Investment Review - 2019

Trying to ignore the 'noise' circulating around financial markets has been particularly challenging in 2019. There has certainly been enough to fret about, but when has there not been something to worry about in global economics and politics?

Highlighting just a few of the macro themes that made the news in the past year:

- OECD global growth forecast reduction
- US/China trade war
- Negative yielding debt
- UK's prolonged exit from the EU

Well, that all sounds fairly grim and far from anything to get optimistic about. However, let us take a step back and consider what this actually meant for investors had they invested back in January, through to the time of writing.

Rank	Market	Index	2019 (%)	2018 (%)
1	US	S&P 500 in US	**29.05**	-4.94
2	Europe	Euro STOXX 50 in EU	**27.68**	-12.03
3	Japan	Nikkei 225 in JP	**19.67**	-12.08
4	UK	FTSE All Share in GB	**18.71**	-9.47
5	Asia	MSCI AC Asia Pacific ex Japan in US	**17.40**	-10.60
6	UK	FTSE 100 in GB	**16.85**	-8.73
7	Emerging Markets	MSCI Emerging Markets in US	**15.68**	-10.08
8	Gold	S&P GSCI Gold Spot in US	**14.65**	-2.81
9	Corporate Debt	Bloomberg Barclays Sterling Corporate in GB	**10.95**	-2.24
10	Government Debt	Bloomberg Barclays Sterling Gilts in GB	**7.57**	0.50

Source: FE Analytics

Despite all the doom and gloom, all the 'dither and delay', most asset classes provided not just positive, but well above average returns, which probably comes as a surprise to many.

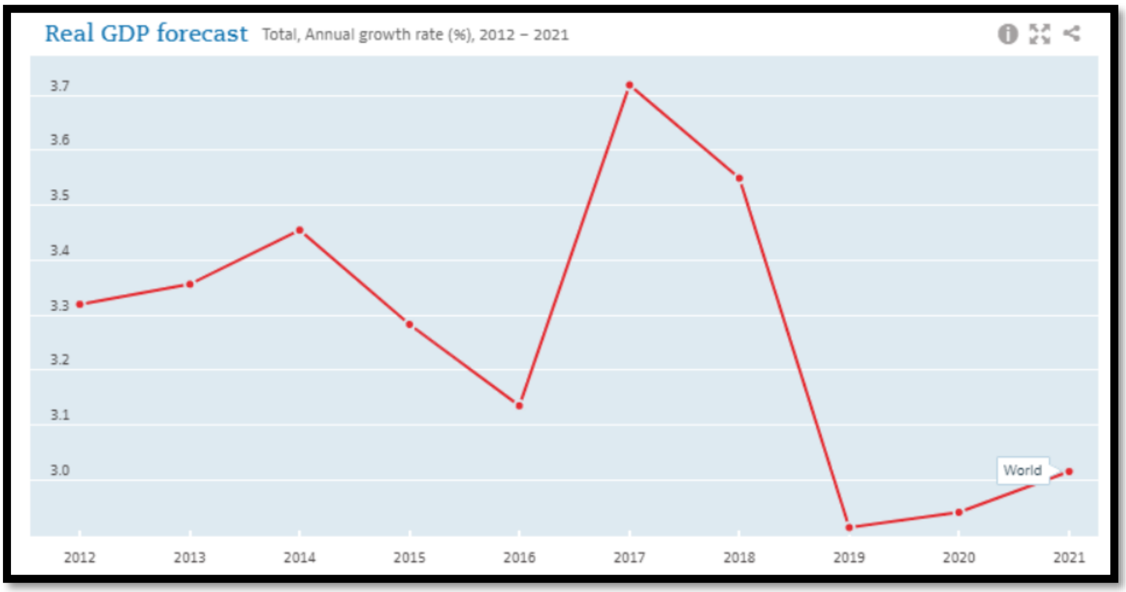
Granted, we entered the year with a market surge, after a sudden fall in values in late 2018 when central banks tightened interest rates. This policy was reversed going into the New Year as the market threw a tightening tantrum, which provided a fillip to equity investors.

The performance in 2019 illustrates that investment markets operate much of the time contrary to how we rationally think they should. Seeking to understand, as best as possible, the longer-term drivers of market trends is more important than the shorter-term impact of news headlines. This is not a ground breaking idea, more a valuable reminder on perspective.

Growth Assets...

