Get Your Skates On!

2017 was a banner year for balanced portfolio investors, with the returns driven largely by equities. 2018 was an absolute shocker, with almost every asset class in negative territory. 2019 is shaping up to be another big winner, with risk-adjusted returns amongst the best since the 1960s. Bonds and equities have prospered in tandem in an environment of low volatility. Risk-parity funds, often demonised as being forced sellers of risk assets during periods of rising volatility, are punching the lights out. This type of strategy is designed to minimise the amount of equity risk in portfolios, with equity tending to be one of the more volatile asset classes. Thus they aim to protect capital during equity markets falls, as they did in 2018. This year they are nipping at the heels of traditional balanced portfolios in a year of strong positive returns, which is no mean feat.

I am often asked how risk markets can be doing so well when the news seems to be so depressing. A well-worn quote from Wayne Gretzky, the legendary ice hockey player, helps to explain: “I skate to where the puck is going to be, not to where it has been”. Top tennis players and cricketers have a similar skill. They won’t necessarily watch the ball’s flight all the way from the opponent’s racket/hand, but they will anticipate where they need to make contact with it based on how it was delivered, the initial trajectory, potential spin, wind conditions, etc. Of course, they don’t get it right every time. They can just make a wrong assessment or skilful opponents can fool them with disguised shots or deliveries. This is, perhaps, where the investing metaphor breaks down. Much as we would like to be able to blame something other than our own misjudgement for an inability to deliver decent returns, it is impossible to argue that economies or markets are wilfully trying to deceive us! (I will acknowledge that company managements, and possibly politicians, can have such an accusation levelled at them on certain occasions, but the effects of such deceit will not usually play out at a broad portfolio level).

So where are we skating to at the moment? First let’s cast our minds back a year. Last December equity markets were in a freefall descent, in spite of the fact that 2018 was one of those rare years (about a 1:4 probability) when analysts’ company earnings forecasts had risen over the course of the year (much of which was anticipated in 2017). Investors were fearful of two things in particular: an escalation of the US/China trade war and an overtightening of monetary policy, especially by the US Federal Reserve. Slowing growth combined with reduced liquidity is the worst possible combination for investors.

2019 has mostly been about retreating from the cliff edge that we were peering over last Christmas. Initially there was the “pivot” executed by central banks, who not only promised to stop tightening policy, but have since loosened considerably. That accounted for the strong rally that took us through the spring. The summer can be viewed as a “muddle through” period, when growth expectations remained under pressure and threats of trade war escalation continued but liquidity support remained strong, limiting the downside for risk assets. Latterly, investors have been betting on more positive growth drivers, while monetary policy remains exceptionally loose – a positive combination. There is continued optimism that Presidents Trump and Xi will finally reach a “phase one” trade deal which will include the rolling back of some existing tariffs as well as agreed purchases of US goods by China and a tightening of Intellectual Property protection. This should help global trade and corporate investment to recover. There is also hope that some of the big drags on Germany’s economy are fading, and also that a loosening of policy in China is beginning to have a positive effect. Finally, there is the prospect of increased fiscal spending as politicians (egged on by voters) pledge an end to austerity, and low bond yields appear to invite the issuance of more debt. One piece of evidence that is being closely watched is the Global Manufacturing Purchasing Managers Index, which, although still in contractionary territory, has now risen for three consecutive months.

All of this has been reflected in a sharp upwards re-rating for equities in 2019 (after an even sharper de-rating in 2018). The MSCI World Index is up 20% year-to-date, while current year earnings estimates have fallen 8%. The 2019 price/earnings ratio has risen from 15x to 19.2x. There’s nothing inherently wrong or dangerous about that, but it does suggest that such gains will be much harder to come by in 2020. As ever it will be a trade-off between earnings growth and the discount rate. Current forecasts suggest anywhere between five and ten percent earnings growth in 2020. If the P/E ratio remains stable, then equity capital returns will be commensurate, which would be more than acceptable. The consensus sees a small rise in bond yields, but broadly unchanged short-term interest rates, which might point to a small reduction in the P/E ratio, but, perhaps more crucially, outperformance by cyclicals and financials. This would suggest that calls for an impending bear market remain premature.

A much weaker equity market would come as the result of two things in particular. The first would be a tightening of monetary policy, which is not on the cards at the moment if we are to believe the statements of the world’s central banks. The second would be a recession, particularly in the US. Without tighter monetary policy it is hard to see one developing, but there is always the political wild card. The threat of a very left wing Democrat president would not be taken well, and there is always the possibility of the trade war escalating further rather than being settled. One thing I can predict with a degree of certainty is that these subjects are going to recur frequently in 2020.

John Wyn-Evans
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FTSE 100 Weekly Winners

Ocado	17.6%
Kingfisher	6.5%
InterContinental Hotels	5.4%
Prudential	5.4%
ITV	5.0%
Bunzl	4.9%
St. James's Place	4.9%

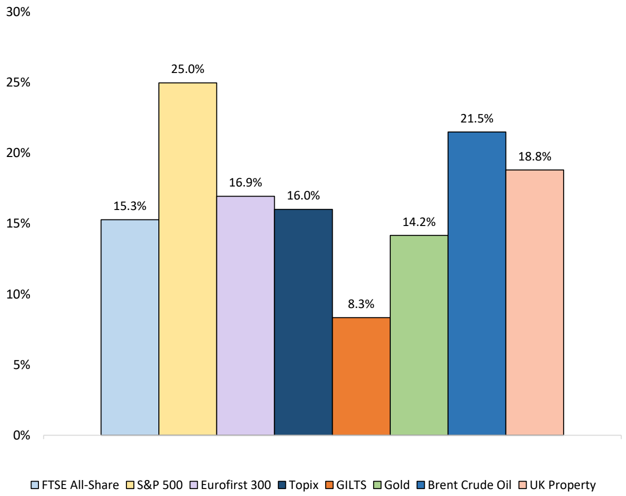
Source:FactSet

FTSE 100 Weekly Losers

Compass Group	-6.8%
BP	-3.8%
Royal Dutch Shell Class B	-3.5%
Royal Dutch Shell Class A	-3.1%
Rolls-Royce	-2.9%
Centrica	-2.5%
Antofagasta	-2.4%

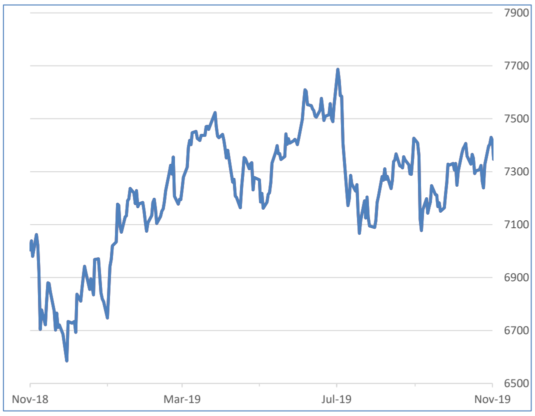
Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet