Investec
Wealth & Investment

Market Commentary

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Overview

The last six months have seen global equity indices rise and fall in two distinct mini-cycles, only to end up roughly where they started. Given the cascade of negative headlines concerning trade wars and political disruption, there is a sense of relief that markets have not fared worse. Balanced portfolios with a greater exposure to fixed income assets, especially sovereign bonds, have benefitted from another surge in bond prices that has seen redemption yields fall to all-time lows in many countries, including the UK. Strictly speaking, then, equities remain in a bull market, but it continues to be perhaps the most mistrusted in history, with traders constantly fearing that a trap door will open beneath them. A recent survey of fund managers by Bank of America Merrill Lynch (BAML) revealed the highest holdings of cash since the financial crisis. Data from fund analysts EPFR show record flows of investment into bond and money market funds, while equity funds suffered net outflows second only to the first half of 2016. With the world's largest stock market in the US just 3.3% below its all-time high established in late July, a sentiment indicator from BAML has given a rare "buy" signal based on investor pessimism and positioning.

Many of the recent headlines have been generated by the President of the United States, Donald Trump. It is his pursuit of a trade war with China that has been the key factor in applying the brakes to the global economy, especially international trade. While we continue to believe that there is some merit in his contention that China has benefitted from an unfairly tilted playing field, we struggle to support the manner in which he has set about achieving a levelling of the terrain. His pursuit of the "Art of the Deal" leads to capricious decision-making and unexpected pronouncements, such as on May 5th when he declared that talks between the US and China had collapsed and that he was going to raise the tariff rate on $200 billion worth of imports from China from 10% to 25%, as well as threatening to impose 25% tariffs on the outstanding balance of imports worth $325 billion if no subsequent agreement could be reached. Although markets subsequently rallied on the promise of renewed negotiations, further tariffs were announced out of the blue on August 1st, leading to a second "risk off" period. Subsequently there has been a regular stream of comments from both sides ranging from petulance to conciliation, but no resolution. We are of the opinion that the tensions between the two countries run deep and encompass far more than trade alone, and so future disagreements seem inevitable.

Not for the first time in recent years the central bank cavalry, headed by Jerome Powell of the US Federal Reserve, has ridden to the rescue with the promise of easier monetary policy. The market's expectation for the path of US interest rates has been revised sharply lower, with futures now discounting more than a full percentage point of cumulative reductions from the peak of the cycle. The first 25 basis point cut was duly delivered on the last day of July – the first US interest rate cut since December 2008. Outgoing European Central Bank President Mario Draghi joined the party by suggesting that the ECB could also lower its deposit rate deeper into negative territory and even restart its Asset Purchase Programme.

Brexit continues to dominate the domestic headlines. The arrival of Boris Johnson in Number 10 and the appointment of a pro-Brexit cabinet has raised the probability of a "No Deal" Brexit, sending the pound to multi-year lows. Growth in the economy ground to a halt in the second quarter, with new investment notably weak. There is also growing potential for a general election, which could evolve into a de facto second Brexit referendum.

Key Influences

We have commented before that judging the balance between growth and monetary conditions is a key plank of successful investment. This has once again been evident in market developments. Growth forecasts came under pressure from threatened trade war escalation, but the promise of renewed central bank largesse limited the downside for risk assets. And yet shares and bonds seem to be following different narratives. How do plummeting bond yields align with still high share prices?

The answer can be seen to some degree in the relative performance of Value and Growth styles. Value investors continue to have a hard time, whereas Growth managers continue to prosper. Companies in the Value category tend to be more influenced by the economic cycle, whereas Growth companies are deemed to be able to generate decent returns even during periods of slower growth. The valuation of Growth shares is heavily influenced by the discount rate or bond yield: a falling bond yield leads to a higher present value for the cash flow they will generate in the future. It is consequently no great surprise that Technology has been the best performing sector in the US. Around a quarter of the US equity market capitalisation is attributed to Technology, against just 6% in Europe and a mere 1% in the UK. Almost inevitably, then, the US stock market has been the best performer amongst major developed markets. Japan, packed full of banks and industrial stocks, has been the notable laggard.

It would not be unreasonable to expect a period of outperformance by Value managers if trade war and Iran tensions were to reduce, which would leave the world on a better growth footing and reduce the need for much looser monetary policy, thus pushing up bond yields. However, more recent rotations into Value have not persisted, and as long as we remain in a relatively low growth world compared with the period before the financial crisis, combined with still high levels of debt, we would be willing to endure a short term period of underperformance by not chasing a Value rally. Our core equity holdings remain built around companies with high returns on capital, strong franchises and sustainable balance sheets.

Liquidity within investment funds has been a big story in recent months, first with the suspension of redemptions from the Woodford Equity Income Fund, and then with mass redemptions from bond funds run by H2O. We have observed in the past that there is a risk of a mismatch between the daily liquidity that is offered by certain funds (whether they be Exchange Traded Products or governed by UCITS regulations) and the ability of the fund manager to raise cash on demand. This is not an issue most of the time, but a period of underperformance leading to redemptions, as experienced by Mr Woodford, can create difficulties. There were no such performance problems at H2O, but a Financial Times investigation into some of their funds' holdings touched a nerve when investors were vulnerable. As long as markets and the economy remain in reasonable health, none of this should be a problem, with investors potentially being compensated for the lack of liquidity with higher returns. However, a period of increased volatility could well uncover further problems. Our fund analysts remain highly vigilant in monitoring such factors, and we cut our cloth accordingly.

