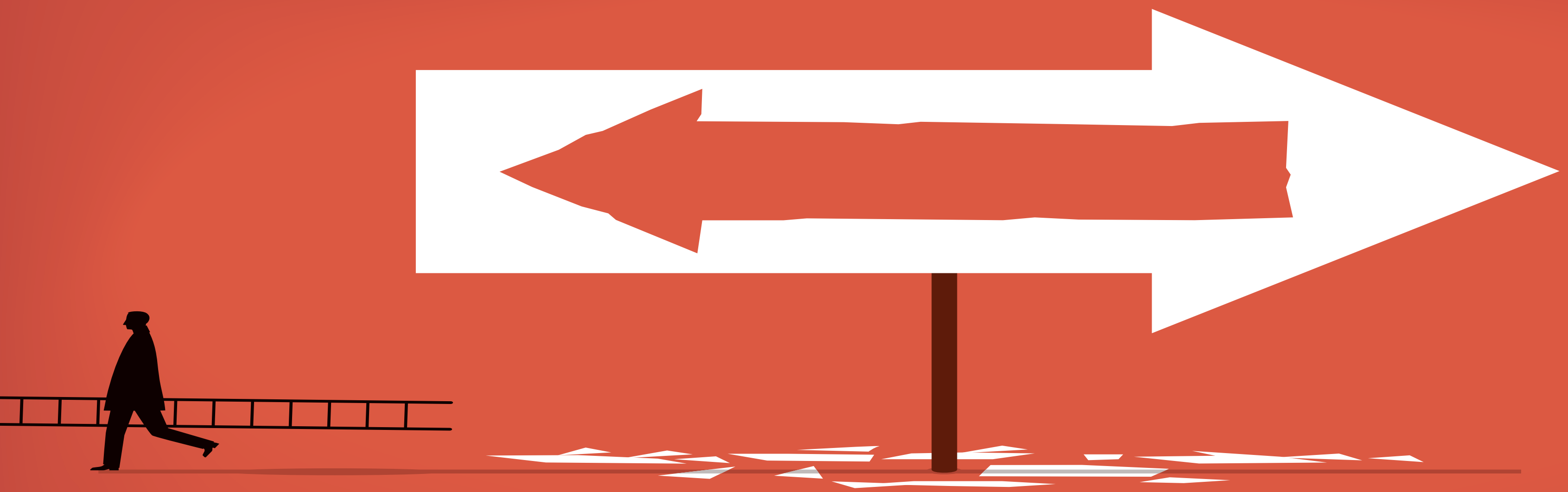

Against the grain

The best contrarian views factor in significant risks of a move in the opposite direction which the market is ignoring

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AT the beginning of every year it's a useful exercise to gather the market consensus of chief economists and chief investment officers, in order to assess where your own market positioning stands against the prevailing view.

One of the investment adages that has served me well over the years is to tread carefully when our own portfolio positioning is in line with a strong market consensus. Being in line with consensus is not always a mistake, but it's important to be aware of this and the investment analysis and thesis should be extremely robust if everyone else had also come to the same conclusion in future market directions.

Reducing risk when one's view is very aligned with the market has historically proven to be a good course of action. The opposite is also true, where views that are against consensus but backed with solid fundamental analysis and historical precedents have proven to be some of the best (and most profitable) investments.

Below is a shortlist of the strongest market consensus views heading into 2016. If you find that your personal investments are fully aligned with the consensus, it is a wise decision to reconsider how the portfolio is allocated.

US dollar strength (especially against the euro)

The euro started falling significantly from mid-2014, having lost -25 per cent to the lows of early 2015. This prompted a large consensus of euro weakness for 2015 which is still in place. Betting on a continued devaluation of the euro is the biggest consensus positioning of the year, often coupled with a bullish European equity to create a hedged buy Europe. The reasoning for such a positioning looks very logical, on the back of continued easing from the European Central Bank (ECB), which is expected to boost European equity and bond prices.

While such reasoning appears to rest on very firm ground, investors need only recall the period prior to 2007 for the perils of being aligned with consensus, especially with regard to FX markets. Back in 2007-8, the strongest global consensus was that the US dollar will continue devaluing, and the euro will challenge the dollar for the status of global reserve currency. Such views seem almost ridiculous now with the benefit of hindsight, but back then many Asian investors with portfolios valued in US dollars insisted on zero exposure to the greenback (their investment base currency), choosing to overweight euros, Australian dollars and Singapore dollars. Since then, despite an unprecedented balance sheet expansion by the US Federal Reserve, the opposite of the consensus occurred and the US dollar index has strengthened significantly.

