INVESTMENT COMMENTARY

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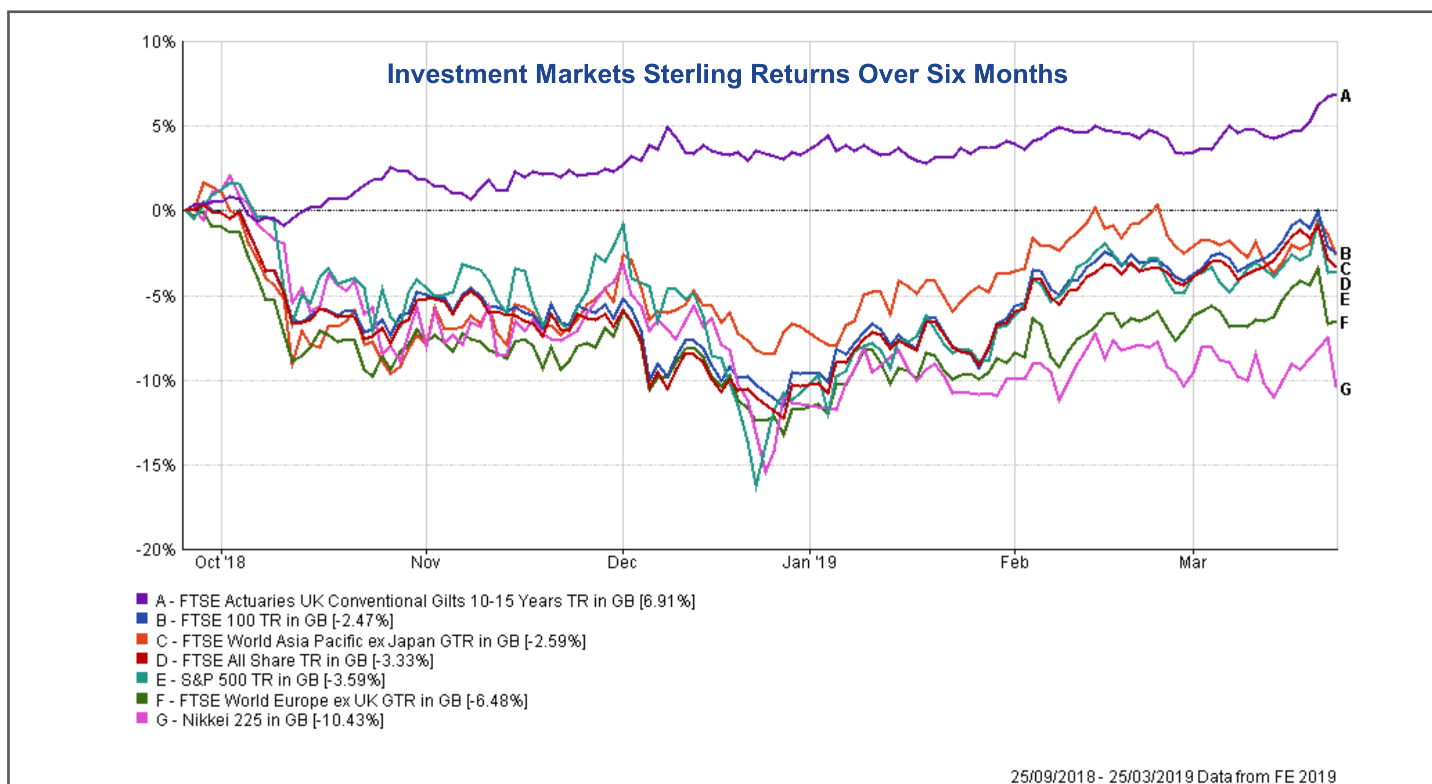
CARTLIDGE MORLAND

Equity markets have made positive returns since the beginning of 2019 but as the chart below illustrates, on a six month basis, the returns from the world's major equity markets have been negative in sterling terms not helped by the very recent downturn in equity markets. Investors have become nervous following the inversion of the US yield curve - very short term bond yields rose above those of longer term bonds at the end of last week. The US Federal Reserve has indicated that interest rates will not rise again this year and have downgraded economic growth forecasts. Therefore investors believe that there could be economic problems in the near future and short term interest rates may need to be cut – hence the preference for longer term US bonds. Investors remain optimistic that the US and China will reach agreement on their trade dispute, but perhaps have a little less conviction than previously, as the US/China trade talks have been delayed. Hope for a Brexit deal has also faded as Parliament has failed to approve any type of exit and the European Union has granted an extension on leaving to April. Against a backdrop of weaker growth in the leading economies, central banks appear to have postponed any further tightening with the European Central Bank (ECB) reintroducing cheap loans for banks in the region in an attempt to support growth. As in the US, interest rate rises in the UK and Europe do not look likely in 2019. Equity markets will remain volatile while fears over global economic growth and so much uncertainty persists, although any positive resolution surrounding trade or Brexit should be beneficial for markets.



