Close Brothers
Asset Management

Investor **Insight**

Quarterly investment view – Autumn 2019

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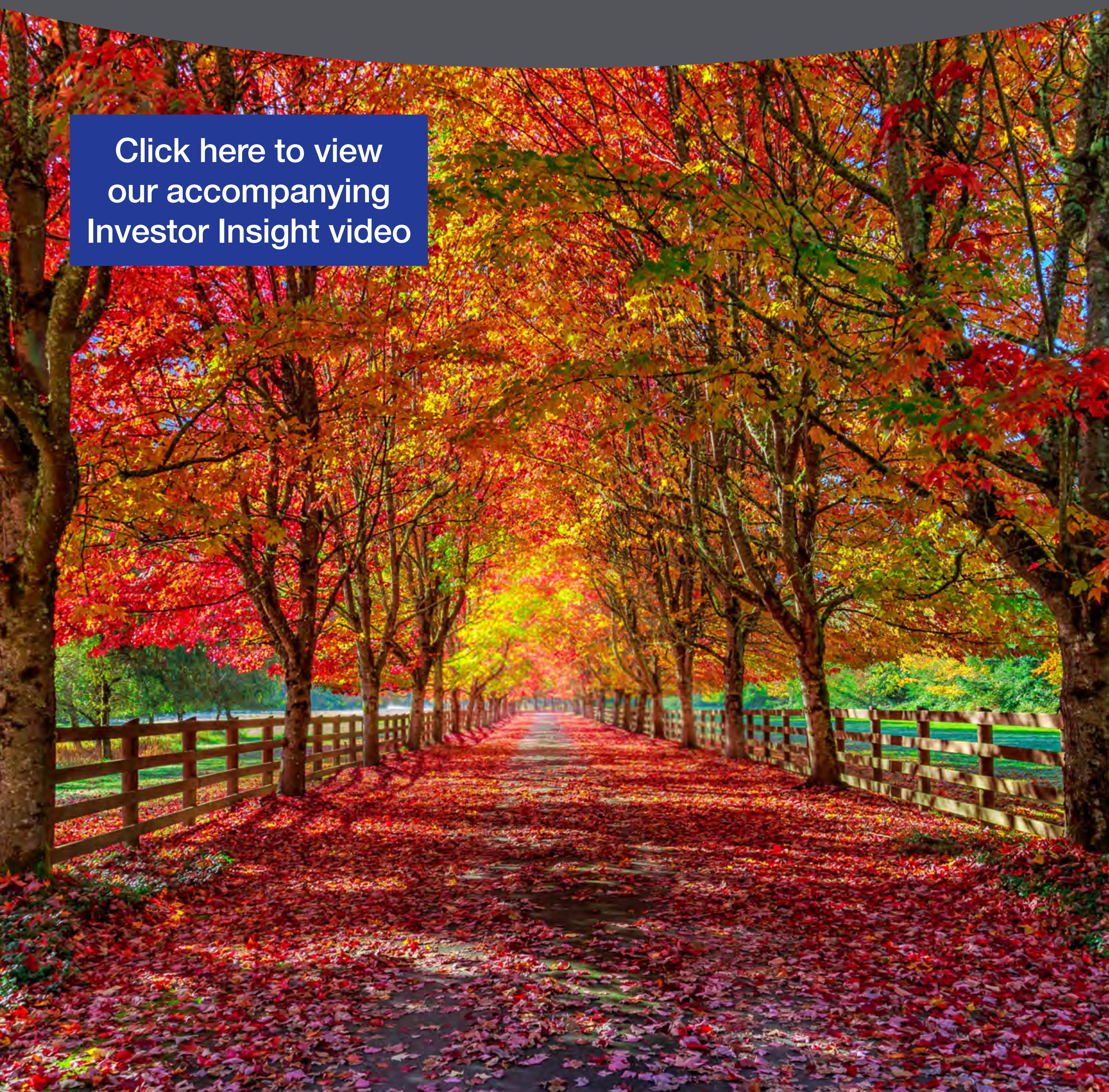


Reflecting on 2019

2019 has been an excellent year for market returns, with most of the asset classes in which we invest being strongly positive. In some respects, this year has over-delivered, making up somewhat for the negative returns of 2018, but also making us more cautious as we look forward to 2020.

