INVESTMENT COMMENTARY

CARTLIDGE MORLAND

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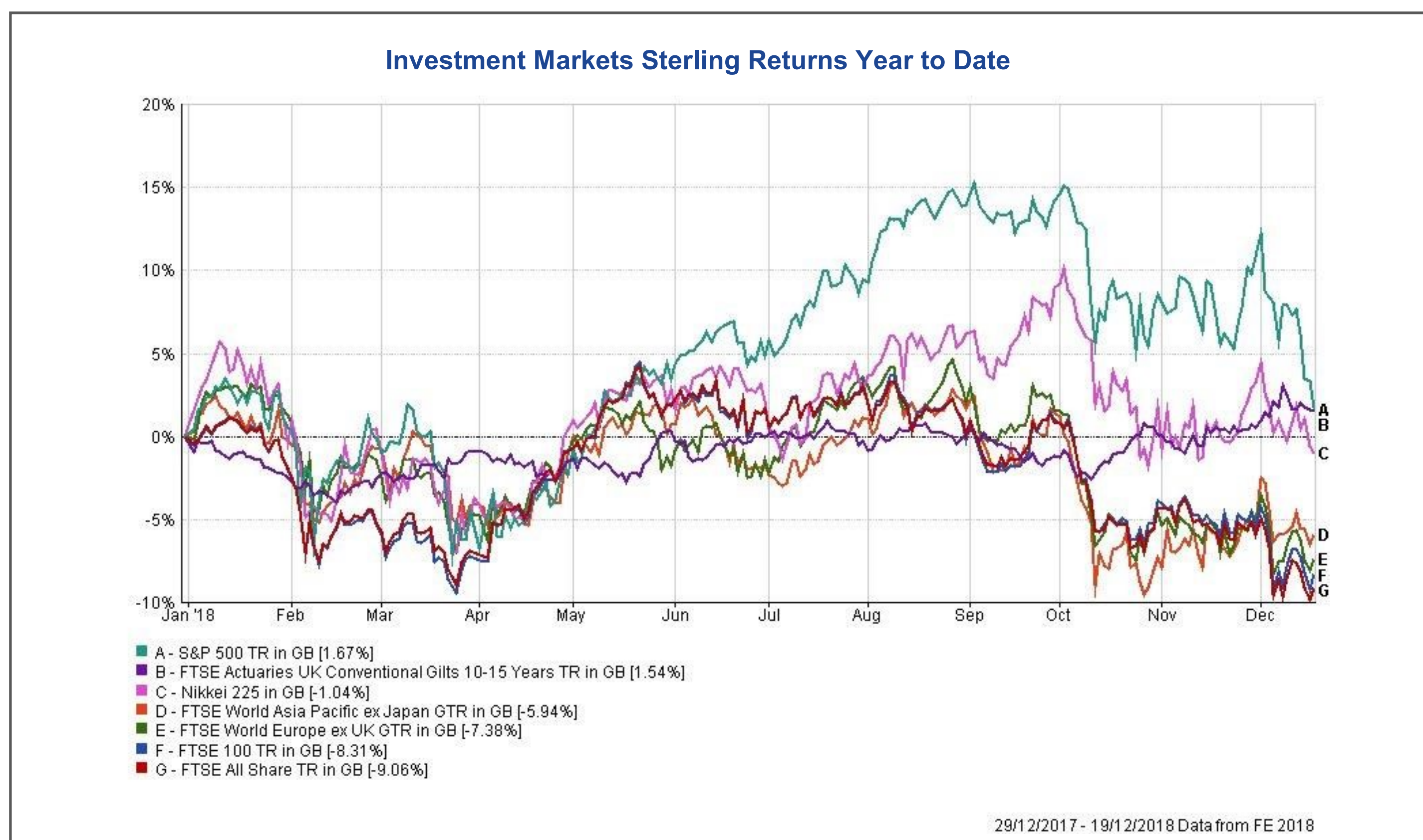
The sharp downturn in financial markets, prevalent since October has taken us by surprise – as we were optimistic for investor returns in 2018. We were however careful to consolidate gains and to reduce excess risks in portfolios following a period of exceptional returns. Predicting the next recession or major fall in financial markets has become an obsession for some and the prospect of a global economic recession in 2020 is being priced in now – rather sooner than anticipated. This leaves 2019 returns highly unpredictable, with much dependent upon the easing of global trade tensions and non-inflationary sustainable growth in the US, without justification for a sharp rise in US interest rates. For domestic investors, the Brexit 'discount' applicable to UK assets will remain until the UK's future economic prospects become clearer.

