Market Commentary 31st March 2019

Overview

The contrast between 2018 and the first quarter of 2019 is quite astonishing. Whereas 2018 has gone down in the annals of history as one of the most difficult for investors to navigate, with very few asset classes generating positive returns, this year so far has delivered very much the opposite experience. Equities, bonds and commodities have delivered gains pretty much across the board. One might be forgiven for thinking that this is evidence of great optimism about the future, either politically or economically, but that is not necessarily the case. In reality, markets became too gloomy about prospects towards the end of last year, and the effect of that mind-set was exacerbated by thin trading around the Christmas holidays. Now markets have rallied in the realisation that things weren't as bad as was being discounted in valuations.

That is not to say that there haven't been some helpful developments. Foremost amongst these has been the fact that central banks in both the US and Europe have put off plans to continue tightening monetary policy. Indeed, futures markets in the US now predict the next interest rate move to be a cut sometime later this year. The risk of a withdrawal of liquidity has also been mitigated, with the US Federal Reserve (the Fed) deciding to leave its balance sheet much larger relative to the overall size of the economy than it was before the initiation of Quantitative Easing required in the aftermath of the financial crisis. The European Central Bank (ECB) has similarly promised to extend the special lending facilities it made available to the banking sector following the euro zone crisis.

Of course, neither central bank would have made such decisions if economies were booming. The truth is that growth remains frustratingly lacklustre, especially following the rare burst of synchronised global expansion that we witnessed in 2017. Although at the time it was heralded as something of return to "business as usual", as companies and consumers finally threw off the shackles of austerity, it now appears to have been a more temporary phenomenon. High debt levels across the world and the rise of a brand of politics that is less friendly to the creation and retention of wealth suggest lower sustainable levels of growth in future.

This sentiment has been reflected in the nature of this year's recovery. Equity markets in aggregate have seen minimal inflows of new money, with buybacks by US corporations continuing to be the greatest source of demand for shares – a phenomenon that brings its own risk from higher leverage as companies tap credit markets for funds. It is notable that defensive sectors have generally outperformed cyclical ones, and that growth has continued to outpace value as an investment style. The renewed fall in bond yields also speaks to an underlying lack of confidence in the future. We note that 10-year Treasury yields in the US have fallen from 3.25% late last year to 2.45%; the 10-year Gilt yield is below 1%; and Germany's 10-year Bund yield is negative again for the first time since the world was in the grip of "secular stagnation" fear in 2016.

It has been pointed out that such a strong simultaneous rally for both bonds and equities is inconsistent, but the composition of the rally suggests that, once again, investors are unsure of what lies ahead and are seeking companies with such characteristics as a strong growth outlook, a high return on capital, or a generous and growing dividend yield. Reflecting developments in the real world, this continues to widen the gap between the "haves" and the "have nots".

In a parallel universe this commentary is being written in a post-Brexit United Kingdom, but, of course, the long-planned date of departure has passed with no resolution. Although Brexit is the hottest of topics across all domestic media and many investment commentaries, it is difficult to add much value to what has turned into the most infuriating, and yet at the same time endlessly fascinating, process. With Parliamentary votes taking place on a nearly daily basis, it is almost inevitable that what is written in this commentary will be outdated by the time it is read – and that even allows for the modern miracle of digital distribution! Many large UK companies earn their crust beyond these shores, and so

will be minimally impacted at the operational level whatever the outcome (although their reported profits will be subject to the effect of a potentially big move in the pound). In the same vein, our investments in a range of non-UK stocks and international funds limits the exposure to any shocks to the domestic economy. We currently see insufficient clarity or value to bet heavily in any direction on the outcomes, which, at the extremes, range from a chaotic “No Deal” Brexit to no Brexit at all.