This year has also been characterised by volatility: we saw sell-offs in both May and August of around 6%. However, if we compare 2019 with 2018 – when markets experienced corrections of first -8% and then -18% – movements have been far more subdued.

What makes this year so unusual is that both strong returns and relatively subdued volatility have come at a time when economic growth around the world has decelerated, bond yields have declined and investors have been concerned about the rising risk of recession.

What has moved markets higher?

Markets have been buoyed by the hope that politicians, by resolving issues which have hitherto weighed on growth, may reverse or assuage the declining economic trend: trade tensions in the US, Brexit in the UK and rising geopolitical tensions, to name a few. Central banks have also committed to increase liquidity injections to keep growth on track; in the words of US Fed Chairman Jerome Powell, we will continue to pursue actions which 'sustain the expansion'. Hence, a glimmer of clarity around policy and a concurrent improvement in economic and earnings growth ahead have helped to drive markets higher.

Looking forward, we believe that developments in policy uncertainty versus investor expectations will continue to cause both periodic optimism and pessimism, fuelling volatility. There is a risk that these policy woes are not resolved and central bank activity does not halt economic deceleration. However, as we look ahead to 2020, our base case is that economic growth improves somewhat, still providing a constructive environment for risk assets.

In this environment of multiple outcomes and uncertain timing, we think a prudent strategy is warranted. We are neutral in equities, conservatively positioned in bonds and adding to alternatives, which we believe can provide ballast and further diversification. The good news is that we are not alone in our cautious outlook. Investors pulled $60 billion out of shares in the third quarter, the most since 2009. In contrast, inflows into bonds were +$118 billion. High levels of risk aversion can be a positive sign for risk assets.

In the paragraphs below, we elaborate on these themes and our current positioning.

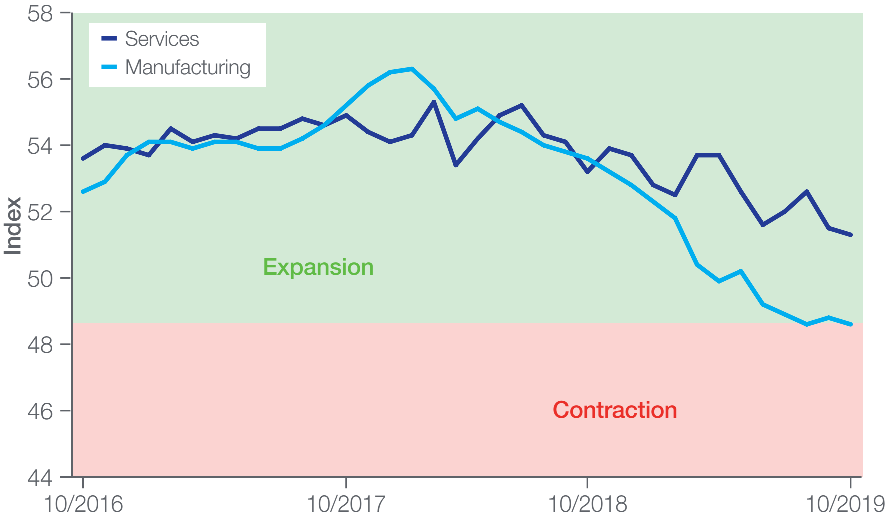
A better year for markets than for growth

While markets have performed well this year, economic growth has disappointed, with unstable geopolitics contributing significantly to this. The Sino-American trade dispute persists, and President Trump is now also taking aim at Europe, while riots in both Hong Kong and Spain highlight civilian dissatisfaction with government attitudes. Attacks on both Saudi and Iranian oil assets have caused oil-price spikes and the UK is set to go to the polls as Brexit negotiations rumble on.

Of these geopolitical risks, it is the China-US trade war that has arguably impacted markets most. The impact was exacerbated by Chinese measures to reform its financial system, which had a negative impact on economic growth. This malaise predominantly afflicted the manufacturing side of the global economy, which is now close to recessionary territory (see Figure 1 on page 3). Weakness in manufacturing globally also tends to be connected to lower trade and business investment. Business investment, key to long-term productivity and non-inflationary growth in global economies, is also stalling in most developed economies of the world. This is not a good long-term sign.

