Close Brothers
Asset Management

Investor **Insight**

Quarterly investment view – Spring 2019

Rainy days, sunny skies

There is a strange dichotomy happening in 2019. On the one hand, economic data across the globe has been weak and, in some cases, such as in Europe, indicates a sharp economic deceleration. Headlines have been filled with the ongoing saga of Brexit and its impact on the UK economy, ongoing trade tensions, and slower global growth, while the US yield curve has recently inverted (long-term bond yields have fallen below those at the short end) which historically has been a sign of an impending recession. However, financial markets tell quite a different story. Indeed, for GBP investors, the global equity index has risen about 10% in the first quarter. While stocks did correct sharply in the last quarter of 2018, rebounds of this magnitude signal that markets are more positive than the headlines. Is it a rainy day or are there sunny skies?

We remain in the sunny skies camp for now, believing that growth and corporate earnings are likely to be better in the second half of 2019. Our base case remains that it will be a positive year for returns, which we expect to be in line with long-term averages, while we continue to see opportunities to add incrementally to returns through our global research and security selection. We base this assumption on the following factors:

- As we examine the detail of the economic data, we find it is not as bad as it might first appear.
- Much of the 'negative policy' actions which helped contribute to the economic slowdown are in the process of being reversed, which should have a positive impact on growth and earnings.
- The Brexit outcome remains uncertain, which continues to cloud the outlook for UK growth. We remain cautious, but believe the tail risk of a hard Brexit has reduced.
- Inflation is benign and is not signalling any need for Central Banks to remove the proverbial 'punch bowl' and tighten monetary policy.
- US Presidential elections (November 2020) and the 70th Anniversary of the founding of the Communist Party in China (October 2019) are important milestones for the two largest economies in the world and policy makers are likely to maintain an accommodative stance.

However, risks remain. We recognise that we are in the advanced stages of this economic cycle and think volatility will remain a feature of markets. Investors should not expect a smooth ride. Rising debt levels and excesses in certain credit markets remain additional risks lurking below the surface. Given current levels of inflation and interest rates, these are unlikely to be a problem for now, but this can change quickly and we continue to monitor them.

As multi asset class investors, we temper our constructive 'sunny' outlook for shares with a conservative positioning in bonds and an allocation to alternatives assets, which can provide some ballast and diversification as and when rainy days emerge.

Not as bad as it seems

The prevailing trend in global economic data has been down, but the data is not as bad as it seems. We have seen a weakening in economic activity right across the globe with a slowdown in key economies such as China, Europe and the UK. The US, which had been the star performer of early 2018 as tax reform took hold, also saw a significant deceleration in the rate of growth in late 2018.

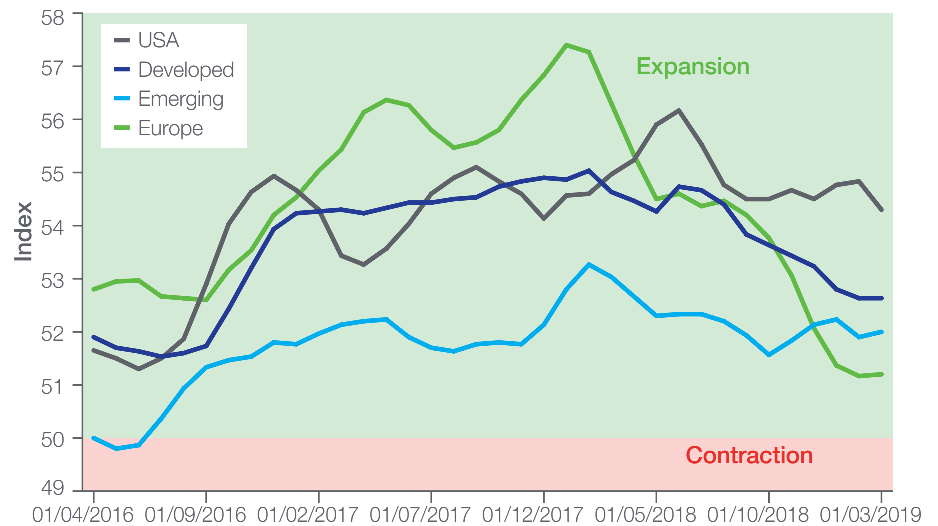
Figure 1 looks at economic data in terms of PMIs (economic data surveys) that are closely watched by investors. The rule of thumb is that when the lines are going down activity is decelerating, and a reading below 50 is indicative of a contraction. From the global synchronised expansion that characterised the data from late 2016 to 2017 (lines all heading higher), global economic data peaked in early 2018 and then significantly weakened in the latter part of the year and into the first quarter of 2019. It should be noted that the longest government shutdown in the US in history (six weeks in Q1) no doubt also had a temporary negative effect.