The economic backdrop has hardly been conducive to higher values in growth assets (equities) over the past few years, at least with conventional thought. Interest rates remain at very lows levels reflecting a lack of demand for credit (loans) or, more likely, an abundance of supply courtesy of central banks. Inflation rates are lower than government targets, indicating weak demand for goods and services, despite the stimulus practices put in place that were initially thought to be temporary, but increasingly look more permanent.

The headline numbers for global growth have been weak and continue to slow, especially in developed markets. The US led the way in 2019 with GDP growth of 2.4%, with the Eurozone and UK expanding by just 1%. Growth has been propped up by emerging markets such as China and India at 6.1% and 5.9% respectively. The Organisation of Economic Co-operation and Development (OECD) reduced its forecast for global growth in 2020 from 3.5% to 2.9% and called for governments to stimulate economies through increased public spending to offset a halt in private sector investment[1].



Source: OECD.org

Governments and independent central banks have been doing their best to stimulate private demand but arguably this has been as effective as pushing against string. In order to boost growth, it may well require higher public spending as the OECD suggest. This growth trajectory does not sound like a tailwind for world stock markets, but all have risen over the year, and quite substantially so.

The **US**, which represents approximately 55% weighting of the 'investable world' continues to be the epicentre of developed market growth.

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[1] Financial Times 21.11.19 - 'OECD urges governments to take 'urgent' stimulus action

Look closer at valuations however and we find only a handful of mainly technology companies (Amazon, Apple, Microsoft etc.) have driven the market higher, with other areas more subdued. This concentration is somewhat concerning as it does not convey broad based economic expansion. Having experienced a near 30% rise it leaves the market as a whole looking relatively expensive against others, when considering how much investors are willing to pay for a slice of company profits (price-to-earnings) and assets (price-to-book).

Europe and **Japan** performed well as central bank support through low (and negative – see below) interest rates and other stimulus measures continue to encourage investors to seek returns on capital through taking risk, when perhaps they otherwise would not if other options existed. The evidence suggests this support seems likely to continue.

Emerging Markets provided positive returns though suffered relatively as sentiment over US-China trade discussions caused widespread concern, particularly throughout the supply chain of US exporting markets. We have had a window to these important negotiations through President Trump's social media efforts with sentiment changing almost daily, but a more formal breakthrough was announced earlier this month which eased tensions. For context, the US imports over 4x the amount it exports to China, so it has leverage.

The **UK** stock market has been a laggard for most of the year. The political unknowns have hamstrung most overseas asset managers from investing in the UK, despite the fall in the value of sterling, which makes UK assets more attractive. Now there is a business friendly majority government in place, interest in the UK should grow again.
The below chart shows the sterling/US dollar exchange rate for the year. The improvement since the general election was called in the hopes of breaking the deadlock can be seen. This is a trend worth monitoring as a rate of 1.31 is still below the 10 year high of 1.71. Volatility in currency markets is a given, but a more positive tone for Sterling is now present and this is important for UK investors who hold overseas assets.

Source: XE.com

Defensive Assets...

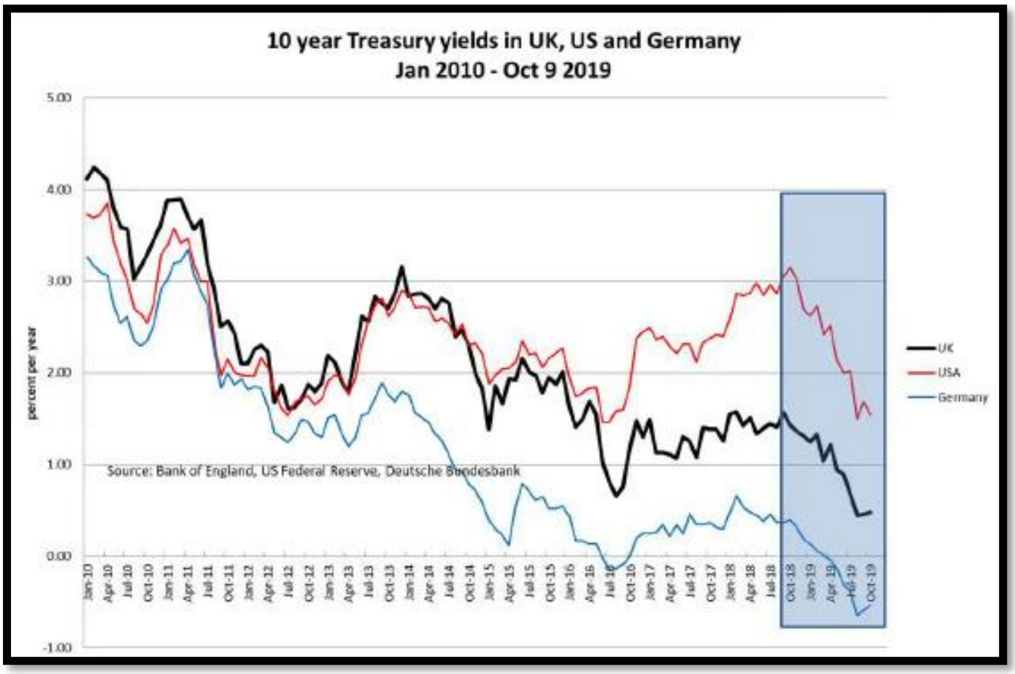
One theme that requires greater explanation, in hopes of setting expectations for the future, is the performance of assets considered defensive i.e. government and corporate bonds, otherwise known as fixed income. These assets provide a known return, subject to the creditworthiness of the borrower, and in the case of a UK government ‘gilt’ the return is effectively guaranteed.

