Investec
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Market Commentary

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Overview

What a difference a month or two can make. Around Christmas time, equity markets were in apparent freefall thanks to concerns over tightening global monetary policy and the threat of escalating trade wars. By the end of January investors had rediscovered some confidence, and the mood has persisted through February. Whereas almost every available asset class failed to produce a positive return for the whole of 2018, creating a considerable headwind for balanced portfolio investors, the start to 2019 has seen gains across the board. The key factors have been a dramatic policy U-turn by the US Federal Reserve Bank (Fed) and optimism that the US and China can reach an agreement on trade.

It is difficult to overemphasise how tough the investment environment was in 2018. One has to go back to 1994 to find a full year in which both bonds and equities provided such poor returns. If one adds credit markets into the reckoning, the late 1960s was the last time investors were provided with such a lack of diversification options. Cash was indeed king, especially in the United States, where the Fed has been gently ratcheting up interest rates since 2015.

The last US interest rate rise was delivered on 18th December, and was accompanied by a statement suggesting more rises to come in 2019 with little regard for the increasing concerns about economic growth. This was the last straw for markets, with the traditional "Santa Claus Rally" turning into an uncontrolled sleigh crash. Fed chair Jerome Powell subsequently rowed back on such a hawkish stance, with many commentators now suggesting that we are at the peak of the current interest rate cycle in the US, a view supported by the futures market. Indeed, at its latest meeting at the end of January, the Fed went out of its way to emphasise that it would be "patient" in assessing its next moves.

Taken in isolation, concerns about Fed policy might have been surmountable, but not when trade war fears were also taken into account, especially as it became clear that the US's more aggressive stance against China was not just a mid-term election vote-grabbing gambit. Nor was it just about trade, with the misappropriation of Intellectual Property, forced transfer of technology, illegal subsidies and poor market access all coming under scrutiny. At the time of writing, negotiations continue, and the tone has become more optimistic. Trump has used the stock market as a barometer for his success, and so must have been disconcerted by the big falls. It would thus appear to be in his interests to reduce the uncertainty. Similarly, China has enough trouble on its plate at home, battling a slower economy that is partly the result of its own more restrictive policies.

One measure of the stress that equity markets found themselves under is the VIX index of volatility. It has traded between 10 and 15 for much of the period following the financial crisis against a lifetime average of around 20. Thus investors have enjoyed steady returns with few large swings – the strong risk-adjusted returns that are the holy grail of fund managers. It has been postulated with some justification that low volatility has been a function of the abnormally generous monetary policy – notably interest rates close to zero, central bank asset purchases and consistent forward guidance as to the future level of interest rates – that was required to prevent the financial crisis from being even worse than it was. As the world economy continued to recover, there was less need for such policy settings, putting central banks on a path to "normalisation". This means that the strong monetary tailwind that investors have enjoyed is fading, possibly turning into a headwind. One consequence is the potential for higher volatility in financial markets.

We entered the New Year with market sentiment being very poor, setting up the possibility of positive surprises, and these have been delivered. However, confidence remains relatively subdued on many measures, and so we can envisage further positive returns ahead. But this is unlikely to see markets rise as smoothly as they have in past years, and so investors should be prepared for a bumpier ride, and also to take advantage of opportunities provided by sell-offs as they arise.

Brexit remains in the forefront of domestic concerns, but relatively peripheral in a global context. We currently find ourselves in limbo, awaiting further votes in Parliament. A delay to the exit date is becoming more probable, and a "No Deal" Brexit less probable. Much of investors' concerns are now discounted in the valuations of UK equities and the pound, although the binary nature of the extreme possible outcomes – "No Deal" or no Brexit – mean that it would be foolhardy to bet the house on one or the other.

