February/March 2019

Investment

market update

Keeping some perspective

If anyone needed evidence as to how investor sentiment can affect financial market performance, one need only look at the views of market participants in the fourth quarter of last year compared with today.

As 2018 drew to a close, it was strikingly apparent that investors were holding out little hope of a favourable outcome to the many issues which were front and centre at the time. There were continuing fears that the US and China would remain locked in a destructive trade war, while the slowdown in global economic growth was viewed as a precursor to yet further economic weakness. Most tellingly, it was felt that the US Federal Reserve's (Fed) intransigence would compel it to keep raising interest rates, even if the economic backdrop didn't wholly support a further tightening in monetary policy.

We believed that the investment landscape was not as bleak as some market participants were suggesting, and it is encouraging that investors have now seemingly adopted a much more positive mindset, as evidenced by the sharp recovery in equity markets since their December lows.

Has anything substantial changed in investment markets since the end of last year?

Potentially the most significant development has surrounded the Fed who appear to have made a remarkable policy volte-face in the space of just one month.

Whereas Jerome Powell, Chairman of the Fed, was happy to suggest that interest rates may be well below "neutral" towards the end of last year (thus setting the scene for a continuing series of rate hikes in the year ahead), one can only conclude that he was severely unnerved by the reaction of financial markets to this proclamation. He and his policymaking colleagues have since been at pains to highlight that further moves are wholly data dependent. Notably, the communique which accompanied January's decision to leave rates unchanged removed all suggestions that the next move would be a rate increase, and instead said that the "committee will be patient" in determining future adjustments.

Financial markets have greeted this U-turn very favourably indeed, although it is entirely possible that Powell has now over-played his hand in the other direction. Nonetheless, a mechanical, 'devil may care' attitude to further interest rate rises by the Fed is no longer a primary concern of equity markets.

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Elsewhere, while there remain continued grounds for optimism, and we believe that a number of issues will be resolved without inflicting significant damage on the global economy and financial markets, it is too early to sound the all clear quite yet.

US-China trade talks continue

When looking at the current state of US-China trade talks, it is undoubtedly good news that both parties continue to negotiate. No dispute can be settled without keeping lines of communication open and we are heartened by February's talks between Chinese vice premier Liu He and US trade representative Robert Lighthizer. The fresh evidence of a continued slowdown in the Chinese economy may also actually be good news as far as these talks are concerned, as China may be even more incentivised to strike a deal. Meanwhile, President Trump would like nothing more than the opportunity to showcase his deal-making ability.

However, before the champagne corks start popping, it should be remembered that there are still some significant obstacles to overcome. Not least, there is continuing disagreement over the backing Chinese companies enjoy from myriad government subsidies, industrial policies and state-owned banks. The US demand that the Chinese government must overhaul or eliminate these programmes, may yet be far less palatable to the Chinese negotiators.

The cost of the US government shutdown

Investors can also take confidence from the reduced likelihood of a further government shutdown in Washington. The 35-day shutdown earlier in the year was estimated by the Congressional Budget Office (CBO) to have reduced economic activity by US$8bn (0.2% GDP), and while some of this will be recouped as federal spending rebounds later in the year, the CBO has estimated that US$3bn will never be recovered.

The funding deal agreed by the Democrats and Republicans is therefore good news; the sting in the tail is President Trump's declaration of a national emergency due to a 'security crisis' on the southern border. This opens up a Pandora's box of issues. Ultimately, one matter could be resolved, only to spark a whole host of new problems and uncertainty.

What does this mean for investment markets?

Financial markets are renowned for moving from one extreme to the other. Fear often follows euphoria; unbridled optimism follows hot on the heels of dejection and despair. Consequently, just as financial conditions were not as inauspicious as suggested in the fourth quarter, neither may everything be quite as rosy as some now believe.

For this reason, we have sought to take advantage of this shorter-term optimism by taking a little risk off the table, principally through a reduction in the exposure to European equities. However, we wouldn't want anyone to misjudge this move; we do not believe that the positive investment cycle is yet at an end. In fact, the surprise could be that it lasts longer than some expect. As a consequence, we remain committed to equity markets and continue to expect that attractive returns can be delivered in the months ahead. It is, however, important to keep some perspective on investment markets. Exuberance may have become a little too pronounced in the short term and some moderate calming measures are probably in order.

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This article was written for you by Justin Oliver, our Deputy Chief Investment Officer, Offshore.

Our investment views as at February 2019

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 fallen, but the overall risk and return profile remains unattractive.
Bonds (Other)	■					→	Greater returns appear to be available for strategic bond managers, but the additional risks taken to achieve them need to be monitored.
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 increased slightly.

Equity allocation	--	-	=	+	++	Outlook	
Emerging markets					■	↑	Emerging markets have outperformed since the end of October 2018, which is an encouraging sign. US dollar weakness will assist.
Europe		■				↓	Political and trade risks have risen at a time when economic growth has been lacklustre. Other regions have greater attractions.
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 remains superior to other developed regions.
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. There will come a time to buy the market.

Currency allocation	--	-	=	+	++	Outlook	
US dollar				■		↓	With the US Federal Reserve seemingly on pause for a while, the US dollar could evidence some weakness.
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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