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Market Commentary

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Overview

The new decade has started with something of a bang – quite literally in one case. While the majority of commentators entered the year predicting a relatively benign outlook for markets thanks to signs of a gradual improvement in underlying economic conditions, we have already been faced with an escalation of tensions in the Middle East followed by the outbreak of a deadly virus in China.

To address these in the order in which they occurred, we will start with the killing of Iranian military leader Qassem Soleimani and the ensuing retaliatory attack. Viewed in retrospect the whole incident seems almost trivial, especially when the minimal market impact is taken into account, but in real time there was a greater sense of alarm. The Middle East has long been viewed as a potential flashpoint, and the relationship between the US and Iran has declined markedly since President Trump backed out of the nuclear deal drawn up under the previous administration in 2015. The main threat from an economic point of view remains the potential loss of oil supplies, notably seaborne cargoes that must travel through the Strait of Hormuz. Thus an immediate rise of more than 10% in the price of Brent crude oil was not well received. However, the response from Iran was relatively muted, with no American casualties, and the whole incident was de-escalated with welcome speed. Even so, it was a reminder of the sort of risks that can lie dormant for long periods before reminding us of their existence.

More positively, our opinion is that the alarmists who immediately reach for the 1973 oil crisis playbook every time there is an incident in the Gulf are being too pessimistic. The oil intensity of the global economy is now around a third of what it was then, meaning that the world can generate three times as much activity for every barrel of oil consumed. Therefore it should be more resilient to higher prices. Additionally, the Gulf states are not as powerful as they were five decades ago. Not only do they control less of the market, but they also need the revenue. The prospect of an oil embargo, which was the key driver of the quadrupling of prices in 1973, remains remote. Further pressure is added by the relentless quest to de-carbonise the economy.

Much relieved by the benign outcome, investors proceeded to push equity indices to new peaks, with the MSCI All-Countries World index making several new highs before topping out on January 17th. This came just as reports of a novel coronavirus began to emanate from China. This turned out to be an altogether more serious threat. At the time of writing, markets are beginning to rediscover their poise, but many uncertainties remain unresolved, setting up a period of potentially higher market volatility.

Investors again reached for a historical playbook, this time referring back to the SARS outbreak of 2003. This episode had a depressing effect on Asian and also global activity for several months, but it must be said that the markets and the global economy were in a very different place then, still grappling with the aftermath of the Tech Bust and 9/11, while also contemplating the imminent outbreak of the second Iraq War. The challenge is to try to find a balance between the immediate negative impact on economic activity and the fact that everything returned to normal within about six months. So far in this case markets have followed a relatively logical path. Businesses more exposed to China's economy have fared worst, notably those in industries such as Travel and Luxury Goods as well as the Oil sector. Gaming companies with casinos in Macau, for example, have seen some twenty percent knocked off their share prices. Again, though, the overall equity market response has been relatively muted, with the global equity index falling just 3.5% from its peak before starting to recover.

Our current opinion is that there is limited benefit in trying to execute a short-term trade in which we sell out of riskier assets with the intention of buying them back when they are cheaper. Primarily we believe that the coronavirus will prove to be containable, even if the number of cases is already greater than those of SARS. Although China is far more connected to the world than it was then and there is the additional factor of the Chinese New Year internal migration to take into account, the Chinese authorities have been aggressive in their response. There also seems to be a welcome degree of global cooperation amongst the medical and scientific communities in trying to create a vaccine, a process enhanced by the progress of technology in areas such as gene sequencing. Finally, it would appear that relevant government authorities remain committed to providing support where necessary, and that includes further monetary stimulus. Undoubtedly there will be a sharp drop in activity in the first quarter of the year, but the world economy should ultimately be able to rediscover the recovery path upon which it entered 2020.

