Investec
Wealth & Investment

Market Commentary

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Overview

One of the best ways to avoid stress when it comes to long-term investing is to make less frequent observations of one's portfolio. Prospect Theory avers that humans feel the pain of loss more sharply than they enjoy the benefit of an equal gain. Thus if, in the short-term at least, stock markets' daily movements are essentially random, there will be roughly as many down days as up days, leading to a perennial feeling of disappointment. Of course, if one were only to open a valuation statement once a quarter there is the potential for a nasty shock, such as was experienced in the fourth quarter of 2018, but that was entirely reversed in the first quarter of 2019.

All of which leads us to report that, for equity investors in particular, the last few months have produced no convincing direction for markets in the end, even if the noise levels have been consistently high. For example, in pure capital terms the headline FTSE All-Share Index is exactly where it was in mid-March, having travelled up and down through this level on more than a dozen occasions. What these numbers fail to record, though, is that the UK market fell by 8% from its July peak to its August trough before recovering again in September, no doubt spoiling many a summer holiday for those who couldn't resist the urge to peek.

Such talk might sound disingenuous, but there is a serious point to be made here. Major turning points in markets are relatively rare, but short-term swings can be driven by temporary factors such as sentiment and liquidity, especially in today's febrile political climate. The equity market setback in August was triggered by news of further tariffs on imported goods from China being imposed by President Trump. That happened just as global economic data was going through a soft patch, with Citigroup's Global Economic Surprise Index (CGESI), which tracks data releases relative to economists' expectations, sitting close to six-year lows. Subsequently, Trump's negotiating tactics have been more constructive while CGESI has returned closer to neutral.

One reason not to hit the panic button in August was that it was becoming increasingly evident that global central banks were once again prepared to deploy the safety net for both markets and economies in the event of further setbacks. They came to the rescue as expected, led by the US Federal Reserve (Fed) and the European Central Bank (ECB). It is easy to forget that less than twelve months ago the Fed was tightening monetary policy by raising interest rates and shrinking its balance sheet, while the ECB was planning to start raising rates again. In the event, the Fed has cut rates three times this year, while the ECB has moved its deposit rate deeper into negative territory, with a 0.1% reduction to minus 0.5%. Euro zone savers now have to pay their banks for the privilege of depositing cash, and negative interest rate mortgages are available in some countries. Perhaps unsurprisingly, the main beneficiaries of such monetary largesse have been bondholders, and performance in this asset class is covered in more detail later in this review.

A few notable market moves deserve mention. The first was a 20% jump in the oil price in response to an attack on key Saudi oil infrastructure on September 14th. This evoked memories of previous oil shocks in 1973, 1979 and 1990, all of which were associated with recessions. However, the fear was short-lived, and the oil price is currently back down at pre-attack levels. Even so, the incident highlighted two risks: one, that Iran is intent on causing further disruption in the region as it responds to punitive US sanctions; second, that Saudi Arabia's oil facilities are vulnerable to relatively low-tech drone attacks. However great the world's desire to wean itself off fossil fuels, a major conflagration in the Middle East would be undesirable on many levels.

The second big spike was in the US overnight repurchase (repo) rate, which jumped from around 2.5% to 10% on September 16th. This is the rate at which banks borrow from each other overnight. The last time such moves were seen was in the early stages of the financial crisis in 2008, and so it was almost inevitable that predictions of another crisis proliferated. The blame was pinned on the fact that there are currently too few dollars in the financial system when a lot of people want or need them. These include companies to pay tax bills, traders to settle purchases of government bonds, the US government to finance its expenditure, the Fed itself to bolster its own cash balances, which had become perilously low, and finally global investors who view the dollar as a safe haven with a half-decent yield of around 1.5%. Unlike the financial crisis, though, this does not appear to be symptomatic of balance sheet stress within the US banking system, even if some banks have been accused of hoarding dollars to fulfil regulatory requirements. Markets have regained their equilibrium, helped by the fact that the Fed, although initially slow to react, injected the requisite liquidity into the system. It is quite possible that we will see further short-term spikes in the repo rate, but for now our opinion is that these will not, in isolation, be the harbinger of a fresh crisis.

