Close Brothers
Asset Management

Investor **Insight**

Quarterly investment view – Winter 2018/19

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In summary

We anticipate that 2019 could be a better year for equity markets. We think that many of the growth and liquidity challenges of last year have been discounted in share price valuations, after the significant declines in the fourth quarter of 2018. Our view is that markets are poised to have a better year in 2019, an outlook based on a number of assumptions which we will continue to test and validate throughout the year.

- While economic growth will continue to be a concern, particularly in the first half of the year, greater accommodation from Central Banks globally should temper the slowdown, and provide liquidity to the financial system.
- The policy challenges of 2018 (such as US-Chinese trade disputes) are likely to find a resolution. Removal of these uncertainties, many of which seem to be moving in the right direction already, could be a positive for financial assets.
- We see a narrowing in the differential between growth in the US (strong growth in 2018) and the rest of the world (on a decelerating trend). This should provide further support for markets outside the US and some stabilisation of the US dollar, good for assets outside the US.
- Given the decline in stock markets last year, valuations are supportive with price earnings (P/E) multiples around 5-10% below 10 year averages. We expect modest assumptions around earnings growth and dividend yield to be enough to support share prices; attractive valuations mean that markets are unlikely to de-rate further from here.
- Volatility will remain a feature of financial markets. The environment of increased volatility is not an aberration but rather a return to long-term market norms. However, large dispersion in share price returns provides a good environment for active investors, underpinning our ability to add incremental returns from security selection.
- Finally, while risks remain in credit markets and in the durability of this economic cycle, we think these risks are likely to remain contained in 2019.
  - There are excesses in certain credit markets and levels of debt globally, but inflation expectations and therefore interest rates are still low.
  - We believe the recent slowdown will be seen as another mid-cycle pause, (we have had four already this cycle) and not the beginnings of a more sustained downturn.
  - We do not see the indicators typically associated with end-of-cycle conditions and hence think there is a low probability of a recession in 2019.

The more positive tone we see in markets as we begin 2019 is reflective of investors becoming more comfortable with the factors highlighted above. However, while we expect the year to end on a positive note, economic and policy decisions, and thus markets, will not move in a straight line. 2019 will have its share of upward and downward moves and we will continue to use our research to identify high quality, resilient investments which we feel will either add to return and/or reduce the experience of volatility in client portfolios. We favour the concept of a barbell approach: exposure to investments that will drive capital growth and total return, balanced with assets that provide some ballast to portfolios against the turbulence in markets due to volatile news flow and financial data.

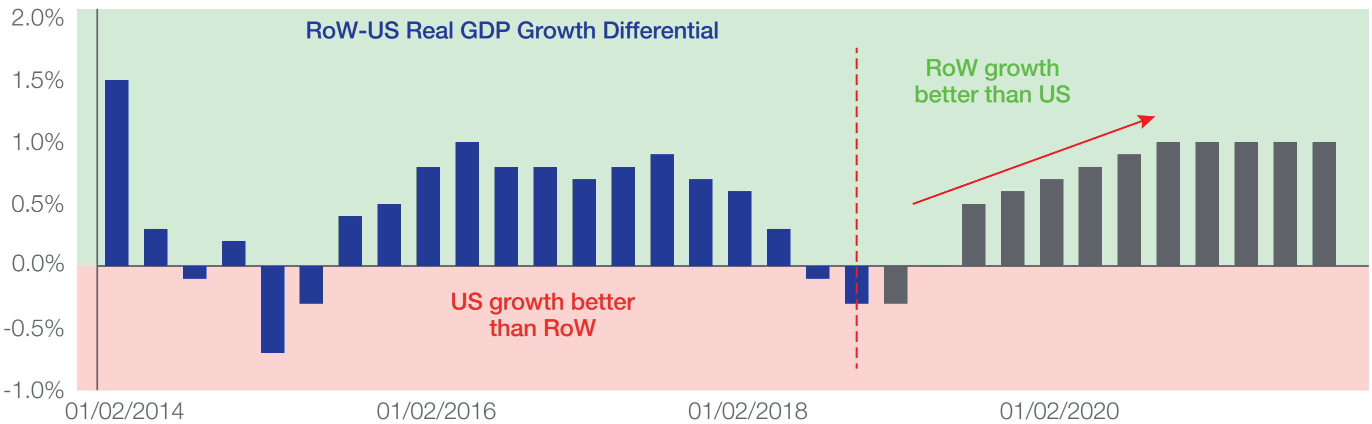
Things are getting better

There were a number of factors which contributed to the sharp correction in markets at the end of 2018, but most particularly a range of policy-induced growth and liquidity concerns, that contributed to a clear slowdown in global activity. These seem to be changing to the positive in 2019.