Even so, we would not wish to appear unduly optimistic either. Equity market returns in 2019 were in the top division, and almost entirely driven by an upwards valuation rerating. To some degree equities need to grow into that valuation, and the outlook for earnings growth this year is already under pressure, even if the longer term should be minimally affected. Combined with the fact that bond yields remain close to historical lows, balanced portfolios will struggle to repeat the outsize gains made last year.

Key Influences

The actions of central banks have been critical to the fortunes of investors over the last decade, and will continue to dominate. The most recent round of messaging suggests that, in aggregate, they are in no hurry to tighten policy. Growth is subdued by historical standards, as is inflation. There is even growing talk of letting inflation "run hot" for a while to balance the previous undershoot of the preferred 2% target. Both the Fed and the ECB are expected to air further thoughts on the subject in 2020. Although this does not provide a fool-proof failsafe mechanism for markets, it should limit the potential for lasting major setbacks. Having said that, the decision by Sweden's central bank to raise interest rates back to zero suggests that we are close to the limits of traditional monetary policy without creating damaging side-effects elsewhere in the system.

The other main actors will be politicians… again. In the UK, much will hang on the post-Brexit transition period and the negotiations with the EU covering our future trade relationship. The initial post-election euphoria has been tempered by the Prime Minister's insistence that he will not countenance any extension of the transition period, which is due to end on December 31st 2020. That perpetuates the risk of a "no deal" Brexit, or at least one that fails to provide an acceptable arrangement for many sectors of the economy. That risk has been recognised in renewed weakness for sterling. The US presidential election will be the major set piece of 2020. First, though, it will be instructive to see how far to the left the Democratic Party is willing to swing in its choice of candidate. An Elizabeth Warren or Bernie Sanders ticket would be poorly received by investors. The Democratic caucuses and primaries get under way in early February. President Trump is expected to run effectively unopposed for the Republicans.

Markets – UK

Equity markets breathed a huge sigh of relief following the Conservative Party's election victory in December. Not only was the threat of an extremely left wing Labour government averted, but there was also the promise that the Brexit logjam would finally be broken. Small and mid-cap companies found special favour thanks to the promise of increased investment in the economy by the government. UK equities have been consistently avoided by international investors since the Brexit referendum, but there is clear evidence that this group has been encouraged to return. This follows the lead of several corporate buyers, who had already been tempted by attractive valuations. The FTSE All-Share Index continues to sport one of the highest dividend yields (4.5%) amongst major markets, and this income looks especially attractive relative to a 10-year government bond yield of 0.6%. However, given that such a large chunk of the yield (>15%) is generated by Oil companies, there is some caution as to how quickly the market's aggregate pay-out can grow.

US

US equities begin the new decade trading at all-time highs, which is testament, in particular, to the growth achieved by its Technology sector, which now accounts for around a quarter of the market capitalisation. One of the features of the last decade has been the paucity of new companies listing on the stock market as more managements elect to remain in private ownership. There has been no shortage of capital available through this channel, obviating the need to raise funds in the public markets. However, the disappointing debuts of companies such as Uber, alongside the failure of WeWork to list at all, suggest that some of the frothier private valuations might be under pressure. The big prospective Initial Public Offering for 2020 is Airbnb, a name familiar to many. The appetite for shares and the valuation achieved will be an important indicator of how investors view the prospects of such innovative and disruptive new businesses.

Europe

Europe is a frustratingly general tag for a diverse group of economies that have a wide range of individual strengths and weaknesses. Germany, as the largest member, tends to set the tone, and it experienced a year to forget in 2019, narrowly avoiding falling into a technical recession. However, that cannot disguise a recession in its manufacturing sector. The slowdown in world trade hit its exports, while the secular shift away from higher carbon-emitting vehicles caught its automotive industry unprepared. The good news is that year-on-year weakness is beginning to bottom out. Europe's perennial problem child, Italy, also appears to be on a more stable political footing for now, which is encouraging. Spain and France have fared relatively well owing to a greater domestic focus, although President Macron is struggling to push through major pension reforms. All in all there are reasonable grounds to expect Europe as a whole to perform better in 2020, especially if President Trump can resist escalating trade tensions ahead of the US election.