We rarely mention gold, but it is the best-performing asset class over the last year, rising 22% in sterling terms. It has been bolstered by low bond yields and interest rates, which reduces the opportunity cost of ownership. It has also benefitted from geopolitical tensions, and retains its long-held safe haven status when the world is feeling more uncertain. Finally, increasing calls for central bank purchases of government bonds to fund current spending, a de facto monetisation of debt, potentially undermines the value of money as we know it, and gold is viewed as a store of value in such a situation.

Brexit has finally seen some progress. First the government agreed not to proceed with a "No Deal" Brexit, before then negotiating a date for a general election. Such events provided a strong boost for the pound, which, on a trade-weighted basis, has risen 8% from its lows in August. As we have warned in the past, this has dampened overall portfolio returns owing to the translation effect on non-UK holdings and the overseas profits of UK-quoted companies. Heading into the election, there is no clear winner despite an apparently healthy initial Conservative lead in the opinion polls. The vagaries of tactical voting and the first-past-the-post electoral system suggest that we will be on the edge of our seats till the ballots are counted.

Key Influences

The length of the preceding commentary leaves less space than usual for the Key Influences section, but we can again reduce it to the enduring trade-off between growth and liquidity. Growth is pedestrian, but generally still positive; central banks have stepped up their monetary stimulus. That should be a recipe for balanced portfolios to continue to make progress, with dividends providing a decent chunk of the return. The main risks to the downside are two-fold. One is that politicians lead us into situations that create severe economic dislocation; the other is that investors lose confidence in the ability of central banks to support the global economy, especially in the face of what remains a considerable burden of accumulated debt. Both require an element of faith, and it is clear from surveys of investor sentiment that, even though many share indices are close to historic highs, there is considerable scepticism in the air.

Following years of austerity and an almost total reliance on central banks, we are seeing a definite shift in favour of fiscal stimulus, with governments being urged to take advantage of low bond yields to increase deficits to spend on, for example, education, healthcare and critical infrastructure. The latter, which covers anything from roads and public transport to super-fast broadband connectivity and carbon-reduction projects, is seen almost as an "open goal" in terms of both voter approval and potential productivity enhancement.

Markets – UK

The prospective dividend yield of the UK stock market is nudging 5% again, which is an extraordinary premium relative to a 10-year

bond yield of 0.6%. To some degree this reflects the uncertain growth prospects for big sectors such as Energy (the anti-carbon agenda), Mining (China uncertainty) and Financials (low interest rates and a flat yield curve). There is little doubt, though, that international portfolio investors, who account for more than half of the ownership of British companies, have labelled the UK as "too difficult", owing to the political background. Corporate buyers, who can take a more strategic view, have started to buck the trend, aiming bids at several companies, including, recently, Cobham, which is a world leader in in-flight refuelling technology. There is even talk that pension fund allocators are exploring the possibility of increasing their equity exposure. High yield per se, though, is no guarantee of value, as the inexorable decline of companies such as Centrica, Imperial Brands and Marks & Spencer has illustrated.

US

Perhaps the most notable US event recently has been something that didn't happen, namely the failed Initial Public Offering (IPO) of WeWork, the provider of trendy office space. Taken together with the post-IPO price declines experienced by ride-sharing companies Uber and Lyft, it shows that investors are beginning to lose patience with loss-making companies led by charismatic (but sometimes dysfunctional) leaders. It is of some consolation that the IPO market is nothing like as frothy as it was in the run-up to the peak of the Technology boom in 2000, but companies that are relying on further capital-raising to sustain their business models might come under pressure. More positively, already-listed tech companies are generally in strong financial shape. Also the US is less susceptible to global trade weakness, and has a more positive demographic profile than many developed world peers.

Europe

The euro zone's Unemployment rate, now at 7.4%, and down from over 12% in 2013, is just a whisker away from the low of 7.3% it hit in 2007. And yet there remains a pervasive air of pessimism. Admittedly there is some divergence between the rates in northern and southern Europe, but the overall trend is down everywhere. Much of the woe stems from Germany, which would appear to be in recession, mainly as a result of a stumbling manufacturing sector. Part of this is down to the weakness of global trade, with Germany being a major exporter, but some is self-inflicted, notably in the automotive sector, where the industry has been caught off-guard by the rapid shift away from the internal combustion engine. Negative interest rates also weigh on the profitability of the financial sector. Any sign of a US/China trade deal and/or a general recovery in economic growth would be highly beneficial to European markets.