2018	2019
In the US the combination of four interest rate rises, a phased reduction in the size of the Federal Reserve (Fed) balance sheet of $50bn per month (QE in reverse) and the strong dollar (a form of monetary tightening), contributed to a global growth slowdown.	The Fed announced a more patient outlook to further tightening in January. Rates are officially on hold, a dovish and supportive message for financial markets.
Trade tensions between the US and China accelerated last year, with a complete breakdown in talks and with President Trump threatening tariffs on $250bn of Chinese imports to the US. Over 30% of global companies in Q3 cited tariffs as a reason for more cautious guidance.	The US and China are currently back at the negotiating table and expect to announce at least partial resolution by March. The tone seems positive thus far, with commitment at the highest level from both sides.
Growth in China slowed dramatically in 2018, as President Xi Jinping implemented a series of structural reforms. The growth slowdown was exacerbated by trade tensions and slowing export growth.	Since January of this year, China implemented a range of fiscal and monetary stimulus measures, with promises of more to come. While efficacy of the stimulus remains uncertain, China is displaying the means and motivation to support growth.
In 2018 there were signs that Brexit uncertainty was weighing on UK growth, especially with business investment. A Brexit decision did not materialise before Christmas.	Events are fluid, but the risks of a ‘no deal Brexit’ and a possible change in government have arguably reduced in the last few weeks.

In light of the above, we expect the slowdown in global growth to lessen as we move through 2019. Central Banks globally remain accommodative and, at the moment, there seems to be scant pressure from inflation to change this supportive policy stance. Indeed, we think one of the themes of 2019 is a reduction in the differential in growth between the US and the rest of the world. As the impact of Trump’s tax stimulus begins to fade, the US is likely to see growth slow, albeit remain solid. Elsewhere, if stimulus from China begins to work (good for Emerging Markets and Europe) and Brexit gets resolved (good for the UK and Europe), we would not be surprised to see a better tone to share price performance outside the US. We expect the Fed to remain dovish, and thus, the US dollar could stabilise or move lower from current levels. These conditions would be particularly favourable for global liquidity, financial markets, and currencies outside the US.

Figure 1. Differential between RoW and US could narrow in 2019



Source: DataStream, Oxford Economics Forecasts.

Earnings remain solid; valuations supportive

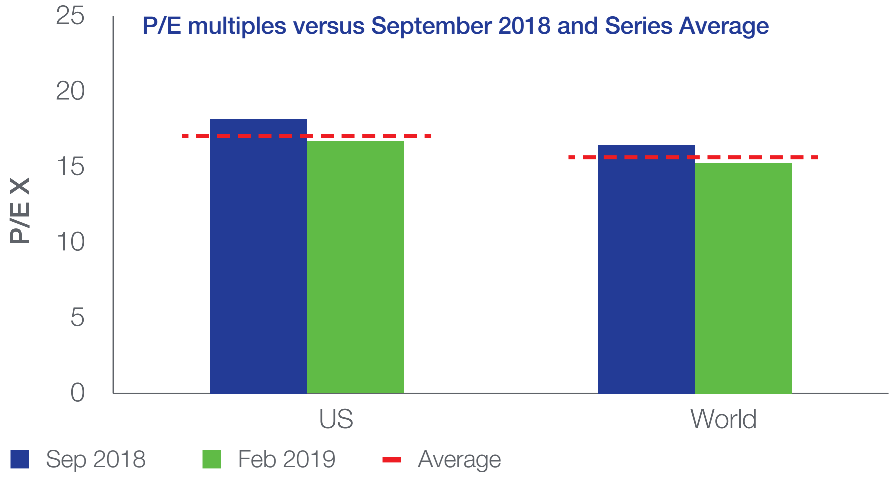
Given that we expect an improved tone to global growth as we move through 2019, we expect earnings growth to remain modest, but positive this year. Current consensus expectations are for 7-9% earnings growth, and 2-3% in dividend yield. Over 2018, equity prices fell despite positive earnings growth, meaning that the price we paid for these earnings declined significantly. The forward P/E multiples for the US and World markets are now 5-10% below 10 year averages.

Even modest earnings growth is enough to support share prices and some markets look particularly cheap. The UK is trading on a valuation discount of 30% to global peers and at a multiple close to a 30 year low, despite positive expected earnings growth. Emerging Markets are trading at a forward consensus P/E at 10x, 15% below their 25-year average of a 30% discount to developed markets. Any change in economic data due to policy changes could bring upside growth and earnings surprises.

However, we expect volatility to remain. The timing of policy issues, while moving in the right direction, could easily become derailed. Uncertainty remains high and policy mistakes can have a negative impact on economic and financial conditions. Moreover, it is important to recognise that the experience of volatility in 2018 is not outside of long-term norms for equity markets. The average level of volatility in the US market since 1945 has been 26.5%. Last year's volatility of 24.7% was simply a return to long-term averages.

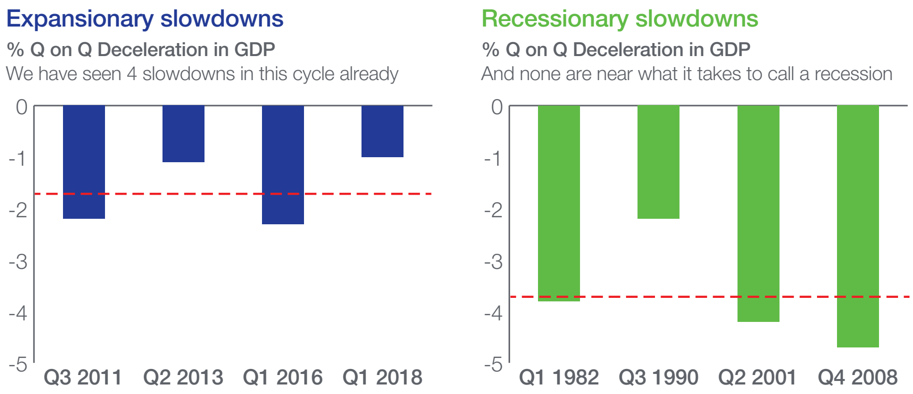
However, it should be noted that dispersion in share price returns remains a good environment for active investors underpinning our ability to add incremental returns from security selection.

Figure 2. Overall equity valuations: from expensive to undemanding



Source: Bloomberg Finance L.P. Data: MSCI World data begins in 2001.

Figure 3. Expansionary mid-cycle versus recessionary slowdowns



Source: Datastream.

Risks remain, but likely contained for 2019

Growth slowdowns are not unusual in the midst of economic cycles. Indeed, from the lows of 2008, we have already had four mid cycle slowdowns including the decline that began in the fourth quarter of 2018. As shown in figure 3, we believe that we experienced in late 2018, what we are calling an expansionary slowdown such as we had in 2011, 2013 and 2016. In all cases, an appropriate policy response led to an improved tone in markets the following year. 2016 was perhaps the most dramatic example, where a more dovish Fed in the US, combined with stimulus in China put a floor under risk assets in late 2016, leading to the significant rally we saw in markets in 2017.

These mid cycle pauses should be contrasted to the type of slowdown we saw in 1982, 1990, 2001 and 2008, where contractions on a quarterly basis were much more significant and heralded the onset of economic recession. Hence, while global growth has decelerated, the size of the decline is modest, and not of the magnitude associated historically with the beginning of a recession.

We do recognise that we are in a later phase of the economic cycle, and in that sense the risk of a recession in the next several years is not immaterial. However, expansions do not die of old age but rather when certain conditions are present. We do not see these conditions at the moment.

- Growth overheating and above long-term trend.

- Central Banks massively tightening in the face of rising inflation.
- Yield curves inverting.
- Earnings growth significantly above trend.

Indeed, we believe we are still in the late phase of the cycle where equities can still outperform bonds.

Nonetheless, we are closely monitoring other risks. One of these includes rising corporate debt levels globally, especially in the US, at a time of somewhat tighter liquidity. The Institute of International Finance has warned that global debt levels, which have moved from 248% of global GDP in 2008 to 315% currently, could be the source of further instability. Most of this increase is in government and corporate debt.