Key Influences

For more than a year we have been highlighting the risk posed to financial assets by the gradual reduction of asset purchases by central banks known as Quantitative Easing (QE). Liquidity created by central banks but not put to work in the real economy – think investment in plant and equipment, inventory, etc. – had to find a home somewhere, and, in a world of negative real deposit rates, that home was financial assets, particularly those that generated meaningful income. Of the four main central banks that have utilised QE, only Japan is currently active. Positively, the Fed appears have decided to curtail the reduction in size of its balance sheet, thus leaving substantially more liquidity in the financial system. Although financial markets have lost their tailwind, it looks less likely to turn into a strong headwind.

The QE reduction was apparent for some time, so the bigger question is why did riskier assets take such fright at the end of 2018? It's all about growth expectations. As long as company earnings were expected to grow faster than any potential de-rating of shares, the total return potential, including dividends, was deemed to be enough to encourage maintaining a higher equity exposure. However, as concerns about global growth escalated, earnings estimates came under pressure. Estimates of earnings growth for 2019 remain positive, but have fallen from 10% last October to 5% currently. Investors often take their cue from the rate of change (or the "second derivative" to put it more technically). Simply put, if expectations are falling, even if they remain positive, that's bad news.

No doubt some of this was cyclical. The US economy has experienced strong growth and the Fed was normalising policy as it should. The world more generally entered a period of synchronous growth in 2017, but that has not been extended. Much of the blame for this can be apportioned to one man whose actions have taken on a disproportionately large significance. Donald Trump has been described as the "wrong answer to the right questions". There is no doubt that he touched a nerve in mobilising a class of voters that felt excluded from the benefits of globalisation, and we have seen echoes of that dissatisfaction in votes in the UK, France, Italy and Germany, for example. He also identified the fact that China has not exactly been playing by the rules in terms of allowing fair access to its markets or the misappropriation of IP. These are very much the "right questions" to be asking. However, it is the way he has gone about answering them that is so disruptive, alienating so-called allies along the way. With a minimum of almost two years left in the Oval Office, his influence is not going to wane, and even though the Republicans lost the House in the mid-term elections, the fact that he managed to shut down much of the government for a record period over his funding request for the Mexican wall shows his willingness to sacrifice growth and stability for his ideals.

Having said that, Trump has shown a tendency to "blink" in response to severe market dislocation, and the Fed has now shown a similar tendency. Thus there is justified hope that we are past the worst.

Markets – UK

Aversion to political and economic uncertainty means that UK equities are the most unloved asset class in the world

according to a Merrill Lynch survey of fund manager sentiment and positioning. The pound, now the unofficial Brexit barometer, has been equally distrusted by currency traders, although has been stronger in 2019 as the threat of a chaotic "No Deal" Brexit appeared to diminish. Both are looking cheap relative to their peers on many measures, although much will depend on how the Brexit negotiations conclude. Contrarians are particularly attracted by a prospective market dividend yield approaching 5%, and there have been hints that foreign corporate buyers see a unique opportunity to acquire assets on the cheap.

US

In December the S&P 500 suffered monthly losses not witnessed since the era of the Great Depression of the 1920s, and yet it is difficult to find an economist who is forecasting even a mild US recession in 2019. Certainly we have passed peak growth for both the economy and corporate earnings, but, once investors have recalibrated their expectations, the economic imbalances that in the past have triggered much deeper falls are not currently apparent. The fourth quarter corporate earnings season has produced the usual range of winners and losers, but, in aggregate, the releases are better than reduced expectations.

Europe

Europe has been caught in the crossfire of the US's trade dispute with China, as well as suffering from some self-inflicted wounds. Only 49% of the revenues reported by companies listed on the Continent (MSCI data) are generated within the EU, and so a combination of global uncertainty and a lack of consumer confidence in China have taken their toll. To make matters worse, Germany, generally viewed as the prime engine of growth on the Continent, has suffered one-off disruption from new emissions regulations for the automotive industry as well as low water levels on the Rhine (a major internal trade conduit). These should reverse in 2019. With the populist wave still gathering momentum, May's European Parliamentary elections threaten to produce a strong protest vote, although it is not expected to hand majority power to the anti-establishment parties. Even so, international investors are likely to remain nervous in the build-up to the polls, potentially offering an attractive opportunity to increase weightings again.