However, looking at this data in detail shows that most of the slowdown can be attributed to manufacturing. As can be seen from Figure 2, the service economy has remained fairly robust and not far off the strong levels of 2017.

Manufacturing data largely reflects goods trade. Hence, weakness in manufacturing numbers has a high correlation with global trade, which was the weakest in 10 years in Q1 2019. Chinese export data was particularly worrisome, with exports down 20% in the month of February, and Chinese exports to the US down close to 30% over the same period. Europe, where close to 50% of its GDP is export related, has also seen a sharp deceleration in export growth.

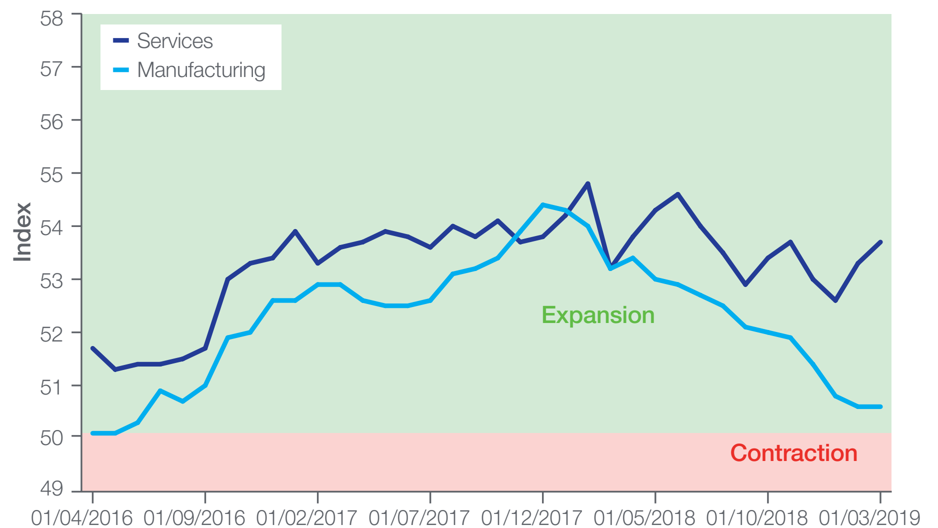
We believe that this manufacturing and export weakness can be partly explained by on-going trade tensions and their impact on supply chains around the world. Hence, any improvement in global trade negotiations is likely to have a positive impact on these numbers.

Figure 1. Global Composite PMIs – 3m average



Source: CBAM, Bloomberg Finance L.P., past performance is not a reliable indicator of future returns.

Figure 2. Global PMIs by sector



Source: CBAM, Bloomberg Finance L.P., past performance is not a reliable indicator of future returns.

After negotiations broke down in 2018, President Trump and President Xi Jinping have come back to the negotiating table and investors expect some form of trade deal between these two economies in May of this year. While trade tensions will no doubt remain a feature of policy under President Trump, a truce between the two largest economies of the world should be positive for global growth. Sources indicate that China has agreed to buy over $1trillion of goods from the US, while negotiations on the protection of intellectual property rights continue. Hence investors are looking ahead; any reduction in tensions over global trade could well lead to a rebound in key economic indicators as we head into the second half of this year.

Policy changes are also growth positive

Policy actions which had a negative impact on growth in 2018 are also reverting to a more accommodative stance, which should filter through into global economic data as the year progresses.

The US Federal Reserve has signalled that it has stopped raising interest rates, for now at least. Four consecutive rate hikes in 2018 combined with a reduction in its balance sheet to the tune of $50bn

per month was, in retrospect, too tight for economic conditions globally. Overseas, the combination of these higher interest rates and, as a result, a stronger US dollar caused liquidity conditions to tighten, too quickly. Hence the volte-face in 2019: the Fed signalling a much more 'dovish' policy stance for this year – no more rate hikes in 2019 and no further balance sheet reduction post September – with some investors even expecting a rate cut (something President Trump is lobbying hard for). The combination of stable US economic activity and a more accommodative Fed (good for risk assets) should support the global economy and may cause the US dollar to weaken, helping global liquidity and growth elsewhere in the world.

China has also changed its policy stance. The Chinese economy had been slowing in 2018 as officials looked to transform growth away from an emphasis on heavy industrial activities towards a more consumer-based growth. The anticipated slowdown, however, was exacerbated by global trade tensions and China slowed too quickly as a result. In response, this year China has embarked on a series of stimulus measures involving both tax cuts and liquidity injections to boost its economy.

We believe that these significant changes in policy in the two largest economies of the world should provide the basis for better economic growth in the second half of 2019. Any deal on trade would be a further positive.