For investors with short euro positions, it is important to keep in mind what could go wrong with this positioning, for example:

- Germany reverses its "tacit approval" of quantitative easing (QE) and instead opposes it on political grounds;
- the ECB's QE programme is so large that it is running out of eligible assets to purchase, limiting its effectiveness;
- unlike Japan, the US and the UK, QE is less effective in Europe given its disparate economies and lack of labour mobility. The EU project can only become sustainable in the long term with full monetisation of every country's debt by the ECB so that a default by Greece or Italy does not call into question the whole EU, just like a Puerto Rico default has zero impact on the debt of the US government;
- the current QE by the ECB proves successful and the weakest European economies (primarily Italy) recover, necessitating a scaling back of the programme; and
- finally all the speculative euro shorts will eventually have to buy back euros, creating a temporary large upward pressure on the currency.

Bonds suffer during cycles of US interest rate hikes

This is one of the most prevailing consensus views that also seem steeped in perfect logic. If interest rates increase, by default bond prices must move down in order to adjust to the higher yield on cash. This view makes perfect sense, but it is also wrong. An investor only has to look at the last US rate hike cycle, where interest rates moved from one per cent to above 5 per cent from 2004 to 2007. Ten-year US Treasury yields were largely unchanged during this period, at around the 4-4.5 per cent level.

This time, looking forward, we are starting from a much lower base yield of 2.22 per cent, so if interest rates really move up to 4 per cent, bond prices should indeed come down. However, there is a distinct possibility that the US economic recovery is weaker than expected, leading to slower rate hikes, whereby the expected losses in bond prices do not materialise, at least for the next 12-24 months.

US equities as the favoured investment destination

Despite ending the year slightly negative, US equities significantly outperformed Emerging Market equities in 2015. Even Singapore equities fell by -14 per cent, or -20 per cent in US dollar terms after taking into account the Singapore dollar weakness.

There is now a prevailing consensus that US equities are the best store of value, just as they are once again expensive. 2015 was the first year where aggregate earnings for the S&P 500 fell year-on-year. Analysts responded by moving the expected growth in 2015 to the following year, where consensus now looks for a high operating earnings growth of +18 per cent. This will prove a high bar to reach, let alone overcome.

The other side of this consensus is an underweight in all Emerging Markets (EM). Valuations in EM are now comparable to the lows seen in 2008. Looking at Chinese stocks listed in Hong Kong, the only countries with cheaper valuations are Zambia and Laos. Kazakhstan, Pakistan, Brazil and Russia are all more expensive than the Hang Seng China index.

Zero exposure to China-related equities

Last year's volatility of Chinese stocks is high enough to test the resolve of the most ardent bull, and investors are continually bombarded with negative news about China's economy. We conducted a recent survey where we asked investors to guess the best and worst performing stock markets over the last two years, starting from end-2013 before Narendra Modi's election win in India, after which Indian equities became one of the big consensus bullish calls from 2014 onwards. As expected, the survey results put India at the top, and China at the bottom.

In reality the opposite is true – India's Sensex gained +27 per cent in the two years, while China's Shanghai Composite gained +75 per cent in local currencies. Rebasing to US dollars shows the same result, India +19 per cent and China +63 per cent.

One of the reasons for this is simple, China started with significantly cheaper valuations. Despite the large gains China equities have experienced in the last two years, the Shanghai Composite is still cheaper than India's Sensex now. The volatility in China is enough to give any investor cause for concern, but zero exposure to the second-largest global economy while it continues to have one of the cheapest valuations in the world is probably not the right decision.

In taking into account global macro consensus views, it is important not to be contrarian just for the sake of it. Mild consensus views that have not reached extremes often tend to be correct in their direction. It is only when trends become well established and an extreme consensus develops, that considering an opposite positioning makes sense. The best contrarian views are the ones that take into account significant risks of a move in the opposite direction which the market is currently ignoring. W

AL Wealth Partners is an independent Singapore-based company providing fund management and advisory services to accredited investors