Returns from the major equity markets have been mainly largely negative over the calendar year against a background of rising US interest rates, slowing global growth, trade tensions between the US and China as well as political uncertainty surrounding Brexit, the Italian budget and unrest in France. Despite the raft of reciprocal tariffs imposed by China and the US on each other and rising US interest rates, the US economy has performed well with strong growth, low unemployment and a modest level of inflation. The US equity market has made a positive return since the beginning of the year in sterling terms as the dollar has been strong against sterling. It has lost value in US dollar terms but has fallen less than other major equity markets. Talk has now turned to the likelihood of a US recession as the yield curve is indicating that yields on short term US Treasuries are higher than longer term ones. This may mean that higher short term interest rates slow the economy. Within the last month, Asia Pacific markets, although still weak, have performed relatively better than other markets as investment opportunities have arisen after steep falls. UK gilts which are included in most portfolios have provided some protection for the portfolio over periods of negative equity market sentiment.



UK

Brexit uncertainty continues to dominate the headlines and to weigh heavily on investor sentiment as the vote on the Brexit deal has been delayed to January 2019. It appears that the government is now preparing for the possibility of a 'no deal'. Sterling has weakened against this background which, in turn, makes UK companies with overseas earnings more attractive to investors. Markets hate uncertainty and this is holding back the domestic sectors of the UK equity market such as retailers and housebuilders. Economic indicators still show that the UK economy is expanding across manufacturing, construction and the services sector. However, retail sales fell in November for the first time since 2015 and recent figures also look weak in the run up to Christmas. On a positive note average weekly wages are rising at their highest level in 10 years – up 3.3%. Consumers should be feeling less squeezed as the level of inflation is at 2.3%. Employment statistics look strong with a record number of people in work and unemployment at 1.38 million – still lower than a year ago. Job vacancies are also at historically high levels. Gross Domestic Product (GDP) growth cooled to 0.4% during the three months to October from a rate of 0.6% in the three months to September, as the economy appears to have hit a softer patch in the Autumn after a strong Summer. Whilst uncertainty prevails around Brexit and inflation is closer to the 2% target, it is unlikely that the Bank of England will raise interest rates any time soon.

EUROPE

As expected the European Central Bank (ECB) announced that it would stop its monthly €30bn per month asset purchase programme in December. Whilst no new purchases will be made, the ECB will reinvest proceeds of bond maturities which will maintain some support. The ECB kept interest rates at 0% at its December meeting and is unlikely to increase them in the short term, as economic growth in the eurozone appears to be weakening. The ECB revised its growth projections for eurozone GDP down to 1.7% for 2019, 0.1% lower than forecasts in September. The ECB President, Mario Draghi, said the balance of risks to the economic outlook is "moving to the downside" due to geopolitical uncertainty and market volatility. Economic indicators point to the French economy contracting against the backdrop of civil unrest whilst the export-led German economy has softened as global growth appears to be slowing, in particular Chinese growth and thus demand. The Italian government has revised its budget so that its resulting deficit level is acceptable to the EU. Given President Macron's recent economic concessions, it is likely that France may well breach the EU deficit limits.