Meanwhile, in the UK, Brexit rumbles on. Parliament appears to be some way from reaching a consensus on the Withdrawal Agreement and the framework for the future relationship with the EU. However, the taboo of requesting an extension has well and truly been broken and a "no deal" Brexit seems an unlikely outcome under May's premiership – though a longer extension does bring the possibility of a general election into focus. While six months may not be long enough for UK corporates and households to sigh with relief, we do expect some pent up activity to come through. A better external environment would be a timely and welcome fillip as well. While the Brexit impasse may weigh on growth in the UK, the UK economy remains a small segment of the global economy and most companies in the UK market are global in focus. Therefore, their fortunes are often more closely tied to what happens in the US and China rather than what is happening domestically. Nonetheless we remain cautiously positioned in the UK until such time as a Brexit resolution becomes clear.

Some green shoots against a backdrop of supportive valuations:

Interestingly, we have already seen some of the green shoots of improvement. As shown in Figure 3, recent manufacturing data from China has already moved out of contractionary territory. If the trend continues it should, in time, have a positive impact on the other export oriented economies of the world, such as Europe and Japan.

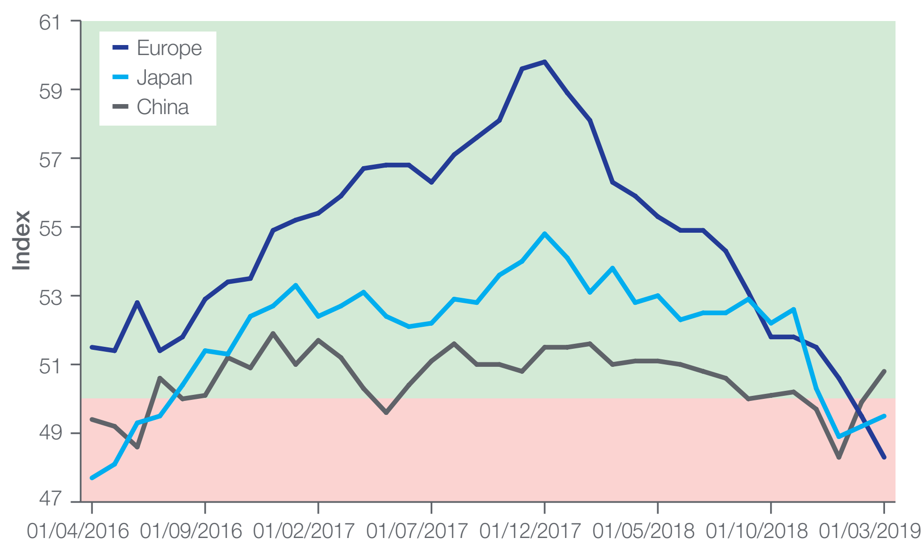
Meanwhile, both the US and China continue to show encouraging numbers in terms of service activity, with both economies' service sectors in expansionary territory. In the US, recent labour data and consumer confidence remain strong, while the recent decline in bond yields has led to an improvement in housing data, with house building and mortgage refinancing powering ahead in recent readings. There are many indicators to look at for strength in the service economy in China, but it is interesting to note that Chinese tourism continues apace, with Chinese tourists taking over 130 million trips abroad last year and spending twice that of the average tourist.

US Presidential elections (November 2020) and the 70th Anniversary of the founding of the Communist Party in China (October 2019) are important milestones for the two largest economies as well, and officials are likely to remain pro-growth. Since 1928, the US presidential election cycle has usually provided a strong backdrop for shares as the incumbent tends to pursue growth-friendly policies. In China, Xi Jinping, who maintains absolute power over the Communist party, will want the anniversary celebration later this year to be marked by good growth in China.

Improvements in global GDP should have a positive impact on corporate earnings, albeit with a lag. As shown in Figure 4, earnings have weakened since 2018, a reflection of current weakness in global economic activity. However, markets are a discounting mechanism, and investors are already looking ahead to improvements in earnings as growth and liquidity conditions improve.