Japan

Japan's rulers have a frustrating habit of undermining incipient recoveries. First the government increased VAT by 2% in October, which will constrain consumer demand despite some other fiscal concessions. Then it lowered the threshold at which foreign investors must seek permission to invest in Japanese companies from 10% to 1%. This potentially restrains the sort of activist investors who have succeeded in influencing corporate governance for the better in Japan, even if the rule is mainly intended to hinder China's technological and economic progress. We make no secret of our view that Japan is the home to some of the best value equities in the world as well being a country at the forefront of innovation, much of which is necessitated by a shrinking and ageing population. But extracting that value is often a lot harder than one feels it should be.

Emerging Markets

The slowdown in global trade has been a major factor in the lacklustre relative performance of EM equities over the last year. Another reason has been the persistent strength of the dollar, which has made servicing and refinancing dollar-denominated debt more expensive. More positively towards the end of 2019 the dollar showed some signs of losing momentum, while the "phase one" China/US trade deal promises to alleviate the trade malaise. Add to that further supportive measures being taken by China's government, including a further reduction in the Reserve Requirement Ratio for banks on January 1st, and the outlook was a lot brighter at the start of 2020. However, in the short term it is clear that the coronavirus outbreak will affect emerging economies, notably those in Asia, more than developed ones. We are looking out for potential bargains.

Fixed Income

Government bonds continue to offer very little to investors by way of income, which leaves their role in balanced portfolios very much as "insurance assets", a role they fulfilled well in January. Even then, there is a feeling that there is a limit to how low, or even negative, bond yields can go, making the risk/reward balance somewhat asymmetric, meaning that investors could potentially lose more money than they could ever make should sentiment change. Another option for investors is take more duration risk – that is to buy bonds with much more distant maturities than the global average of eight-and-a-half years. Holders of Austria's 100-year bond made out like bandits when yields plummeted in the summer of 2019, but also gave a lot back when yields rose again. Longer maturities also mean higher volatility, which is not for everyone.

The biggest threat to the government bond market remains inflation, and despite the odd scare there remains little sign of it breaking higher thanks to the strong disinflationary forces of technology and demographics. But we remain on high alert for any shifts in the trend.

UK Gilts have delivered a total return of 1.35% over the last three months and 9.52% over the last year. Index-Linked Gilts returned 0.41% and 9.53% over the same respective periods. Emerging Market sovereign bonds produced a total return of 0.8% in sterling over the three months to end January (9.8% over 12m). Global High Yield bonds delivered 1.66% (7.3% over 12m).

Conclusion and Outlook

The first month of the 2020s has provided a sharp reminder that investors can be surprised by the turn of events, notably those in Iran and China on this occasion. But there is also the lesson to be taken that panicking in the face of such developments can be a mistake. Yes, markets usually suffer an immediate reaction driven by a combination of extreme risk-aversion and short-term opportunism, but we tend to remain invested with a longer term horizon. It is a very rare human operator who can be sufficiently perceptive and also objective to be able to time both sides of the trade to perfection. Furthermore, our preference for companies with strong balance sheets and the ability to compound high returns over long periods confers a degree of resilience on portfolios.

Monetary policy and (geo-)politics remain the most influential macro factors for investors, and neither looks set to diminish. This combination has meant that it has been more difficult to add value through tactical asset allocation, and for much of the last three years we have remained close to neutral in terms of our appetite for portfolio risk relative to the benchmark. Luckily, we have other strings to our bow in the form of stock and fund selection, and continue to evolve our process to create even more success in these disciplines. This will increasingly include a focus on three letters that are becoming highly prominent in the investment world: E.S.G, which stand for Environmental, Social and Governance, subjects with which clients and portfolio managers are becoming more and more engaged. We will provide more details about how we apply these screens to our portfolios as the year progresses.

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