Japan

Despite continuing to screen well for companies providing excellent value, Japanese equities suffered some of the worst losses in the final quarter of 2018 owing to the country's high exposure to global trade, notably its close relationship with China, which is itself decelerating, and the effects of severe weather. Thanks to its ageing and shrinking population, Japan struggles to create strong growth and inflation, but as a consequence it remains a leader in innovative technologies that can be exported to the rest of the world. Compared to most large developed countries it also has a stable political environment and can look forward to hosting both the Rugby World Cup and the Olympic Games in the next year-and-a half, which will boost domestic activity.

Emerging Markets

Emerging Markets have begun to find their feet again after a torrid period for most of 2018. Trade war concerns were to the fore, but they also suffered from the relentless strength of the US dollar. Many EM countries and companies have dollar-denominated liabilities that become harder to service and repay from local earnings when US interest rates and the dollar are rising. The Federal's Reserve's policy U-turn has dramatically reduced the threat, and policy reflation in China should also bear fruit. Meanwhile we continue to see attractive relative value in EM, as well as stronger long-term growth prospects.

Fixed Income

Government bonds rediscovered their role of portfolio insurance at the end of 2018, providing some counterweight to falling equity markets. Their strength was bolstered by the fact that inflation expectations remain very well contained, even this late in the economic cycle. However, with running yields remaining so low (1.31% for a 10-year UK Gilt), total returns still look paltry compared with history. If bond investors are to make large capital gains it will only be in an environment of very weak growth or recession and a possible return to fears of deflation and secular stagnation, which would, in all probability, have highly negative implications for the riskier elements of portfolios.

Higher yields (or "carry") are available in credit markets, but these corporate bonds carry a higher risk of default. The rising "spread" of corporate bond yields over government bond yields is seen as a harbinger of weaker profitability ahead. However, regulatory changes and the shift in the ownership structure towards retail funds (both actively and passively managed) in credit markets mean that this sector can send unreliable signals about the state of the underlying economy, much as it did in 2015. As long as the US economy stays out of recession, default rates should remain low, providing a potential tactical investment opportunity.

UK Gilts have delivered a total return of 2.36% over the last three months and 2.54% over the last year. Index-Linked Gilts returned 2.13% and +1.26% over the same respective periods. Emerging Market sovereign bonds produced a total return of2.39% in sterling over the three months to end January (6.79% over 12m). Global High Yield bonds delivered 1.18% (5.14% over 12m).

Conclusion and Outlook

Successful investment management is all about finding the right balance between possible risks and potential rewards. We entered 2018 relatively cautiously owing to worries about more restrictive monetary policy, the febrile political situation and the fact that volatility had been subdued for what felt like an unnaturally long time. The shake-out in October encouraged us to take a more constructive (although not outright bullish) view as valuations became more attractive. It is fair to say that the further sell-off in December was more severe than we might have expected, although we did believe that volatility was set to remain higher. December's falls should also be viewed in the context of thin markets, when many are on holiday and investment banks are winding down their books to make their balance sheets look as healthy as possible for the year-end snapshot that goes into the annual accounts. Furthermore we continue to believe that the ownership structure of markets, with substantial amounts of money being run mechanistically, can exaggerate short-term swings. For example, when volatility rises there are funds that are forced to reduce their holdings of riskier assets in favour of safer bonds and cash. This can exacerbate any declines.

It will not have escaped readers' attention that we spend a lot of time in these reports focusing on events beyond these shores. Investing around the world gives us far greater access to a wider range of investment opportunities and the ability to diversify risk. Big economic blocs such as the US, China and the euro zone have a much larger impact on the fortunes of the majority of large UK-listed companies (which remain at the core of portfolios) than anything that happens domestically. Currently we do not see recessions developing in any of the major regions, and so we remain committed to full weightings in equities. However, for all the reasons discussed above, the road ahead will be bumpier and overall returns are set to remain relatively subdued compared with most of the period since the financial crisis.

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