US

Newsflow in the US is currently dominated by interest rate policy and trade tensions. The Chair of the Federal Reserve (Fed), Jay Powell, commented recently that interest rates were "just below" a neutral level that neither hastens nor slows growth. Rhetoric around the level of interest rates has therefore changed as in November, he had said the bank had a "long way" to go before reaching that neutral level. As anticipated, with the US economy growing at 3% in 2018, the Fed increased its main rate at its December meeting by 0.25% to a range of 2.25-2.50%. The Fed also indicated that future rises may come at a slower pace due to concerns about weaker global growth. It revised down its forecast for US economic growth to 2.3% for 2019 from 2.5% predicted in September. Two more interest rate rises are expected next year – so fewer than the three or four previously predicted. The loss of Congress in the mid-term elections by the Republicans could lead to less support for President Trump's stimulative economic measures and therefore impact on growth. The US economy continues to expand but at a slightly slower pace. Manufacturing increased in November. The labour market remains robust with the unemployment rate at 3.7%. The total non-farm payroll employment increased by 155000 in November. Following the recent G20 summit meeting, President Trump and the Chinese President, Xi Jinping, agreed to halt new trade tariffs for 90 days to allow for talks. Mr Trump agreed not to boost tariffs on $200bn (£157bn) of Chinese goods from 10% to 25% on 1 January 2019. China committed to buy a "very substantial" amount of agricultural, industrial and energy products, to reduce the trade balance between the two countries and phase out 40% tariffs on US made cars. China has begun to buy US soya beans once again. Both countries are committed to "immediately begin negotiations on structural changes in respect to forced technology transfer, intellectual property protection, non-tariff barriers, cyber intrusions and cyber theft".

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ASIA PACIFIC

As expected the Chinese authorities have pledged to "maintain economic activity within a reasonable range" following new data showing that economic growth in the country continues to decline. Chinese retail sales grew by 8.1% in November, the slowest rate of growth since 2003, while industrial production grew by 5.9%, the weakest in almost three years. Chinese exports have remained resilient in the face of US tariffs, but weak consumer spending and slowing investment in housing construction are proving a drag on the Chinese economy. It is expected that further economic stimuli will be announced by the Chinese authorities. Despite supportive monetary policy, which has seen the assets of the Bank of Japan (BoJ) rise to 100% of GDP, there has been little impact on the level of inflation. Inflation expectations remain close to zero. The annual rate of consumer price inflation, without energy and food, is still well below target, at 0.4% in the year to October. Lack of inflation still remains a problem nearly six years after the higher target rate of 2% was set. Worries are emerging about the strength of the economy, after contraction in the third quarter but it would seem that this weakness was due to a series of natural disasters. The latest Tankan survey of large manufacturers does not show any weakening. The Organisation for Economic Co-operation and Development (OECD) forecasts growth of 0.9% in 2018 and 1% in 2019. The Japanese unemployment rate is at its lowest since 1992, at 2.4% in October.

EMERGING MARKETS

The change in rhetoric around US monetary policy with perhaps fewer interest rate rises has been beneficial for sentiment towards emerging markets. Lower oil prices were supportive of those emerging markets that are net importers of oil although negative for oil producers like Brazil. The OECD expects Brazilian economic growth to gain momentum during 2019 and 2020 as private consumption, supported by improvements in the labour market, looks set to increase. Monetary policy is expected to tighten during 2019 as the economy gathers momentum. However, the new government needs to cut expenditure and a political consensus for a pension reform is required. Maintaining strong growth will require further efforts to strengthen productivity. Russia increased its main interest rate and economic fundamentals appear more solid, although US and European sanctions continue unabated. In India, the governor of the central bank resigned unexpectedly and was replaced by a less confrontational official. The rupee fell in value but the Indian economy appears to be performing relatively well with inflation at 2.3% pa and industrial production strong.

FIXED INTEREST

There has been a significant shift downwards in gilt yields indicating that there is almost no chance of the Bank of England raising rates in the next 18 months. Negative political news around Brexit has been the driver of demand for gilts coupled with equity market weakness. Bond markets have not had a good year overall as they try to adjust to monetary tightening after a decade of loose monetary policy in the wake of the Global Financial Crisis. Central banks are starting to reverse the policy direction towards a more 'normal' setting. Very recently, global investors have become more bearish as concerns over the economic outlook increases. Their net underweights have been reduced considerably in December with government bonds rallying sharply as investors anticipate that the US economy will lose momentum as the impact of tax cuts lessens. Earlier in the year government bonds had been out of favour due to rising US interest rates and less monetary stimulus in Europe. The US yield curve is being closely monitored. When long-dated bonds yield less than short-dated ones, the bond market is predicting that interest rates will need to be cut by the central bank because recession may be coming.

