Investec
Wealth & Investment

Market Commentary

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Overview

Despite a recent setback, 2019 continues to be a much more rewarding year for investors than 2018, a year which went down in the annals of history as one of the most difficult to navigate, with very few asset classes generating positive returns. In contrast, almost all asset classes are in the black this year, with bond market returns now beginning to catch up with equities as concerns grow about the effect of trade wars on global growth. Certainly the optimism that prevailed during the first quarter has abated.

The escalating tension between the US and China has been the main feature of the second quarter of the year. Although the risk of a trade war had been on the radar for most of Trump's presidency, there was widespread confidence that the two sides would reach an agreement some time during the spring, allowing President Trump to declare a vote-boosting victory in the build up to the 2020 election campaign. Hopes were shattered on May 5th, when Trump tweeted that he was going to raise existing tariffs on Chinese goods to a higher rate, while also threatening to impose tariffs on the outstanding balance of imports, amounting to some $325bn. China retaliated in kind. The situation was exacerbated by a ban on companies providing components and services to Huawei, now the world's leading provider of telecommunications equipment. The Chinese company has become the centre of America-led security concerns amongst western governments. China, in turn, has threatened to curtail the export of rare earths, elements that are essential to the manufacture of many high-tech products.

Logic decrees that an outright trade war and a new "Technology Cold War" are detrimental to both sides in terms of their depressing effect on growth and the negative sentiment that would be created amongst citizens. In the US this would imperil Trump's chances of being re-elected, while in China it might trigger social unrest. Therefore a deal should be mutually beneficial. But logic could be the loser if the leaders on both sides are motivated more by "saving face" than by acting pragmatically in the wider interest.

The most helpful developments have been in the area of monetary policy, with central banks in both the US and Europe putting off plans to continue tightening monetary policy. Indeed, futures markets in the US now predict the next interest rate move to be a cut later this year. The risk of a withdrawal of liquidity has also been mitigated, with the US Federal Reserve (the Fed) deciding to leave its balance sheet much larger relative to the overall size of the economy than it was before the initiation of Quantitative Easing required in the aftermath of the financial crisis. The European Central Bank (ECB) has similarly promised to extend the special lending facilities it made available to the banking sector following the euro zone crisis.

Of course, neither central bank would have made such decisions if economies were booming. The truth is that growth remains frustratingly lacklustre, as evidenced in a recent round of downgrades by bodies such as the International Monetary Fund and the World Bank. The burst of stronger activity in 2017, as companies and consumers finally threw off the shackles of austerity, now appears to have been a temporary phenomenon. High debt levels across the world and the rise of a brand of politics that is less friendly to the creation and retention of wealth suggest lower sustainable levels of growth in future.

In a parallel universe this commentary is being written in a post-Brexit United Kingdom, but, of course, the long-planned date of departure has been postponed, and we will soon have a new Prime Minister at the helm. Although Brexit is the hottest of topics across all domestic media and many investment commentaries, it is difficult to add much value to what has turned into the most infuriating, and yet at the same time endlessly fascinating, process. Many large UK companies earn their crust beyond these shores, and so will be minimally impacted at the operational level whatever the outcome (although their reported profits will be subject to the effect of a potentially big move in the pound). In the same vein, our investments in a range of non-UK stocks and international funds limits the exposure to any shocks to the domestic economy. We currently see insufficient clarity or value to bet heavily in any direction on the outcomes, which, at the extremes, range from a chaotic "No Deal" Brexit to no Brexit at all.

Key Influences

At its simplest, successful asset allocation can be reduced to the correct response to the interaction of just two forces: liquidity and growth. Liquidity covers a number of factors, including: interest rates; the dynamics of central bank balance sheets; the propensity of commercial banks to extend credit; the balance between buyers and sellers in asset markets. Growth speaks for itself. When the provision of liquidity is generous and growth is strong (and, perhaps more importantly, being upgraded), markets tend to do very well. This was very much the case in 2017. Most of the time there is a bit more tension between the two forces. If growth is very strong, central banks will tend to rein back liquidity to head off any threat of overheating. This will eventually put a brake on growth. On the other hand, the same central banks will loosen policy in response to a slowdown, thus providing the promise of future recovery. In both of these environments, there can be something of a battle between bulls and bears, but the damage will be relatively limited, and often equity markets will continue to grind out positive total returns.

The worst conditions for investors are when liquidity is being tightened in the face of falling growth expectations, and that is where we found ourselves in the fourth quarter of last year. The experience was painful, although mercifully short. Central bankers, notably at the Fed and the ECB were (eventually) alert to the risks, preventing further falls in equity and credit markets. The good news, for now at least, is that central banks are highly sensitive to growth concerns, and appear ready to loosen policy again if there is a threat to the continued economic expansion. Certainly that has been the developing tone from the Fed, and futures markets are of the opinion that the next move will be an interest rate cut in the autumn. Bond markets are sending a similar message.

The growth picture is murkier, but we remain reasonably optimistic that any slowdown will not accelerate into a recession. Lower bond yields in the US have pushed mortgage rates back down, lending support to the housing market. At the same time a tight US labour market is delivering decent wage growth, with, thus far at least, minimal signs of it feeding through to price inflation. It also helps that we see no sign of the sorts of excesses building up in the economy that made the last two downturns so punishing. On the other side of the world, China has been delivering policy stimulus to the economy since last summer, and there are tentative signs that this is beginning to bear fruit. Europe is the cylinder that refuses to fire, but even here there is some optimism that the one-off factors that have blighted Germany's economy will reverse. More positively, first quarter Euro Zone GDP growth of 0.4% exceeded expectations, and the unemployment rate has fallen to a new cycle low of 7.7%. Even so, a febrile political environment and the legacy of a dysfunctional banking sector suggest that growth will struggle to match that in the rest of the world.

A wildcard in the growth hand is the outcome of those trade talks between the US and China – talks which, in fact, encompass a lot more than trade and might well define the relationship between the two global superpowers for years to come. A swift and mutually beneficial exchange of signatures on a deal before the summer holidays could set risk markets up for a pleasant run. An escalation of tensions would have a more negative effect. On balance we believe that it is in neither side's interest currently to escalate the dispute, but, not for the first time in recent years, our fate lies in the hands of politicians.

Markets – UK

UK equities have perked up, but are still subject to Brexit sentiment swings and the influence this has on sterling. Companies more exposed to the domestic economy benefitted early in the year from the gradual easing of "No Deal" fears, but have again succumbed to the pressure of weak activity owing to continued Brexit uncertainty. There is also evidence that there was considerable inventory building ahead of the original Brexit date at the end of March, and this will now have to be run down. There remains insufficient clarity for us to wish to increase exposure yet. The rising probability of a disruptive general election and the potential for a Labour (controlled) government also acts as a repellent.

US

Following a torrid final quarter in 2018, US equities recovered strongly in early 2019, only to succumb to trade war fears. Technology stocks were once again a major component of the gains, but some of the gloss was taken off by the disappointing market debuts of ride-sharing trailbreakers Lyft and Uber. The Fed's decision to take its foot off the monetary brake has been a strong support, but investors remain wary that this economic cycle (which will be the longest in history by the end of July) is too long in the tooth. If Trump goes ahead with his next threatened round of tariff increases, covering more consumer goods, it will begin to have a much greater impact on consumers' purchasing power, increasing the risk of outright recession.

Europe

Europe is trying hard to replace the UK at the top of the political dysfunction league table, with populist parties and more extreme policy promises dominating the agenda. Even so, the outcome of elections for the European Parliament in May was not as bad as feared. Although anti-establishment parties fared well, they could not conjure up a majority. Given the uncertainty, international investors are giving Europe a wide berth. This might present an opportunity to increase exposure, but for the fact that the region in aggregate still struggles to generate much growth. There is a suspicion that Europe has spent so much time navel-gazing over the last decade that it has structurally fallen behind the US and China, the two other main engines of global growth.

