Canaccord Genuity Wealth Management

December 2018

Investment
# market update

## Politics, interest rates and trade wars – can we expect more volatility in 2019?

**The market correction that started in October has taken on a life of its own and volatility has continued on the back of new events, such as the arrest of the Huawei CFO in Canada and the leadership challenge to Theresa May in the UK.**

As unpredictable political events may continue to cause volatility, forecasting returns and markets in 2019 is fraught with danger. However, in staying focused on the economic fundamentals, we see more upside than downside next year.

Which brings us to the UK. Political events are going too fast for us to write about them, but there is one basic question: when will the UK market become so cheap that all uncertainty is fully priced into it? We think we may be approaching that juncture and would seriously consider an extra investment in UK equities, especially if an event can trigger some further drop in relative valuations for the UK vs. the rest of the world. We are watching UK equities very carefully for signs of international investors returning to the country they abandoned in droves over the last two years.

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Our positive view on markets is also predicated on the outcomes of a couple of crucial issues: the Federal Reserve’s (Fed) management of rising interest rates and the trade war between the US and China.

**Will the Fed manage interest rates effectively?**

The Fed’s monetary policy has markets worried that a recession may be forthcoming if interest rates keep rising without paying attention to the strength of the US economy or to underlying inflation levels. The Fed has the opportunity, for the first time in its history, to engineer a ‘soft landing’ of the US economy, namely to extend the economic cycle without causing a recession by hiking too much.

**Will Trump agree a trade deal with China?**

President Trump has the option to get a trade truce signed with China and to remove all tariffs on imports and exports. This would not solve all the contentious issues between both countries (such as intellectual property, hacking, etc) but it would go a long way towards reassuring companies that they can invest in their businesses and keep exporting (or importing) without fear of surprises.

We think both of these issues should be resolved satisfactorily for the markets, with a decent pause in Fed hikes and a proper cease-fire between Trump and the Chinese ahead of the 2020 presidential election. However, there is obviously some risk that it may not turn out that way, with the inevitable market volatility that would accompany it.

The one investment area most dependent on the outcome of these issues is emerging markets. Upon favourable Fed and US-China outcomes, they could soar, having underperformed the world this year. Conversely, their downside could still be significant if both events turned out wrong.

One additional concern for markets is the slowdown in the US and Chinese economies. Whereas both should be quite orderly and some form of fiscal stimulus could be applied, it is unclear how far the slowdown could go. There has been frontloading of export orders both in the US and China to get ahead of potential trade tariffs and we are now starting to see some stockpiling in the UK ahead of a possible hard Brexit. Although future corporate earnings should still deliver attractive growth, markets may fret at the sight of much lower GDP figures in early 2019. We would see this as catch-up, rather than anything sinister.

In a nutshell, headlines do not deter us from finding attractive markets worldwide. Politics may continue to cause further volatility in the New Year but we remain focused on the economic fundamentals.

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**This article was written for you by Michel Perera, our Chief Investment Officer.**

# Our investment views as at December 2018

The view in this table refers to our balanced, risk profile 5 model portfolio. This risk profile has a benchmark with 61.5% in equities, 22.5% in bonds, 13% in alternatives and 3% in cash.

Indicative positioning of £ 'balanced' portfolio.

| Asset class positioning | -- | - | = | + | ++ | Outlook | |
|---|---|---|---|---|---|---|---|
| Alternatives | | | | ■ | | → | Viewed as a way of moderating portfolio risk at a time of high volatility in equity markets and rising bond yields. |
| Bonds (Govt) | ■ | | | | | ↓ | Yields in the UK and US have recently fallen, but the overall risk and return profile remains unattractive. |
| Bonds (Other) | | | ■ | | | → | Greater returns appear to be available for strategic bond managers, but we should be aware of the additional risks taken to achieve them. |
| Commodities | | | ■ | | | → | Bears watching due to weaker US dollar and reduced supply. Most industrial metals are in contango (future prices below spot prices). |
| Convertible bonds | | | | ■ | | ↑ | Convertibles offer a good mix between the defensive characteristics of bonds, while retaining exposure to equity upside. |
| Equities | | | | | ■ | ↑ | Equity markets should continue to be supported by solid economic fundamentals, despite rising interest rates and recent turbulence. |
| Property (Direct) | | | ■ | | | → | Income, rather than capital growth, should be viewed as the primary reason for investment, given rising bond yields. |
| Cash | | | ■ | | | → | Cash levels have been reduced. |

| Equity allocation | -- | - | = | + | ++ | Outlook | |
|---|---|---|---|---|---|---|---|
| Emerging markets | | | | ■ | | ↑ | Emerging markets have struggled, but offer value. Fundamentals generally sound, although pockets of weakness exist. |
| Europe | | | ■ | | | → | Growth moderated in first half of the year, and political and trade risks have risen. Some stock specific opportunities remain. |
| Far East | | | | ■ | | ↑ | Valuations appear cheap; China and global trade are key to the region's outlook. Chinese debt levels and housing bubble are a concern. |
| Japan | | | | ■ | | → | Stock market offers value and some sectors of corporate Japan are in good shape. Macro data slowly improving. Leveraged to world growth. |
| North America | | | | | ■ | → | Economic and earnings momentum has justified an increase in exposure, augmented by US exposure in healthcare and technology themes. |
| Sector specific | | | | | ■ | ↑ | Healthcare and technology remain long-term themes. May consider further thematic opportunities. |
| UK | | ■ | | | | → | Economic fundamentals are not compelling and political concerns are pronounced, but opportunities may come with political solution. |

| Currency allocation | -- | - | = | + | ++ | Outlook | |
|---|---|---|---|---|---|---|---|
| US dollar | | | | ■ | | ↑ | Growth and interest rate differentials will likely continue to support the US dollar; Donald Trump will increasingly rail against strength. |
| Euro | | | ■ | | | → | Upside could be capped by Brexit concerns and by any escalation of Italian debt concerns. |
| Sterling | | | ■ | | | → | Sterling's prospects remain heavily dependent upon the Brexit outcome and hence the outlook is binary. |

**'=' Weighting within 1% of benchmark. '+ / -' Weighting between 1% to 5% away from benchmark. '- - / + +' Weighting in excess of 5% away from benchmark.**

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