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Quarterly Investment Bulletin

January 2019

General Economic Overview – Quarter 4 2018

The final quarter of 2018 maintained the uncertain outlook established at the beginning of the year. Even the US stock market has felt the global downturn, remaining only marginally positive (in sterling terms) after the Federal Reserve rate rise, which caused political and investor disharmony in December. It is not just down to equities that we have had such a negative year - a recent Morgan Stanley research note indicated that up to mid-December there were 21 asset classes that had seen negative returns in 2018. This is in contrast to the optimism on which we came into the year, off the back of a very positive 2017. This optimism was short lived as we saw markets fall in February based on certain themes that have dominated the year. The themes can be summarised as: the uncertainty of the political landscape, the strength of company valuations against earnings expectations, escalating trade disputes allied to a slowdown in Chinese growth, a strong US currency and quantitative tightening.

Many analysts predicted greater stock market volatility in 2018 and this was broadly in evidence throughout the year, although there were periods when calm ruled, as it did in 2017. The main source of this volatility was said to be the shift to quantitative tightening following a long period of loose monetary policy. The US and UK have been in this mode for some time but only recently did the ECB join in with bond purchases set to cease in early 2019. There has never been a period of such prolonged central bank intervention in global markets and many investors have been nervous about the likely repercussions as it is taken away, one of which has been the increase in volatility that we have seen at various points in the year, including more recently in December in the US market.

Equity valuations at the beginning of the year reached significant multiples, particularly in the US, and this led to some investors taking profits, concerned about the likelihood of future earnings keeping up with such high valuations. Technology companies have led the way over the last few years which has resulted in even higher valuations for this sector, giving way to significant volatility in some stocks as negative stories started to affect sentiment. Bond markets have not fared much better as yields have generally risen in government and corporate debt and spreads have moved out. In particular emerging market debt has struggled against a weaker economic backdrop as was shown in countries such as Argentina and Turkey which were particularly affected by US dollar strength.

The political landscape across the globe has been volatile in 2018 particularly in Europe with even the more stable countries of Germany and France, as well as those less stable such as Italy, falling into uncertainty under the threats of the various populist movements. For the UK investor the threat of Brexit has been the key theme and the inability of politicians on both sides of the divide to agree a solution will continue to be a threat into 2019. Arguably this is priced into equity markets giving UK stocks some value relative to global markets. In terms of global growth, the US has continued to lead the western world with Europe seen as the most disappointing after the previous year's improvement.

Much of the last 50 years has been characterised by increased globalisation but those sands are now shifting and although most nations are committed to free trade in some form, the tides of nationalism and populism have grown stronger since the GFC. For many fund managers, trade wars are a major worry for 2019 although the scale of this has diminished through the year. Sentiment and activity have been affected in 2018 and this theme is likely to continue over the next few years. The IMF has indicated that

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the tariffs imposed so far have not had significant effects on global growth (about 0.1-0.2%), however these effects could intensify if the additional tariffs are imposed, causing widespread escalation and feedback loops in financial markets. The role of China in the global economy will be crucial to this as a dogmatic approach to trade that isolates China could create a global Cold War.
A certain amount of instability was also seen in Asian and emerging markets as they reacted to the possibility of trade disputes, whilst at the same time the strength of the US dollar hit those emerging markets that have more dollar linked economies. The dollar's strength was a constant theme in 2018 reflecting the Fed's policy of raising rates.

Despite the negative picture painted by most asset classes, global growth is predicted to be relatively robust in 2019 although most commentators believe that we have passed peak growth, and that the next few years will see a gentle moderation with greater divergence across a broader range of countries.

Equity Markets Overview

The year started with what was termed a 'melt-up' as US stocks raced ahead to be 3% higher after the first week in January and looked to be carrying on from a very successful 2017. The positive sentiment continued for several weeks but as we know, since February, a very different course has been taken. The final quarter, and more specifically the final month of the year, resulted in a very unsatisfactory year for world equity markets overall. The rise of volatility at the beginning of the year set the tone, as investors in inverse volatility funds saw their assets diminish as the funds buckled and this rippled through the US stock market and then more globally. We have also had the continuing issues for the global tech stocks which started with Facebook and Cambridge Analytica but affected many of the large US tech giants at different points and in different ways. One of the main influences on the wider global markets was the ongoing strength of the dollar which continues to be painful for emerging markets with large dollar borrowings. In the background rate rises were continuing in the US and looked to be increasing in frequency which worried investors in October and led in part to the recent worries over further US tightening in 2019. Asia, Europe and emerging markets proved to be the most difficult to negotiate last year, more specifically the more domestic mid and smaller cap stocks. Most regional stock markets have struggled in this environment.

