Close Brothers
Asset Management

Investor **Insight**

Quarterly investment view – December 2018

Finding stability and resilience in turbulent markets

2018 has been a difficult year for investors across most asset classes, but we remain cautiously positive about the outlook for 2019. While volatility is likely to remain a feature of markets next year, negative sentiment and attractive valuations mean that a reduction in policy-induced concerns could lead the markets higher than today's levels. Below we detail what has caused market gyrations this year and how we are positioned for 2019, a year we think will bring relief and some joy to long-term investors.

Looking back

2018 has been a particularly difficult year for financial markets at the index level, with equities, bonds and alternatives in negative territory (end of November, 2018). Only the US market is in positive territory, buttressed by Sterling gains for a UK-based investor. This negative turnout is highly unusual. It has occurred only twice in the past 50 years – during the 1970s' stagflation episode and the Global Financial Crisis although, even in 2008, government bonds delivered a positive and uncorrelated return. That stocks and bonds moved more in line this year, both to the downside, means that the benefit of stock/bond diversification has been less effective in 2018. This phenomenon is quite typical in a rising interest rate environment.

The experience of negative returns has been exacerbated by extreme volatility – large price moves up and down – with daily gyrations across asset classes, sectors and stocks, more than four times that which we experienced in 2017. In some respects, 2018 has been the polar opposite of last year. 2017 was a year of strong returns and very low volatility, resulting in some of the best risk-adjusted returns in 30 years. 2018, in contrast, has been a year of largely negative returns and higher risk. Sentiment, not surprisingly, has gone from being quite positive at the beginning of 2018 to anxious and uncertain as we close the year. Over the past two-year period, however, investors have received above average returns at an average level of risk.

The culprits

The four main culprits causing the widespread malaise have been:

1. **The global synchronised recovery of 2017 has morphed into a growth slowdown and desynchronization.** While growth in the US has massively improved, from 2.5% in 2017 to close to 4% in 2018, on the back of the Trump fiscal stimulus programme (tax cuts, deregulation, cash repatriation), growth in the rest of the world has slowed. Much of the growth slowdown has been caused by loss of growth momentum in China, the world's second largest economy, and its impact on demand and export growth in Asia and Europe.

2. **Tariff tensions have impacted investor expectations for growth in 2019.** Although the tariffs implemented in 2018 have not impacted GDP much this year, investors have feared what the trade tensions, particularly between the US and China, might mean for 2019. Until November, tariff discussions between the US and China had clearly broken down with President Trump threatening further escalation. Post the G20 meeting in Argentina at the end of November, China and the US have agreed to a temporary truce and aim to reach a trade agreement over the next 90 days. Constant tweets by President Trump and confusing messages from both sides, however, have kept markets on edge.

3. **Central Banks are embarking on interest rate normalisation draining liquidity from financial markets.** After eight years of monetary stimulus to the tune of circa $15 trillion globally, Central Banks are winding down on quantitative easing, removing the liquidity support for financial assets. In the US, the Fed's articulation of rate rises had seemed too hawkish and out of step with the growth fears enumerated above. Recent flattening in the US yield curve was a further signal that the Fed needs to ease its tightening bias.

4. **Brexit in the UK has created an environment of extreme uncertainty weighing on growth, Sterling, and the appetite for UK assets.** Fears of a calamity, if a soft withdrawal is not agreed, have been amplified by the fragile state of Prime Minister

May's government. While May soldiers on, having survived the no-confidence vote of her party, passage of the Withdrawal Agreement is still uncertain, with the permutation of outcomes changing daily and almost impossible to predict.

What has made these issues so difficult is that **in all cases they require some kind of policy response**. In other words, investors are left to judge how various politicians and policy makers will respond to the threats and growth slowdown. Predicting the actions of political leaders is never an exact science. Hence, markets have been left to vagaries of daily tweets, communications, media headlines and negotiating posturing on public display. The markets have thus become fixated on the actions of players as opposed to fundamentals, players themselves driven by disparate agendas and changing priorities. The calm of 2017 has been replaced by a political Babylon of epic proportions.

These near-term, policy-induced risks have been further exacerbated by end cycle concerns. The bull market and economic expansion from the lows of 2008 are now 10 years in duration, a time traditionally associated with the end of an investment cycle and the start of a new bear market and recession. Investors fearing the end of the cycle have been quicker to sell after price rallies (to protect profit) as opposed to buying after price dips.

Looking to 2019

Our overarching outlook is cautious, but constructive. While there is much to be worried about, as long-term investors, it is important that we look beyond this near-term market turbulence.

The four areas of concern articulated above **all have a natural denouement or point of resolution** ahead. What we believe is that:

- Global growth scares will remain in 2019, but we do not predict a recession next year. Growth momentum in the US will remain solid, albeit at a lower rate than in 2018, as the effect of fiscal stimulus begins to wind down. Elsewhere, growth should improve moderately as recent stimulus measures by China take hold. This creates an interesting opportunity for the Fed to slow down its rate increases, causing the US dollar potentially to move lower. This would be good news for Europe and Emerging Markets.