Gilt prices are generally valued off the Bank of England base interest rate, which remains low at 0.75%. Why then, throughout this year, has the result of lending money to the UK government been a gross risk-free total return of 7.5%?

There are a number of reasons but perhaps the most straightforward is the idea of ‘flight to safety’ and the guarantee of a return of capital, no matter how low that return is. This demand has pushed the capital value of government and, in turn, corporate fixed income assets higher and corresponding yields lower.

Our independent economist Peter Stanyer refers to the return being seen as ‘stealing performance from tomorrow’. An investor today is unlikely to receive the same return from these defensive assets going forward and that needs to be taken into account.

Now, let us go one step further. The chart below, courtesy of Peter, shows that investors in Germany (though far from the only country) are willing to accept a negative return on their investment or, to put it another way, are willing to pay the bank to look after money.



Source: Peter Stanyer (Bank of England, US Federal Reserve, Deutsche Bundesbank).

There is in fact approximately $17 trillion of global listed bonds providing investors with a guaranteed negative return, which is a number equivalent to 20% of World GDP[2].

So why would someone invest for a guaranteed negative return?

1) Fear – whilst a guaranteed loss, it is at least a quantifiable loss.
2) Deflation – the real return or value may actually be positive, if the price of goods falls.
3) Speculation – if interest rates continue to fall further into negative territory, capital values of fixed income bonds will increase further.

This is an unusual situation and it is far from clear how fixed income prices might move from here. The latter point of speculation could demonstrate the 'greater fool' theory, in that an investor might accept a negative return because the asset is expected to be sold to an investor willing to accept an even more negative return. It is more of an institutional rather than private investor issue at this point, as positive returns, albeit historically low, remain available in the market to retail investors.

It is a dichotomy really in that growth assets are delivering strong returns indicating bullishness, whereas on the other hand defensive assets are also delivering strong returns, which could be considered a sign of bearishness.

What is clear is that for cautious investors, it is a more difficult environment than in recent memory to deliver strong returns, without increasing the allocation to growth assets and thus carrying the capital risk. This may well be a necessary and acceptable adaptation to the environment providing sufficient cash reserves are in place to endure volatility. The clear separation of savings from investments is something that those who attended our Titanic Autumn conference will recall we highlighted.

Confidence...

It seems with the lack of clarity in the UK since the EU referendum back in 2016 and the political deadlock, there has been a distinct lack of confidence in the UK. Without confidence, businesses do not invest and consumers rein in discretionary and big ticket spending and a vicious circle can ensue.

The below chart shows the December reading of the Purchasing Managers Index (PMI) that fell to its lowest level since the 2016 election, showing a slowdown throughout the year and contraction in business activity leading up to the election.

[2] Bank of International Settlements September Quarterly Review – www.BIS.org

Source: IHS Markit

With the December election furore now water under the bridge, we can move on. With a majority party in parliament we are over the first hurdle and can progress towards greater certainty of the economic landscape and build confidence in how the future will look.

The market mood certainly felt more upbeat after the election result, with Sterling moving higher, gilt yields rising and values falling (a sign of confidence and good for long-term investors) and the more UK focused FTSE 250 index moving higher than the FTSE 100.