The corporate debt market in the US, for example, is triple the size it was in 2008, with greater ownership by passive investments. US leveraged loans are also an area of concern. At $1.3 trillion, this private debt market is now larger than the US high yield market and as large as the size of the sub-prime market in 2008. These loans, which are largely issued to finance M&A, buybacks or pay off junk bonds, are more senior than other types of debt, but frothier conditions in this market has meant that debt is being issued with less interest cover and less covenant protection for investors. We do not have exposure to this market, but it could be a source of instability if other things happen to de-stabilise financial or economic conditions. The corporate debt levels in China have also grown significantly in recent years.

Finally, political risks remain a concern. Brexit remains unresolved, with a delay likely. Similarly, while relations between the US and China have improved, no concrete agreement has been reached and 'brinkmanship' may very well continue past the expected resolution deadline in March.

Current positioning

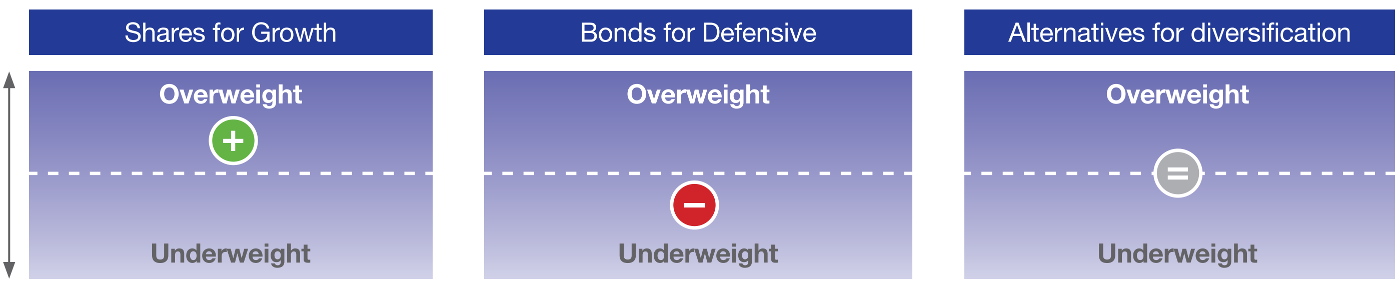
In light of the above, we continue to be **modestly overweight in equity**, but we are maintaining our strategy of broad diversification across asset classes in a barbell approach. We hold those areas of the market that we expect to most benefit from a better economic environment and undemanding valuations, coupled with the areas of the market that we expect to offer greater protection in periods of volatility.

Within equities, we still favour global exposure, holding international companies within the UK and strong global franchises overseas. In both cases, we have tilted towards more defensive companies and stocks that have good long-term value characteristics – those trading at undemanding P/E multiples, with high degrees of cash flow and business resilience. We continue to favour stocks in the technology, health care and selective financial sectors. We think there may be an interesting opportunity to reduce our weightings in the US in favour of markets elsewhere. Emerging Markets and the UK trade at undemanding multiples and could offer upside surprises on any positive change in policy fundamentals this year.

Within fixed income, we maintain our short duration exposure, investing largely in high quality corporate debt, which continues to offer an attractive relative yield. Our short maturity stance makes us less exposed to any future interest rate rises. The shorter maturity also means that, as bonds mature, we can recycle liquidity into more attractive opportunities, potentially with a higher yield, as market conditions change.

With a view to increasing diversification further, **we have maintained exposure to a range of alternative assets**. Depending upon the mandate, our range of investments includes exposure to gold, absolute return investments, and infrastructure with dividend yield support. These have all performed relatively well in the midst of market volatility. As we identify additional investments in this area, this could well be where we add investment capital.

Figure 4. Positioning Q1 2019



Source: CBAM, as at January 2019.

Our Investment Team

As active managers, we aim to add value to client portfolios through the tactical asset allocation process (the tilting of asset classes) within agreed ranges and bottom-up security selection. Our **Strategic Policy Committee**, chaired by our Chief Investment Officer, determines our tactical asset allocation. The committee uses an analytical framework that focuses on the key issues of economic growth, valuation of asset classes (relative and absolute), liquidity conditions, currency risk and policy management. Members discuss the implications of overweighting and underweighting individual asset classes, using data and judgment before arriving at a shared house view. Within our decision-making process, we incorporate proprietary analytics and research from specialist independent research firms.

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