- Neither President Trump nor President Xi Jinping wants to derail the global economy. Trade discussions will be fraught with contentious issues, not least of which is how to balance Trump's desire for greater market access and IP protection with China's mantra of state capitalism and future technological leadership. However, we think that negotiations will find a way forward, providing relief to all financial markets. Any breakthrough here would be positive for the US, China, Europe and Emerging Markets.

- The Fed has recently signalled that interest rates in the US are closer to neutral. In other words, fewer anticipated rate rises ahead. While the trajectory is still uncertain, we think the Fed has begun to appreciate the market's concerns around growth. Inflation is not an issue in the US (as confirmed in the headline number of 2.2%) and, despite the tighter labour market, the economy does not appear overheated. Confirmation of fewer rate rises from the Fed would be positive for the US and Emerging Markets.

- Finally, Brexit will (should) get resolved. The exact outcome is far from certain. However, a resolution (even involving a transition period) is likely early next year. A soft form of Brexit would be positive for the UK equity market, which is trading at a 30-year low in valuation terms. It would also be positive for Sterling and UK growth next year. On the other hand, a hard Brexit is priced-in to some extent, and may provide company-specific investment opportunities as share prices overreact on the downside. In addition, there is the possibility, once the uncertainty clears, of a fiscal stimulus – the promised 'deal dividend' – and the release of pent up capital investment to provide a boost to economic growth in the coming years.

Changes in any (or all) of these policy dynamics could dramatically change investor sentiment and the macro narrative. Markets are discounting the worst, so we believe that any positive turn in these concerns will change the tone and price action of markets to the upside.

We also do not see the end of the cycle next year. As the adage goes, bull markets do not die of old age – but they peter out when certain economic and sentiment conditions are present. We do not see growth as overheating nor monetary policy as being massively too tight. Indeed, while the US is further along in its cycle, some might argue that the growth cycle has not really even begun for Europe and the UK. Policy rates, moreover, are still low in absolute terms. Indeed, we have never had a recession or bear market with real policy rates below 2%. Today they are at 0% in the US and still negative elsewhere in the world. Sentiment is far from euphoric and the kind of end-market 'bubble' conditions are simply not present at the moment.

On a positive note, earnings growth has remained strong everywhere in the world. Given that markets have fallen while earnings have been rising, this means that the price we pay for these earnings has come down dramatically. By way of example, the MSCI World Index is trading at 14.7x forward earnings, 15% below its long-term 30-year average and at a level traditionally considered 'attractive buying territory.' Emerging Markets are trading at 10x earnings, also at a 15% discount to the long-term average and at a 30% discount to the developed world. These valuations provide long-term investors with an interesting margin of downside protection.

This type of volatile market also favours active stock selection, as picking winners and avoiding losers becomes a more important driver of performance. While indices have been struggling this year, there are many stocks we own that are up 10% and more. Our focus on disciplined, fundamental, global research is helping to cushion performance through positive security selection.

In summary, we expect volatility to continue and growth to be more moderate in 2019, but we can also see significant 'potential' market turning points ahead, which could augur for a positive turn in markets at a time when valuations are very attractive.

Our positioning into the New Year

We have continued to follow our strategy of broad diversification across asset classes and markets, continuing to make sure we have an appropriate mix of exposures that will rally if the macro/policy narrative changes, combined with assets that we believe will provide defensive characteristics and stability.

For equities, **we still favour global exposure** so we hold international companies within the UK and strong global franchises outside. In both cases, we have tilted towards more defensive companies and stocks that have value characteristics – in the sense of trading at undemanding price-to-earnings multiples with high degrees of cash flow and business resilience. However, we have also maintained our exposure to areas we think are attractive on long-term fundamental grounds, such as Emerging Markets and Asia, enterprise technology in the US and selective financials, to name but a few.

Within **fixed income, we maintain our short duration exposure**, investing in UK government paper and high quality corporate debt, which continues to offer an attractive relative yield but also remains less immune to rate rises. The shorter maturity also means that, as bonds mature, we can recycle into more attractive names, potentially with higher yield.

With a view to increasing diversification further, we have added **exposure to a range of alternative assets**. This includes exposure to gold, absolute return investments, and infrastructure with dividend yield support that have all performed relatively well in the midst of market volatility.

Closing note

We are glad to see the end of 2018, and 2019 will not be without its fits and starts. However, for long-term investors, we advise to stay the course and not to fixate on near-term policy gyrations. The global economy is still in good shape and earnings are positive. There is plenty of opportunity for a diversified, fundamental investor to navigate through the noise and to uncover market gems. Positive changes to the policy narrative could trigger sharp rallies to markets that appear oversold on valuation and fundamental grounds.

We thank you for your support and wish you a wonderful Christmas and a happy New Year.

Close Brothers Asset Management
10 Exchange Square
Primrose Street
London EC2A 2BY
www.closebrothersam.com

Private clients please contact:
Your investment adviser or the client services team
Tel: 0800 988 8565
enquiriesam@closebrothers.com

Intermediaries please contact:
Darren Saddler
Head of Intermediary Sales
Tel: 020 7426 4187
darren.saddler@closebrothers.com