UK

The inability of Parliament to reach an agreement on a Brexit deal has weighed on sentiment towards the UK economy, with domestically focussed companies out of favour in the equity market and business investment fragile. The relative strength of sterling has been dictated by the Brexit newsflow. Larger companies tend to perform better when sterling weakens as they derive the majority of their earnings overseas and therefore benefit from a weaker sterling exchange rate. The economy grew by 0.5% in January 2019 after contracting by 0.4% in December 2018. For the three months to the end of January, the economy grew by 0.2%. However, forecast growth for this year has been revised downwards due to the weakness in business investment. Wages have risen by 3.4% pa on a three monthly basis whilst the current inflation rate is 1.9% pa. Therefore real wages are rising which should be supportive of the economy as consumers have greater spending capacity. The labour market remains robust with the unemployment rate at a 44 year low of 3.9%. Higher tax receipts have helped Government finances with government borrowing predicted to fall to its lowest level since 2002. At its March meeting, the Monetary Policy Committee (MPC) of the Bank of England (BoE) voted unanimously to keep Bank Rate at 0.75%. Although wages are rising, the MPC commented that "other indicators of domestically generated inflation remained modest".

US

The US economy continues to grow but the prospects of sustaining 2.9% growth this year have diminished as the impact of tax cuts fades, coupled with uncertainty surrounding trade issues with China and Brexit. Growth in Quarter 4 2018 slowed to 2.6% pa. The US Federal Reserve (Fed) have downgraded its expectations for US economic growth from 2.3% pa predicted in December to 2.1% pa at its March meeting. Two additional rate rises had been expected in 2019 but the Fed is now indicating that rates will be kept at the 2.25%-2.5% range for the rest of the year. Consumer prices are growing at their slowest pace in two years (at 1.5% pa) which also reduces pressure on the Fed to increase interest rates.

The labour market remains healthy overall, but only 20000 jobs were added in February from a level of 311000 in January, although the figures may be distorted by the government shutdown. The US dollar has weakened as a result of the pause in the interest rate hiking cycle which should benefit US exporters. The all-important US housing market appears to be softening with housing starts falling and house price growth at the slowest rate in three years.

EUROPE

Economic indicators point to the eurozone manufacturing sector contracting in January with output and orders slowing. The export-led German economy continues to suffer as the Chinese economy slows and the US/China trade dispute remains unresolved. In addition, its car manufacturing has slowed due to slow compliance with new emissions regulations. German business confidence is at its lowest level since late 2014. The ECB has downgraded the eurozone's economic growth prospects for 2019 from 1.7% predicted in November 2018 to 1.1% forecast at its March 2019 meeting. Inflation forecasts have also been cut and inflation is predicted to remain under the 2.0% pa target until 2021. Against this view of a weakening economy, the ECB has reintroduced Targeted Longer Term Refinancing Operations (TLTRO) which offer cheap loans to eurozone banks with the aim of increasing lending to support growth. Mario Draghi, President of the ECB, warned that the eurozone was in "a period of continued weakness and pervasive uncertainty". The eurozone economy is heavily dependent on exports and so continues to be negatively affected by global trade issues and Brexit uncertainty.

ASIA PACIFIC

The Chinese manufacturing sector is showing weakness with output growing at the slowest pace on record. The trade dispute with the US is taking its toll on domestic demand as well as exports. Exports have declined by the greatest degree in three years. The Chinese authorities have set a lower GDP growth target of 6-6.5% in 2019. The slowing of the Chinese economy is having a negative effect on the region as a whole with South Korean and Japanese exports also lower. Hopes are raised for a resolution of the trade war with the US, and together with the pause in interest rate rises in the US, the Chinese equity market has been the strongest performer in 2019. The latter is a partial rebound from a steep decline in 2018. The Bank of Japan has kept its main interest rate on hold as global growth slows. Japan's manufacturing production has contracted for the first time in three years in February, as China imports less from Japan. Inflation remains very low in Japan with the lower oil price feeding through. The higher sales tax to be introduced in October should see inflation spike but is unlikely to reach a 2% target in the short term.