Markets – UK

UK equities continue to look superficially cheap, especially on a yield basis, but dividend cuts from the likes of Vodafone and Centrica, with other big payments also under threat, highlight the risks of being stuck in value traps. In the early part of the year it was big Resource companies such as Royal Dutch Shell and BP (thanks to the oil price), and Rio Tinto and BHP Group (courtesy of supply disruptions driving the iron ore price sharply higher) that made the biggest contributions to market gains. Latterly it has been more defensive growth sectors, such as Consumer Staples and Pharmaceuticals, which have benefitted from growth concerns and a lower discount rate. Bids from overseas for companies such as Entertainment One, Greene King, Merlin and Cobham suggest that buyers are beginning to sniff out bargains amidst the political turmoil.

US

The US has shown most other developed equity markets a clean pair of heels this year, mainly thanks to its high proportion of Technology companies. This is despite disappointing public market debuts for ride-sharing companies Uber and Lyft. More successful was the flotation of Beyond Meat, the producer of plant-based (although apparently extremely palatable) meat, which has risen six-fold. There is a virtuous circle of capital, intellectual property and a vast consumer market available in the US which continues to make it well placed to take advantage of technological advances. For now, it also looks as though the Fed has put a safety net beneath investors. We continue to believe that President Trump will do everything in his power to keep the economic plates spinning at least until next year's election.

Europe

Europe sidestepped a potential landmine in the form of EU Parliamentary elections in May, with extreme, anti-establishment parties failing to make the sort of inroads that were feared. However, pressure remains on the bloc to breathe some life into a still sluggish economy. Hopes are rising that Germany, which has the most firepower in the form of a current budget surplus, will pull the trigger. The appointment of Christine Lagarde as the new President of the ECB was well received, and she has been a champion of greater fiscal stimulus. Europe as a whole would benefit from a trade agreement between the US and China, owing to the region's greater-than-average exposure to global trade.

Japan

Despite having been attracted by apparent good value and improving corporate governance, we have to admit that investment in Japan has been frustrating. Happily our preferred managers of Japanese equities continue to extract better returns than those available from the broad market. It is easy to forget that Japan is still the world's third largest economy in dollar Gross Domestic Product terms, despite a shrinking population which presents it with a long-term growth challenge. But, necessity being the mother of invention, it is home to some of the world's most innovative companies. It also benefits from having a government and central bank that are fully aligned in their policies.

Emerging Markets

Emerging Markets (EM) are dominated by China, for which this year has been a very mixed bag thanks to trade war threats and a domestic economy that continues to decelerate, even if its growth rate is the envy of the developed world. The unwritten contract between the Chinese government and its people, offering increased prosperity in return for uncontested rule, suggests to us that more stimulus will be applied should the economy weaken further. Argentina has been the notable casualty, as President Macri appears to be heading for an election loss to left-wing populists, while the country looks set to default on its debt - only two years after issuing a bond with a 100-year maturity. The best thing for EM would be a weaker dollar, which would loosen financial conditions for indebted companies.

Fixed Income

Central bank policy shifts and fears of economic weakness were reflected in bond markets, with the US 10-year Treasury yield dipping below 1.5% and the UK 10-year Gilt to 0.40%, while the German 10-year Bund yield fell to an all-time low of minus 0.7%. Indeed, such is the demand for safe assets that around $16 trillion worth of global sovereign bonds are trading with a redemption yield of less than zero, thus, in all probability, guaranteeing a loss of real value for the purchaser if held to maturity. This underlines the fact that investors have little option but to take on more portfolio risk in order to generate positive real returns.

At least the hurdle for real returns is not as high as it might be, with inflation remaining remarkably subdued, especially in the face of near-record low unemployment rates in many developed countries, including the UK. The debate about the sustainability of low inflation rages on. The argument in favour centres around technology benefits and ageing populations, while the inflation hawks cite the historic impact of low unemployment on rising wages and ultimately price inflation. The evidence is insufficiently conclusive for us to take a strong view either way, but we do observe that investors in aggregate are not well positioned for a burst of higher inflation should it occur.

UK Gilts have delivered a total return of 5.83% over the last three months and 11.06% over the last year. Index-Linked Gilts returned 7.15% and 16.96% over the same respective periods. Emerging Market sovereign bonds produced a total return of 8.1% in sterling over the three months to end August (18.94% over 12m). Global High Yield bonds delivered 5.76% (12.1% over 12m).

Conclusion and Outlook

When we raised our risk tolerance in portfolios at the end of 2018, it was in response to the fact that we thought equity and credit markets had sold off too much in response to fears of slower growth and too tight monetary policy. Subsequently the lower growth outlook has been recognised in company earnings forecasts for 2019, which at a global level have fallen from around 10% last October to 2-3% today. But at least it's still growth. At the same time central banks, led by the US and Europe, have executed a policy U-turn, thus providing liquidity support to financial markets. Geopolitical risk hangs over the market almost constantly, but a game theory approach suggests that in almost all cases, be it US vs China, US vs Iran, US vs North Korea, or (to provide some light relief) Brussels vs Rome, the result of escalation would be so damaging to both sides that neither will ultimately dare to push the other over the brink. However, the risk of a miscalculation or mistake is not negligible, which helps to explain, for example, the strong performance of gold so far this year.

Investors, both private and professional, have to recognise that we live in times we have never experienced before, especially with reference to the amount of debt that has been created in the world and the extraordinarily low - even negative - yields on cash and government bonds. Add to that the profound influence of new technologies, ageing populations and the widespread challenge to the liberal order that has dominated the West since World War II, and the challenges of investing can appear almost overwhelming. However, a clearly thought-out investment process and robust financial planning are indispensable weapons in this fight, and we continue to believe that our capabilities in both areas are up to the task. The current US economic cycle is now the longest in modern history (dating back to 1854). It will inevitably slip up at some point, and we remain as attuned to the task of protecting capital in a downturn as to maximising returns during the growth phase.

John Wyn-Evans
Head of Investment Strategy

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