Key Influences

At its simplest, successful asset allocation can be reduced to the correct response to the interaction of just two forces: liquidity and growth. Liquidity covers a number of factors, including: interest rates; the dynamics of central bank balance sheets; the propensity of commercial banks to extend credit; the balance between buyers and sellers in asset markets. Growth speaks for itself. When the provision of liquidity is generous and growth is strong (and, perhaps more importantly, being upgraded), markets tend to do very well. This was very much the case in 2017. Most of the time there is a bit more tension between the two forces. If growth is very strong, central banks will tend to rein back liquidity to head off any threat of overheating. This will eventually put a brake on growth. On the other hand, the same central banks will loosen policy in response to a slowdown, thus providing the promise of future recovery. In both of these environments, there can be something of a battle between bulls and bears, but the damage will be relatively limited, and often equity markets will continue to grind out positive returns.

The worst conditions for investors are when liquidity is being tightened in the face of falling growth expectations, and that is where we found ourselves in the fourth quarter of last year. The experience was painful, although mercifully short. Central bankers, notably at the Fed and the ECB were (eventually) alert to the risks, preventing further falls in equity and credit markets. The good news, for now at least, is that they remain in a watchful but patient mode, and have effectively promised to keep policy settings unchanged until the evidence supports another shift, in whatever direction that might be. However, there is still a lively debate within the market as to whether the next move in US rates will be up or down, and so there is still room for more volatility.

The growth picture is murkier, but we are reasonably optimistic that the worst of the growth scare is behind us. Lower bond yields in the US have pushed mortgage rates back down, lending support to the housing market. At the same time a tight US labour market is delivering decent wage growth, with, thus far at least, minimal signs of it feeding through to price inflation. It also helps that we see no sign of the sorts of excesses building up in the economy that made the last two downturns so punishing. On the other side of the world, China has been delivering policy stimulus to the economy since last summer, and there are tentative signs that this is beginning to bear fruit. Europe is the cylinder that refuses to fire, but even here there is some optimism that the one-off factors that have blighted Germany’s economy will reverse. Even so, a febrile political environment and the legacy of a dysfunctional banking sector suggest that growth will struggle to match that in the rest of the world.

A wildcard in the growth hand is the outcome of trade talks between the US and China – talks which, in fact, encompass a lot more than trade and might well define the relationship between the two global superpowers for years to come. A swift and mutually beneficial exchange of signatures on a deal before the end of April could set risk markets up for a pleasant run into the summer. An escalation of tensions would have a more negative effect. On balance we believe that it is in neither side’s interest currently to escalate the dispute, but, not for the first time in recent years, our fate lies in the hands of politicians.

Markets – UK

UK equities, while having started to perk up, are still subject to Brexit sentiment swings and the influence this has on sterling. Companies more exposed to the domestic economy have benefitted from the gradual easing of “No Deal” fears, but, without a final resolution, confidence remains low.

Overseas investors still view the UK as too treacherous to navigate. Such uncertainty offers opportunities to those willing to take a bet on the outcome, but there has been insufficient clarity for us to wish to increase exposure yet. And the consequences of a chaotic departure from the EU in April could be extremely negative, both for the pound and the domestic economy.

US

Following a torrid final quarter in 2018, US equities have recovered strongly in 2019, with Technology stocks once again being a major component of the gains. It is now clear that investors were pricing in much too sharp a slowdown last December, and so the recovery has an element of normalisation about it. The Fed's decision to take its foot off the monetary brake has been a strong support, as has expectation that there will not be an escalating trade war between the US and China. However, we have to acknowledge a sharp deceleration in corporate profit growth as the benefits of past tax cuts recede and the economy settles into a lower growth trajectory.

Europe

Europe is trying hard to replace the UK at the top of the political dysfunction league table, with populist parties and more extreme policy promises dominating the agenda. Elections for the European Parliament in May threaten to deliver more seats into the hands of anti-establishment parties who will try to wrest back power from Brussels. Given the uncertainty, international investors are giving Europe a wide berth. As with the UK, this might present an opportunity to increase exposure, but for the fact that the region in aggregate still struggles to generate much growth. There is a suspicion that Europe has spent so much time navel-gazing over the last decade that it has structurally fallen behind the US and China, the two other main engines of global growth. More positively, the ECB has followed the lead of the US Federal Reserve in curtailing its policy tightening.

Japan

Japan has a structural problem second to no other major developed country – a shrinking and rapidly ageing population. These pressures were exacerbated by an appalling typhoon in the autumn of 2018 as well the country's close trading relationship with China, which has been in a cyclical slowdown. These latter elements should have less of an effect in the near future, allowing for further recovery. Japan remains home to a relatively high number of companies that look exceptionally cheap; some with immense cash balances that are the result of years of caution. Corporate governance developments and the increasing influence of activist investors raise hope that this value will be recognised. Meanwhile Japan has an outstandingly stable political environment, which should count for something in today's uncertain world.

Emerging Markets

Emerging Markets is a misleading generic label for a list of countries that covers Central and South America, Eastern Europe, parts of Africa and most of Asia. Some are driven primarily by domestic consumption, others by the exports of manufactured goods and many by the production of commodities. And yet they often move together, unified by their sensitivity to US interest rates and the dollar, given that much EM debt is financed by dollar-based investors. The dominant influence remains China, which has been weathering a period of cyclical slowdown. However, it appears that more stimulatory policies enacted by China's government are beginning to have an effect, improving sentiment across the EM complex.

Fixed Income

Government bonds played a strong role in offsetting some of the losses experienced in riskier assets towards the end of 2018, and have continued to deliver positive returns even as equities and corporate bonds have recovered in 2019. This is a little unexpected, but can be explained by the more

lenient monetary policy stance of the world's central banks as well as the huge pool of global savings that continues to seek a home. It was notable that bond issues during the first quarter by a range of countries attracted bids far in excess of what was on offer. There is also a lingering element of fear that the next global recession lurks around the corner, and so the demand for insurance assets remains firm. The lack of strong upward consumer price inflation pressure is also helpful. However, the very low yields available on 10-year paper (ranging, for example, from sub-zero in Germany and Switzerland, to around 1% in the UK and as high as 2.45% in the US) suggest that future returns will be minimal and make it very difficult to generate portfolio returns above inflation without taking on more risk in other asset classes.

Higher returns do remain on offer in the riskier areas of the corporate bond market, notably High Yield. The "carry" available continues to look attractive, but must be balanced against the risks to capital inherent in a future weaker economic environment.

UK Gilts have delivered a total return of 3.38% over the last three months and 3.71% over the last year. Index-Linked Gilts returned 5.75% and +4.88% over the same respective periods. Emerging Market sovereign bonds produced a total return of 3.86% in sterling over the three months to end January (10.5% over 12m). Global High Yield bonds delivered 4.13% (9.39% over 12m).

Conclusion and Outlook

Our most recent tactical shift was to recommend adding more risk to portfolios at the end of 2018 in the face of what we believed to be an over-reaction to fears of slowing growth and tighter liquidity conditions. In retrospect we could have been more aggressive, but the longevity of this cycle suggests that we are much closer to the end than to the beginning. We have been edging closer to the door in readiness to leave the party for the last couple of years, but conditions have never suggested that we leave the festivities for good. Even so, it is a well-documented behavioural trait that investors experience the pain of loss far more intensely than the joy of gain, and so we will continue to strive to minimise the losses when the end of the cycle does eventually arrive. Economic cycles have not been abolished and bear markets are an inevitable component of the investment cycle, and it is important that all investors understand their tolerance to such events within the context of a long-term investment plan.

One way to avoid permanent loss of capital is to invest in companies that are less likely to go bankrupt or to come begging for cash in a downturn. While we cannot guarantee perfect foresight, our robust research process seeks to mitigate risks while providing material reward. That might sound like a truism, but is not so easy to enact and often involves blocking out siren voices enticing us onto the rocks. This attention to detail is embedded in our analysis of bonds, equities, alternative assets and in our fund selection process. It reflects the trust that has been placed in us to manage clients' wealth during these difficult times, a responsibility that we do not take lightly.