EMERGING MARKETS

Emerging markets have been supported by the prospect of US interest rates not rising in 2019 and therefore perhaps a weaker US dollar. A lower inflation outlook driven from the falling oil price is beneficial to these markets too as it also relieves pressure on the central banks of developed economies to increase interest rates. An easier monetary stance is good for these markets although Russia may see increasing inflation as a lower oil price leads to weaker currency and therefore inflation from imports. In Brazil, economic data indicates stronger activity in the services sector and improved retail sales. Indian Gross Domestic Product rose 6.6% pa in the final quarter of 2017, down from a revised 7% pa in the previous quarter. Tensions between the nuclear-armed rivals India and Pakistan have the potential to hurt foreign investments and impact on business sentiment in an economy that is one of the fastest-growing in the world, although now facing weaker domestic demand and a global economic slowdown. Against this backdrop and with inflation relatively low, the Indian central bank may well cut interest rates again.

FIXED INTEREST

The softening of policy by the major central banks since the start of 2019 has seen bond markets perform relatively well. The US Fed has indicated that interest rates will not increase further this year, the ECB has relaunched TLTRO with interest rates unlikely to rise until 2020 and the BoE has maintained Bank Rate at 0.75% at its latest meeting, against a background of uncertainty surrounding Brexit and lacklustre UK economic growth. Consequently, corporate bonds have continued to recover

FIXED INTEREST continued

with spreads tightening sharply over the past month. Gilt yields have reduced in recent months as they adjust to the more accommodative stance being adopted by central banks with interest rates not increasing and inflationary pressure muted.

COMMERCIAL PROPERTY

Last year UK commercial property was one of the best performing major asset classes with returns coming mainly from income rather than capital growth. Despite uncertainty surrounding Brexit, the UK commercial property market continued to prove attractive to both domestic and global investors, with transaction levels above their long run average at £60.2bn in 2018. Weak sterling, legal structures and regular valuations make the UK commercial property market popular for investors. London continues to be the largest recipient of cross-border investment globally. However, international investors are now considering assets in major regional UK cities too. In the very short term, many deals are on hold until investors know the impact of any Brexit deal. The retail sector remains challenged as shopping moves online away from the high street. The warehouse element of the industrials sector has benefited from this evolution with online retailers requiring large warehouses from which to distribute goods. The yield from commercial property remains relatively attractive in comparison to UK gilts and total returns over the next five years are likely to be driven by income rather than by capital gains.

OUR VIEW

Fixed interest assets, through UK gilts and corporate bond funds, are included in portfolios where risk parameters dictate within the low/lower medium risk asset allocation as part of a portfolio diversification strategy. They tend to provide downside protection for portfolios when equity markets are falling and there is a 'flight to quality' by investors. The returns from lower risk assets seem likely to remain modest in the longer term. Gilt yields remain below inflation as do bank deposit rates and at 3/3.5% pa investment grade corporate bond yields are also very low. Commercial property is not delivering significantly more once management costs have been deducted from yields. The values of these asset classes appear likely to remain stable – and the yields are at least reliable – but with inflation at 1.9% pa, the real return available is modest.

Far greater yields are available from equities with the FTSE All Share yielding well in excess of 4% pa and many large cap stocks considerably more. US, Asian and European markets also offer access to high yielding stocks. In the US, taxation distortions have led to corporate focus on share buybacks, rather than payment of dividends. US companies have returned more than the total capitalisation of combined European markets (including the UK) by use of this mechanism since the credit crunch. Whilst dividend payouts from US shares remain comparatively modest, share prices have been driven up massively by these buybacks. Some favour legislation to remove the tax inequality between buybacks and dividends. Were this to occur dividends would presumably increase, whilst US share prices would rise less dramatically.

Our message is that investors need to continue accepting the inherent risks of equity investment in order to reap the returns they need in order to meet their objectives. Equity investment and its yields/capital growth will complement the more stable, but far lower returns now available from lower risk assets. More typical volatility has now returned to markets which is nerve-wracking for all investors but confidence is justified - in that portfolios which are well diversified in terms of risks/opportunities and actively reviewed, with appropriate adjustments made, will continue to deliver over the longer term. Total portfolio returns were flattered post credit crunch by the artificial inflation in bond values, caused by central bank buying (quantitative easing). For all that the ECB has resumed a programme – we will not see a repeat - portfolio investors need to grow used to lesser returns from their lower risk assets.

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