There is more to do of course, with the EU withdrawal agreement bill to be passed in January but firstly amended to ensure the UK leaves by the end of 2020 with any extension to the transition period outlawed. There is a budget due early in the year from which public spending intentions, which were absent from the conservative manifesto, will be detailed. All of this clarity is good for decision making at both the corporate and household level.

Despite the OECD suggestion to stimulate the economy through higher public spending, the government's finances might preclude that from happening. It is true that years of austerity have stabilised the national debt, but it is still as it was in 2015 at 81% of GDP and much higher than at 63% of GDP in 2010[3]. It has been announced that borrowing will only be undertaken for viable investment, so it is unlikely that broad spending increases will be announced. Maybe it is not needed, as with clarity the private sector may be reinvigorated and release so called pent-up demand.

Looking Forward...

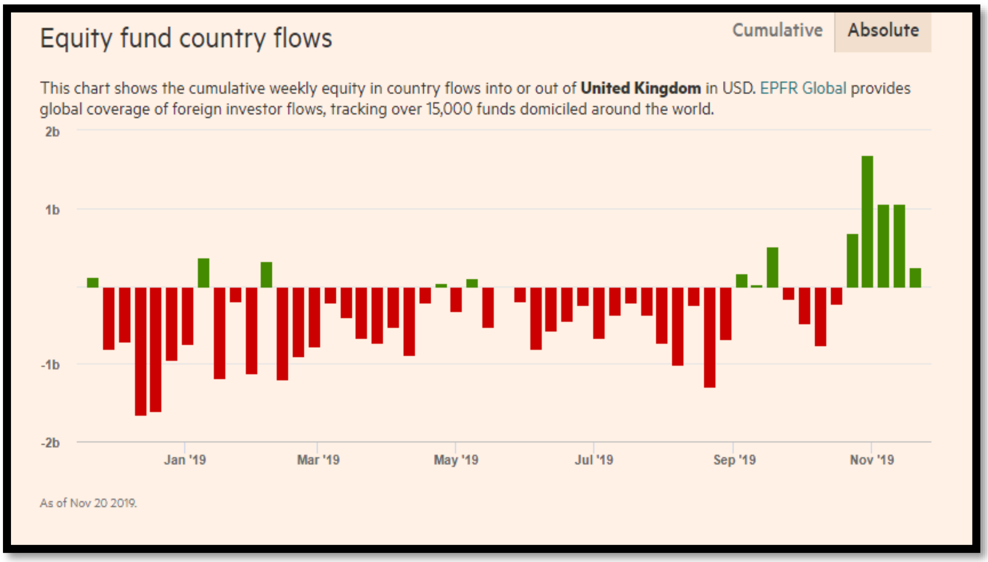
From an asset allocation point of view, the current investment landscape is as challenging to forecast

[3] www.tradingeconomics.com

as, well, as ever. We understand the folly of prediction and will always adhere to the principle of diversification of investment, which is the only tried and tested means of long-term wealth creation. We know we cannot forecast which asset class is going to perform the best in 2020, so we choose a multi-asset approach to capture upside potential, and minimise downside risk.

That said, we keep a close eye on economic developments and market trends and one development will be to target a greater allocation to the UK, albeit slowly and proportionately, as we discover more from the UK-EU negotiations. A no-deal exit will obviously be disruptive to both UK and EU businesses, so you would hope that the two sides agree at least a framework before the end of 2020.

This clarity should increase interest in the UK. The chart below, shows that leading up to the general election, with the likelihood of a stable government, the UK saw a reversal of fund flows having largely been left in the dark by investors these past few years.



Source: Financial Times

The re-allocation to the UK may come in part from the US where investors have enjoyed a good ride over the past decade and have an election year ahead, with the price-earnings ratio of the market being relatively expensive with a multiple of 23x, as against the UK at 16x[4].

There is room for optimism in 2020 as the UK progresses towards a clearer future and we look forward to sharing our investment thoughts with clients in regular commentary as we move through the year.

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[4] www.ishares.com/

Please remember:

Taking withdrawals may erode the capital value of your fund, especially if investment returns are poor and a high level of income is being taken

Investments can go down as well as up in value - this means you might get back less than you put in

Past performance doesn't predict or guarantee future returns

There's no such thing as a 'risk-free' investment - each asset class has its own specific risks