UK

It is not surprising that the UK economy took a downturn in economic growth in 2018, after a strong 2017, as Brexit issues came more to the fore and company executives prepared for the possible outcomes. There is still hope that a deal will be struck before the March deadline but it has become increasingly unpredictable as to which way the balance is tipping. The downside of the uncertainty is obvious from a company perspective with less inward investment taking place and more contingency planning. The stocks on the UK market have much of this priced in and there are some managers that now see some value in the UK market. The safe position for those invested has been to invest more into the mega and large cap stocks that have global earnings, are more insulated from the domestic issues and that may well benefit from a further fall in sterling. Domestic mid and small cap stocks suffered this year as they took

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the brunt of the uncertainty. Not all the issues facing the UK were domestic however as global issues also influenced markets particularly the slowing of European growth linked to the issues faced by the larger economies both politically and economically. A slow-down in UK growth prospects also has a knock-on effect in Europe. More generally the UK economy is not in bad shape and has a resilience built in from its global trading position and strength in financial services which has been robust so far. Any further moves to relocate banking and other services away from the UK will be damaging in both the short and the long term.

US

The world's largest economy has continued to prosper in 2018 with the economy growing at over 3%. This has undoubtedly been helped by the support offered in tax cuts and incentives to repatriate foreign profits initiated by president Trump at the beginning of the year. His ability to get things done has now weakened, particularly since the recent mid-term elections which saw his majority in congress reversed. The other overriding global influence has been the continuation of the trade spats with China with both sides applying 'tit-for-tat' policies. At the moment this has not been a huge influence on global trade as it has been at the periphery of traded items but the fear is that it could easily escalate and markets across the globe have been influenced by the news surrounding this during the year. The other major global influence has been the US dollar. The strength of this in 2018 has not been surprising as it has been influenced by the continued raising of Fed policy rates but the effect on other markets has been more of an issue and it has certainly influenced how emerging stock markets have performed this year. The S&P 500 has had a poor year despite strong economic growth and favourable employment and inflation data, with political and global economic issues still weighing on investor sentiment. Many investors have seen strong earnings data support market valuations but there is perhaps doubt that this can continue, now that the tax cut effect is wearing off and wider global growth is deteriorating. 2019 predictions for US growth are still good and with little wage and inflationary pressures this may still provide a positive picture for their equity market in 2019.

Europe

The growth and recovery in Europe that attracted many investors in 2017 was surprisingly absent in 2018. The uncertainty caused by regime change and political shifts to a more populist environment should not be underestimated. Italy has proven to be a difficult problem for Brussels as they continue to resort to non-EU methods of resolving the budget issues that they face. As well as political disruption the decision by the ECB to reduce and then stop its bond purchase programme made for more nervous markets. The ECB has been less of an influence on global trends than the Fed in the US but the decision to follow other major global central banks into reducing support has been a factor in the rise of volatility in European bourses.

The slowing of the Chinese economy has had a definite effect on the economies of France, Italy and Germany, and another negative for European growth was the slowdown in the global auto sector, especially the diesel market which resulted in an economic contraction in Q3 in Germany. The French economy has struggled more than expected in the last quarter as the protests on fuel have seen

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executives' confidence about business fall in December for the third month in a row, to its lowest point since November 2016, while new orders declined for the first time in 34 months. A closely watched survey of purchasing managers' confidence in France's manufacturing and services sectors dropped to 48.7 in December, below the expectations of analysts polled by Reuters. Although valuations in Europe are still attractive, investors are not as keen as in early 2018 because of these other politically induced factors.

Asia

As is usual with this sector the data tends to be dominated by China and in this quarter by the relationship with the US. China has seen a slowdown in growth rates to around 6%, much higher than the western world, but lower than the previous years. The tariff related issues are a major concern for many companies on both sides of the political arguments with rates of 10% holding out for the moment but the fear is that these will get raised to higher levels causing further global contagion. The Chinese authorities are aware of the damage being caused to the country by the trade dispute, with the announcement of President Xi's right-hand man Wang Qishan's involvement signifying how important the Chinese take this. A trade dispute at a time when the country is trying to de-leverage has not made life easy for Xi. The economy is clearly slowing, with the manufacturing PMI index at 49, the weakest since early 2016. The slowdown in both autos and smartphones, two industries especially important to China, have compounded problems. President Xi will have to find a balance between giving ground on trade which will clearly help the economy, but doing it in a way which avoids risking his nationalism credentials. One small plus for the global economy has been the significant fall in the oil price, with US WTI trading below US$50. Most recessions have occurred when the oil price is rising not falling.