COMMERCIAL PROPERTY

November is set to be the first month since September 2016 to deliver negative capital performance at an IPD (Investment Property Databank) All Property index level as the impact of falling values in the retail sector finally outweigh the positive returns still being generated in office and industrial sectors. Ongoing uncertainty around the UK's trading relationship with the EU is continuing to weigh on investment activity. There a fewer sellers of stock across all the sectors and transaction volumes for the last quarter of the year are likely to be lower than previous quarters. After several years in which capital performance has been a key component of total returns generated by commercial property funds, income is likely to be the main driver of performance for the foreseeable future.

OUR VIEW

Investors fear the upward momentum in corporate earnings will falter as global economic growth slackens in 2018, pauses in 2019 and then reverses by 2020. Following the 'credit crunch' of nine years ago there is a determination not to be 'caught' holding excess risk. Investors MAY be responding prematurely to perceived risks which may yet be averted.

Equity prices have risen strongly since early 2009 and in certain markets/sectors, valuations have risen too far based on unrealistic assumptions with regard to future earnings growth. This has been especially true of certain tech/social media stocks in the US with investors suddenly mindful of risks and keen to consolidate gains. Fear of general over-valuation has led US equity prices down and added to pressures in other markets. Meanwhile, risk-free US Treasury yields have improved markedly so increasing their attraction to investors.

OUR VIEW continued

Parts of the UK FTSE 100 offer genuine value opportunities and given 69% of those companies' earnings are derived from overseas, the international aversion to UK assets is surprising. Where portfolios have fallen to slightly underweight positions in UK equity income funds, we are topping up holdings. The yields from equity income funds are well in excess of 4% pa which is more than acceptable with inflation at 2.30% pa with gilt yields and bank deposit rates trailing. Yields are particularly important during a period in which increased capital values appear less likely. We maintain an overweight position, typically 20/25% of UK equity exposure, in UK small/mid-cap funds. These funds have suffered far more of late as they are more domestically focused and the prospect of a Brexit induced recession is worrying investors. There is no merit in selling at current prices.

The volatile German market has experienced a significant fall which we consider to be unjustified. Many German companies are world beating and financially successful so we have been adding exposure where we can at the expense of other European markets. These companies are not suddenly worth so much less than they were two/three months ago.

There is growing belief that Asian/Emerging markets have bottomed and that they are worth buying – not least because the prospect of a more muted rise in US interest rates will be highly beneficial. For the most part, our current exposures are modest because we significantly reduced exposure in order to consolidate previous gains. We have insufficient conviction to increase exposure presently.

We continue to favour Japan partly due to strengths of the corporations but also because the Yen is a safe haven currency. For a similar reason, we have been gaining exposure to dollar bonds; the dollar is the World's reserve currency and the yields on US Treasuries are relatively attractive in less certain times.

UK fixed interest is less exciting – yields are relatively modest and the prospect of a fall in Sterling is deterring overseas investors, leading to potential erosion of capital values. Conversely, gilts do support our UK equity market positions whilst investment grade sterling bonds also provide a degree of stability. We are therefore maintaining our exposures concentrating on high credit quality.

For those dependent on their pension/investment portfolios for income these are more worrying times. Income paid from capital reduces portfolio values and therefore increases withdrawal rates. In most portfolios we are holding a reasonable amount of cash and are taking these levels up to one year's income needs. We also hold large stocks of 'lower risk' assets that we can sell in preference to equities, if we need to raise cash. We will not be seeking to sell equities down because, except in the case of fundamentally over-valued assets, markets will find their proper level and any 'over-selling' will result in a 'V' curve as buyers return. In these times it is really a case of sitting tight, apart from where there are any over-valued assets, managing damage limitation and waiting for the cycle to run its course. Presently, investors are purging themselves of excess risk based on elevated fears. Unless there is an abrupt improvement in global trade tensions, fear of a resulting slow down in the global economy will remain the dominant theme.

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