CANACCORD Genuity
Wealth Management

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Investment
market update

Not the time to sell

Recent equity market turbulence has given investors a frisson of fear, as has often been the case over the course of the bull market that began way back in March 2009.

The FTSE All-Share Index is down 11% from its May peak, for instance, while the EURO Stoxx index is down nearly 18% since early 2018. Even the performance-leading US market is feeling the heat, with the technology-heavy NASDAQ index down 12% and the wider represented S&P 500 down 9% from their more recent highs. So what has conspired to take the wind from stock market sails and has pushed many equity indices into correction territory (a correction is defined as a fall of 10% or more)?

The main cause of the recent equity air pocket was the rise in US 10-year government bond yields above 3.2%, as the US Federal Reserve (Fed) raised the Fed Funds rate and at the same time accelerated the pace at which they are selling down their stock of bonds accumulated during quantitative easing. Mathematically and in theory, since long-term interest rates are used to discount future company dividends and earnings to arrive at a stock market valuation, a rise in long-term interest rates causes the future value ascribed to company dividends and earnings to fall.

It's also said markets climb a wall of worry, and there are plenty of bricks in that wall at the moment; amongst which, in no particular order: a trade war between the US and China; rising US interest rates and the tightening of global monetary conditions; Brexit uncertainties; US midterm elections; the Italian budget standoff with the EU; rising bond yields, and perversely at the same time, a fear that the US yield curve may soon invert (usually a signpost of impending recession); higher oil prices; the potential awakening of inflation with very low unemployment in the US, the UK, Germany and Japan among others; the repercussions of political intrigue in Saudi Arabia; faltering Chinese GDP growth; emerging market stress; high levels of corporate and government debt; and a more general sense that this prolonged bull market, at nearly 10 years' duration, is very long in the tooth.

What's our view?

Our view is calmer. We think equities will resume their upwards momentum backed by a combination of factors. We still see steady global economic growth across the world, led by the US locomotive. Companies are increasing their capital expenditures, especially in the US, but also more widely; this improves productivity and growth potential. Company profits are still rising, particularly in the US where tax cuts have boosted earnings – but even in slow growth Europe they have risen by over 10% year-on-year.

> **“The main cause of the recent equity air pocket was the rise in US 10-year government bond yields above 3.2%.”**

In response to slightly lower growth, the Chinese authorities have begun to launch a series of measures designed to stimulate activity. Even if they're rising gently, by historical terms interest rates are still very low – the European Central Bank's reference rate is still -0.4%. In addition, after the recent pull-back, equity valuations across the world are now much cheaper - using consensus estimates, the US market is trading on a 12-month forward price-earnings ratio of 15x, the lowest since 2012. Finally, there are now plenty of technical indicators that point to markets being oversold.

> **"There will sure be a time to remove risk aggressively from portfolios, but now is not that time."**

This is not to say that any recovery will be smooth. It is unlikely that any time in the near future will we again experience the kind of serene upwards movements we saw in 2017, when a combination of very low interest rates, quantitative easing across the world and synchronised global economic growth made for an environment of unprecedentedly low volatility and good equity returns, especially in the US.

What action have we taken?

We must also begin to acknowledge some of the worries, in particular around the longevity of the economic cycle, that have contributed to the present malaise. Our most recent asset allocation meeting saw most members of the committee focus on the continued good prospects for equities, but also recognise that market stress is increasing, with a more uncertain trade and geopolitical outlook further clouding the horizon. To this end, we decided to add a position in convertible bonds to our portfolios.

These are hybrid assets, which combine some of the capital-preservation features of fixed income securities with the potential upside that equities provide over the longer term. To us, their inherent defensive characteristics, whilst maintaining exposure to equity markets, seem ideal for this stage in the market cycle.

With rates rising and investors increasingly looking to identify the trigger for the first recession in a decade, markets often encounter periods when sector leadership changes and when uncertainty increases. At times such as these, it's important to hold one's nerve, and focus on global fundamentals that in our opinion remain generally positive.

When markets get as nervous as they are today, it's all too easy to panic and throw the baby out with the bath water. However, we still think that equities offer good long-term value, and current turbulence is throwing up interesting opportunities.

There will surely come a time to remove risk aggressively from portfolios, but now is not that time.

This article was written for you by Richard Champion, our Deputy Chief Investment Officer.

Our investment views as at October 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 have risen and may become interesting at some point, but overall returns are not attractive compared to other asset classes.
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 and Brexit concerns are pronounced.

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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