The trade war with China has demonstrated that Trump, together with some of his closest advisors are signalling a determination not just to take a hard line on trade, but also on intellectual property 'theft' with perhaps a bigger longer-term aim to confront China's threat to US world dominance. The wider region's manufacturing sector virtually stagnated in October and November, likely impacted by elevated global trade tensions and weaker growth in China. Meanwhile, trade figures for October have been mixed. Singapore and Malaysia saw a pick-up in export growth, with Malaysia's trade surplus reaching a multi-year high. On the other hand, the Philippines' trade deficit surged due to the government's infrastructure drive, which has sucked in imports, while Indonesia reported limp export growth and Thailand's trade balance worsened year-on-year. Looking ahead, ASEAN should continue to grow at a healthy pace, private consumption should be supported by wage gains and strong labour markets, and fixed investment ought to expand robustly – GDP growth for the region is expected to come in at 4.9% in 2019. If the US dollar weakens this area could benefit significantly.

Japan

The fall in Japan's GDP in the third quarter was attributed to the effect of the natural disasters that took place in 2018. The expectation is however that as data becomes available on the fourth quarter this position will become more positive, indeed, business sentiment at Japan's major manufacturers improved in quarter four, following declines in the previous three quarters of 2018, according to the recent Tankan survey by the Bank of Japan. The Tankan index for large manufacturers held steady at 19 in the fourth

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quarter, compared to a median forecast predicting a two-point fall point from economists polled by Reuters. More recently the threatened increase in the consumption tax planned for October 2019 has been tempered by a series of tax breaks for housing and cars that it hopes will avoid a plunge into recession that occurred the last time this was done in 2014. One of the hopes for Abenomic policies is that inflation will come back into the system boosting company profits allowing wage increases and helping to reduce the national debt burden. This has been partially successful but the November data suggests this is weakening below the 1% target. The recent data indicates core inflation has fallen to 0.8%. The currency is also a concern for investors as the recent strength in the currency following global uncertainty is a longer-term threat to Japanese economic output. The trading concerns highlighted by the US - China trade problems have not yet had a significant impact on Japan's exporters but any escalation may prove more problematic.

Emerging Markets

Emerging markets have been at the forefront of losses for sterling investors in 2018 with the higher levels of volatility affecting returns as has been the pattern for these markets over many cycles. Pessimism about future global growth, the US-China trade conflict, rising US interest rates and a strengthening US dollar have led emerging market (EM) investors to switch to more defensive stocks in recent months. October saw technology-related stocks record double-digit declines, while the utilities and telecommunication services sectors fared much better. More recent global declines in technology stocks such as Apple have certainly affected suppliers in emerging and Asian markets but not consumer facing stocks such as Tencent and Alibaba. The fact is that this is a very different world from past crises: most emerging countries have floating exchange rates, current account surpluses and more favourable debt levels than their developed market peers. Moreover, Turkey accounts for less than 1% of the MSCI Emerging Markets Index, while Argentina is not in the index, and its weighting is expected to be even smaller than Turkey's when it is included in 2019. In terms of trade concerns and rising tariffs between the United States and China – this may provide further focus toward greater regional agreements. For example, tensions between China and Japan have started to ease, resulting in Japanese Prime Minister Shinzo Abe visiting China in October to discuss increased cooperation, the first such trip by a Japanese prime minister since 2011.

The long-term structural case for EM continues to centre on demographics, consumption and technological advances. The dollar has proven to be a link that some EM countries struggle to break, especially those with larger borrowings but whilst market falls have been higher than Asia the delta has not been as significant as in previous market downturns. As with Asian markets a weakening of the dollar could result in significant market improvements.

Fixed Interest

The story of 2018 has been of regional disparity in fixed interest markets, with the US and UK increasing rates, whilst there have been country specific, often political factors, affecting fixed interest markets elsewhere. Despite raising rates in 2018 the US 10-year Treasury bond return was positive for sterling

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investors. Brexit uncertainty was heightened as the announcement of a Withdrawal Agreement between the UK and EU drew widespread criticism. Ten-year gilt yields fell from 1.57% to 1.28% in the final quarter of the year delivering a small positive return for investors. The Bank of England increased rates in August. In Europe, 10-year Bund yields declined from 0.47% to 0.24% as data remained weak. At its final meeting of the year, the ECB confirmed it would end its bond purchase programme, but downgraded its growth and inflation forecasts for the year. Italian 10-year yields were volatile, and overall fell from 3.15% to 2.74% as the government reached an agreement with the EU on the budget, having reduced its fiscal deficit target to 2.04% (previously 2.40%). Italy has now reached agreement with the EU which keeps it out of the 'excessive deficit procedure', where the EU monitors a country's debt. In a weakening economic situation there is greater likelihood of yields falling and investors are anecdotally starting to add more duration to portfolios with a recessionary environment more likely in the next twelve months.