Japan

Japan has a structural problem second to no other major developed country – a shrinking and rapidly ageing population. These pressures were exacerbated by an appalling typhoon and earthquakes in the autumn of 2018 as well the country's close trading relationship with China, which has been in a cyclical slowdown. These latter elements should have less of an effect in the near future, allowing for further recovery. Japan remains home to a relatively high number of companies that look exceptionally cheap; some with immense cash balances that are the result of years of caution. Corporate governance developments and the increasing influence of activist investors raise hope that this value will be recognised. Meanwhile Japan has an outstandingly stable political environment, which should count for something in today's uncertain world.

Emerging Markets

Emerging Markets is a misleading generic label for a list of countries that covers Central and South America, Eastern Europe, parts of Africa and most of Asia. Some are driven primarily by domestic consumption, others by the exports of manufactured goods and many by the production of commodities. And yet they often move together, unified by their sensitivity to US interest rates and the dollar, given that much EM debt is financed by dollar-based investors. The dominant influence remains China, which has been weathering a period of cyclical slowdown now exacerbated by trade war fears. However, China has implemented more stimulatory policies, and these should begin to bear fruit later as the year progresses.

Fixed Income

Government bonds played a strong role in offsetting some of the losses experienced in riskier assets towards the end of 2018, and have continued to deliver positive returns even as equities and corporate bonds have recovered in 2019. Returns have notably accelerated in response to trade war and global growth fears in May. A huge pool of global savings that continues to seek a home provides strong underlying support. There is also a lingering element of fear that the next global recession lurks around the corner, and so the demand for insurance assets remains firm. The lack of strong upward consumer price inflation pressure is also helpful. However, the very low yields available on 10-year paper (ranging, for example, from -0.2% in Germany, to 0.9% in the UK and as high as 2.1% in the US) suggest that future returns will be minimal and make it very difficult to generate portfolio returns above inflation without taking on more risk in other asset classes.

Higher returns do remain on offer in the riskier areas of the corporate bond market, notably High Yield. The "carry" available continues to look relatively attractive, but must be balanced against the risks to capital inherent in a future weaker economic environment.

UK Gilts have delivered a total return of 4.39% over the last three months and 4.14% over the last year. Index-Linked Gilts returned 8.83% and 8.12% over the same respective periods. Emerging Market sovereign bonds produced a total return of 6.83% in sterling over the three months to end May (12.1% over 12m). Global High Yield bonds delivered 5.46% (9.27% over 12m).

Conclusion and Outlook

Our most recent tactical shift was to recommend adding more risk to portfolios at the end of 2018 in the face of what we believed to be an over-reaction to fears of slowing growth and tighter liquidity conditions. In retrospect we could have been more aggressive, but the longevity of this cycle suggests that we are much closer to the end than to the beginning. We have been edging closer to the door in readiness to leave the party for the last couple of years, but conditions have never suggested that we leave the festivities for good. Even so, it is a well-documented behavioural trait that investors experience the pain of loss far more intensely than the joy of gain, and so we will continue to strive to minimise the losses when the end of the cycle does eventually arrive. Economic cycles have not been abolished and bear markets are an inevitable component of the investment cycle, and it is important that all investors understand their tolerance to such events within the context of a long-term investment plan.

One way to avoid permanent loss of capital is to invest in companies that are less likely to go bankrupt or to come begging for cash in a downturn. While we cannot guarantee perfect foresight, our robust research process seeks to mitigate risks while providing material reward. That might sound like a truism, but is not so easy to enact and often involves blocking out siren voices enticing us onto the rocks. This attention to detail is embedded in our analysis of bonds, equities, alternative assets and in our fund selection process. It reflects the trust that has been placed in us to manage clients' wealth during these difficult times, a responsibility that we do not take lightly.

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