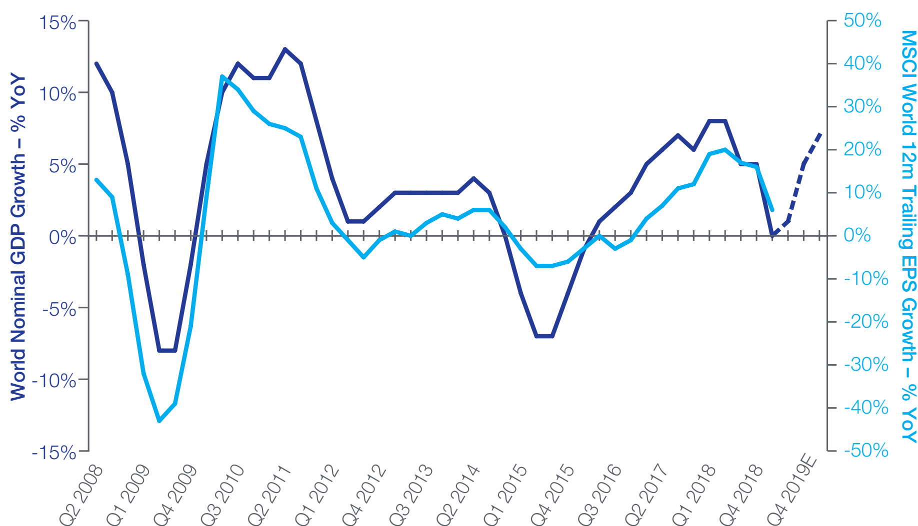
For the time being, inflation remains benign signalling that Central Banks can remain accommodative and bond yields should remain well anchored. As long as this is the case, it remains a constructive backdrop for continued gains in shares, albeit with volatility likely along the way. Markets do not

Figure 3. Industrial economies: Manufacturing PMIs



Source: CBAM, Bloomberg Finance L.P., past performance is not a reliable indicator of future returns.

Figure 4. Nominal GDP Growth versus MSCI World 12m EPS Growth



Source: DataStream.

rise in a straight line and we would not be at all surprised to see some pullback or consolidation from recent gains. However, as long as the global growth and policy framework are improving, and yields remain around current levels, this environment remains supportive for risk assets, such as shares.

Cycle risks remain

Whilst we maintain an optimistic economic outlook, we must be cognisant of the fact that we are likely into the latter phase of the economic cycle. Nevertheless, we believe the probability of an impending recession is still low, and we do not currently see the warning signs that would prompt us to move to an underweight position in equities.

We continue to closely monitor the cycle risks, particularly areas of excess caused by many years of low interest rates around the world. These include rising debt levels globally, with Government and corporate debt levels higher than in 2008 and high yield credit markets, particularly in the US, looking stretched. Leveraged loans are a particular area of concern – the Bank of England estimates that USD2.2 trillion of leveraged loans are outstanding globally, providing a potential risk to financial stability. As long as yields remain low and growth supportive, these risks remain contained, but they are lurking below the surface and remain on our list of risks to watch.

Better growth may, ironically, also pose a risk to asset prices. Stronger than expected growth in the US may cause the Fed to return to a more hawkish stance and resume monetary tightening sooner than the market expects. Higher interest rates may well put equity markets under pressure.

As alluded to, political risks also remain a concern. Brexit remains unresolved, and the outcome is likely to be unclear for several months. Similarly, while relations between the US and China have thawed somewhat, no concrete agreement has yet been reached and we expect trade tensions to continue to be an issue under President Trump.

Positioning

We maintain our modest overweight in risk assets, but are also broadly diversified geographically and across asset classes. We hold those areas of the equity market expected to benefit from a better economic environment, as well as secular growth themes that trade on undemanding valuations relative to expected earnings growth. We like quality companies with strong balance sheets and good cash flows.

In the US, we continue to favour technology shares as corporate expenditure on digitisation of businesses continues apace. All companies have to come to grips with how software, Artificial Intelligence and use of digital technology can improve customer propositions and/or be used to enhance efficiency. We particularly like technology companies exposed to the digitalisation of established and industrial businesses. We also favour global leaders in the financial, healthcare, and consumer discretionary sectors in the US.

In the UK, we remain largely focused on global businesses, with a more limited exposure to the domestic economy, given ongoing Brexit uncertainty. Our positioning could well change if Brexit is resolved as we continue to believe that there is pent up activity and the potential for a 'deal dividend'. In addition, an increase in government spending, as promised by Chancellor Hammond, could be supportive to more domestically orientated companies. Elsewhere, we focus on global companies with good cash flow and business resilience, while we have recently increased our exposure to economies benefiting from an improvement in China and the global economy, be they in Europe or Asia.

Within fixed income, we maintain our short duration exposure, investing in UK government paper and high quality corporate debt, which continues to offer a relatively attractive yield, while also remaining less sensitive to interest rate rises. The shorter length of time to maturity also means that, as bonds redeem, we can recycle cash into more attractive names, potentially with higher yields, depending on the path of rates ahead. With a view to increasing diversification further, we maintain a range of alternative assets, depending on the mandate. This includes exposure to gold, absolute return investments, and infrastructure with dividend yield support, all of which offer further risk diversification.

As multi asset class investors, we like exposure to growth themes counterbalanced with portfolio investments that provide ballast in case of volatile markets. While periods of consolidation remain possible, our base case remains that 2019 will be a positive year for returns – which we believe will be in line with long-term averages – and a year where we can continue to add incrementally to returns through our global research and security selection.

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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