The corporate credit market has been in step with government markets, with spreads quite tight for most of the year giving little additional value to investors. Corporate bonds had a challenging quarter and underperformed government bonds. A deterioration of risk sentiment led to the broad-based underperformance across investment grade credit sectors relative to government bonds. High yield was weak, led down by the energy sector, particularly in the US. Over the year high yield investors have had a better level of return thanks in the main to the strength of the US market and low default levels.

The outlook for fixed interest is mixed for 2019 with more rate rises looking likely in the US but much more uncertainty elsewhere. EM debt has perhaps the strongest potential but this is woven in with greater risk.

Property

Although the UK commercial property asset class has fallen out of favour in recent years this was one of the few asset classes in 2018 to deliver positives returns, mostly from income. There continue to be sensible reasons to have an allocation to property in a diversified portfolio given its diversification benefits and lack of correlation to other asset classes. Whilst liquidity in open-ended funds can be an issue at pressure points, if investors recognise the stability of the yield component and are prepared to take a longer-term view, then property can be an effective element in a portfolio.

The UK commercial property market remains stable but returns have moderated compared to the previous few years. The potential outcomes of the Brexit negotiations, and negative connotations for the London property market in particular, are leading many UK fund managers to reduce or avoid central London property, although the market continues to be supported by strong overseas demand. The area of distribution / logistics / warehouses remains popular due to the demand for last mile delivery, same day delivery, click and collect etc. but this is pushing up prices. The retail sector continues to struggle with profit warnings and financial difficulties announced from a number of high street retailers, such as Mothercare, Carpetright, Toys R Us and John Lewis, as internet shopping continues to take market share, so fund managers need to be very selective in this area. Liquidity levels within commercial property funds remain above average in many cases, which is a longer-term fall-out from the EU referendum result and

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the subsequent investor sentiment towards the asset class, and this may continue for some time, which will impact absolute returns.

The global REIT / property securities market is sensitive to interest rate movements and is dominated by US assets within the global REIT space, therefore the path and outlook for US interest rates and US economic growth will be important influences on future returns. The fixed income market may not price in the same interest rate path as the Federal Reserve forecasts, so there is the potential for a negative knock-on effect to property securities/REITs should markets need to re-price.

Summary

Intra-regional moves in equity markets in 2018 can be explained by the fact that until the end of the third quarter the US was the only major economy growing above trend having outperformed consensus. In particular, the EU and China had disappointed. This divergence in growth among the major regions and the policy consequences of that divergence also explained the changes in asset prices, including the rise in the dollar and the underperformance of the emerging world, with global GDP expectations favouring the US currency, in complete contrast to the events which occurred the previous year.

Looking at the fundamental factors driving markets, fears of economic growth slowing too quickly and monetary conditions tightening too fast (via higher interest rates and the ending of QE) are the principal reasons behind the dramatic and very unseasonal declines in equity markets globally. In combination, slower economic growth and tighter monetary conditions set up a potentially dangerous position for a world still deeply in debt and where Central Banks have relatively little ammunition, especially outside of the States, with which to fight an economic downturn. Global tensions mean the scope for a coordinated policy response are much less favourable than in 2008/09. Put succinctly, the Central Banks' normalisation process is colliding with slowing global growth and has the potential to make things worse, at a time when Trump's ill-timed trade war has cast further doubt on the outlook for global activity.

At this point the recession probability has risen, but not yet to high levels and the yield curve has not inverted. There remains scope for worst case outcomes to be avoided, but this will need some positive developments in terms of Fed policy and some form of resolution of the trade disputes occurring globally over the next few months. There are reasons to believe the odds in favour of these occurring have improved, but it is impossible to be dogmatic about this. Even if correct, immense technical and psychological damage has been done to equity markets. Fundamentally, the economic political and geo-political landscapes will remain much more challenging than had appeared to be the case 12 months ago, so any recovery in equity markets is likely to be contained below the highs seen during 2018.

Markets today are not at the level they were at the end of January 2018. One significant plus of this is that valuation levels have improved significantly post the market correction with few markets now trading in expensive territory as long as significant earnings declines do not occur. Inflation has not picked up as many feared with wage growth at best only around the 3% level. This will make it easier for Central Banks to ease off from tightening monetary conditions. The fall in the oil price is also positive for continued

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muted levels of inflation. Government bond yields are little changed over the past 12 months providing some valuation support for markets when the earnings outlook stabilises.

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