Japan

Citizens of Japan had much to celebrate at the Rugby World Cup, but might not be so enthralled with the 2% increase in Value Added Tax that kicked in at the beginning of October. Previous such increases have pushed the economy back into recession, but this one is at least accompanied by generous offsets in other parts of the fiscal structure. We have been of the opinion for some time that things are moving the right way in corporate Japan, especially in terms of corporate governance, and there are also signs of more resilient profitability for Japanese companies. Should the global economy be entering a period of more persistent slow growth, then Japan has at least had thirty years' experience of how to deal with it. And once the World Cup is over, it's time to focus on the 2020 Olympics!

Emerging Markets

Trade war fears and a persistently strong US dollar have conspired to create an unfavourable investment background for EM equities, although good underlying value has limited the damage. It is relatively encouraging that Argentina's latest bout of political turbulence, which led to a 50% fall in the dollar value of its stock market in the last three months, has not been especially contagious. Indeed, Indian Prime Minister Modi's slashing of the corporate tax rate from 30% to 22% was greeted with near-euphoria. A weaker dollar and trade resolution are required to trigger a sustainable period of outperformance.

Fixed Income

Bond yields plummeted again during the summer in response to trade war escalation, which only served to exacerbate fears that we are in a period of "secular stagnation". Central bank action to loosen monetary policy was also a strong tailwind. The 10-year UK Gilt yield hit a new low of 0.4%. Given that the market-derived expectation for domestic inflation 10 years hence is 3.1%, it is very difficult currently to see how anyone holding to maturity can expect to generate anything other than a loss in real terms. That is not to say that current holders will be unable to sell their bonds at a better price in the interim, although some would argue that this depends on the presence of a "greater fool" as the prospective buyer. Somewhat chastened, though, we must admit that the "greater fool" in recent years has been the seller of bonds who never envisaged such low yields

This yield shift continues to force investors to assume more risk in terms of volatility and their ranking in the capital structure in pursuit of half-decent returns. It also leaves investors in conventional gilts more exposed than ever to the risk of higher inflation, which central banks around the world are trying to generate. The economics community remains divided on the secular outlook for inflation, and we still cannot find sufficient evidence to make the case either way.

UK Gilts have delivered a total return of 6.2% over the last three months and 13.4% over the last year. Index-Linked Gilts returned 7.6% and 17.8% over the same respective periods. Emerging Market sovereign bonds produced a total return of 3.3% in sterling over the three months to end October (15.9% over 12m). Global High Yield bonds delivered 2.5% (10.7% over 12m).

Conclusion and Outlook

Although the timeless truths of investing in companies and bonds never change, the circumstances in which we invest are constantly evolving. Indeed, one could observe that the current circumstances, which include unprecedented levels of global debt and historically low interest rates, have never been experienced before. Thus, to some degree, politicians and central bankers, as well as investors, are having to make up new rules of engagement, often reactively. Investors who rely entirely on historical precedent are at risk of making serious errors of judgement. Bearing this in mind, although we adhere to a strong process which tends to shield us from the short term effects of the slings and arrows of outrageous fortune, we are constantly refining our process and our evaluation of the risk and reward inherent in all asset classes when making asset allocation decisions.

Although there has been a massive shift in favour of passive investment in recent years, we remain very much of the opinion that active management is a value-generating proposition. While we do not dismiss the effective, low-cost solution of index funds in certain circumstances, today's world requires sound judgements on many deeper levels. Disruption is rife in many industries, and identifying the winners and losers can add a lot of value. Passive investors tend to end up owning both. Our equity selection process focuses on companies which we deem to have a durable competitive advantage bolstered by strong finances and sound management, which sounds a lot easier to define than it is in practice. We apply similar rigour to our fund selection and bond investments, ever cognisant of the fact that losing money, as we observed earlier, is a lot more painful than making it.

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