Fortunately, it is the consumer and the services side of the economy that have kept growth from contracting even further, and in some respects, kept recession at bay. While some parts of the services sector have shown weakness, this area of the global economy continues to remain solid, thanks to strong labour markets, unemployment remaining low and decent wage growth. The consumer in the US is particularly important in this regard, as strength here has a knock on effect to other areas of the world.

Figure 1. Global PMI surveys.



Source: Close Brothers Asset Management, Bloomberg Finance L.P. Past performance is not a reliable indicator of future returns.

So far, the US consumer has remained relatively resilient.

Base case is that growth will improve

The IMF defines a global recession as growth slipping below 2.5% a year. Although growth is at its weakest since the financial crisis, expectations are for 3% global growth in 2019, moving slightly higher as we move into 2020.

There are a number of reasons to be optimistic. There are some signs of an improvement in tone of the Sino-American trade negotiations. Recent progress towards a 'Phase One' agreement facilitated the delay of the next round of tariffs, due to be implemented in October, which would have weighed further on growth. While we are sceptical that a full and lasting agreement can be reached, any good news has the potential to boost business confidence, which could, in turn, help investment spending. A resolution of Brexit would likely provide a commensurate boost to business sentiment in the UK and Europe.

Meanwhile, central banks around the world have moved into a more accommodative phase, with further easing expected by the market. Reversing its tightening stance, the US Federal Reserve (Fed) implemented rate cuts in August and September, with the market expecting another in October. The Fed also halted quantitative tightening and instead introduced measures to increase liquidity provision. In Europe, the European Central Bank cut rates to -0.5%, and restarted an open-ended quantitative easing (QE) programme. The People's Bank of China also continues to ease monetary policy, while the Chinese government has increased infrastructure spending and reduced taxes to support growth.

The increase in China's credit impulse (growth in credit relative to the size of the economy), is smaller than in previous China cycles, but appears to be impacting the economy. Chinese survey data bears this out, with the manufacturing PMI measure surfacing above 50 in August (below 50 signals a contracting economy). However, recent data has also pointed to an overall slowdown in GDP growth. We expect further stimulus measures to be taken.

In addition to this stimulus, we see greater hope that governments employ fiscal levers to boost growth. In the UK, both the Conservative and Labour parties are set on increased spending and, with 2020 being a presidential election year in the US, there may be some news on the fiscal front there as well. Both Republicans and Democrats agree on the need for increases in infrastructure investment. In Europe, the next German government may be more open to abandoning 'black zero' (the legal requirement for budget surpluses), making more expansionary fiscal policy possible across the Eurozone. Negative interest rates in Europe give more room to manoeuvre, as interest costs are a part of the structural deficit. Whether this will be acted upon remains to be seen.

If some or all of these measures are implemented and effective, then growth should pick up into 2020 and fears of recession fade. However, prevailing uncertainty will keep investors on edge and likely cause continued bouts of market volatility. We should not expect a smooth ride from here.

The trouble with bonds

2019 has been a very positive year for bond markets, with UK, European and US government bonds all delivering returns of around 10% in local currency terms. However, the dynamics of bond markets now present investors with several challenges.

With bond yields marching lower this year, an ever increasing proportion of the global bond market offers investors a negative yield. Why is this? First, slow economic growth and high geopolitical risk have caused investors to favour safe-haven assets, such as government bonds. Second, central banks are becoming more accommodative, shifting interest rates lower and encouraging investors to anticipate still lower rates. This pushes the prices of bonds up and their yields down. As a result, the value of outstanding negative yielding bonds has more than doubled to $15 trillion in the 12 months to September. This means that the risk and reward characteristics of owning bonds have deteriorated.

A second phenomenon we have witnessed this year is a change in the relationship between bonds and equities. Throughout recent decades, bonds have generally exhibited a negative correlation with equities – when bond prices have been rising equities have generally been falling and vice versa. However, we have seen this relationship breaking down of late, meaning that holding bonds is a less effective way to diversify sources of risk and return within a portfolio. Is this a blip? It is worth noting that if we look at a longer timeframe, prior to the last 25 years, bonds and equities have had a positive relationship, meaning there is a risk that both asset classes could experience a correction at the same time.

A narrow market brings other risks

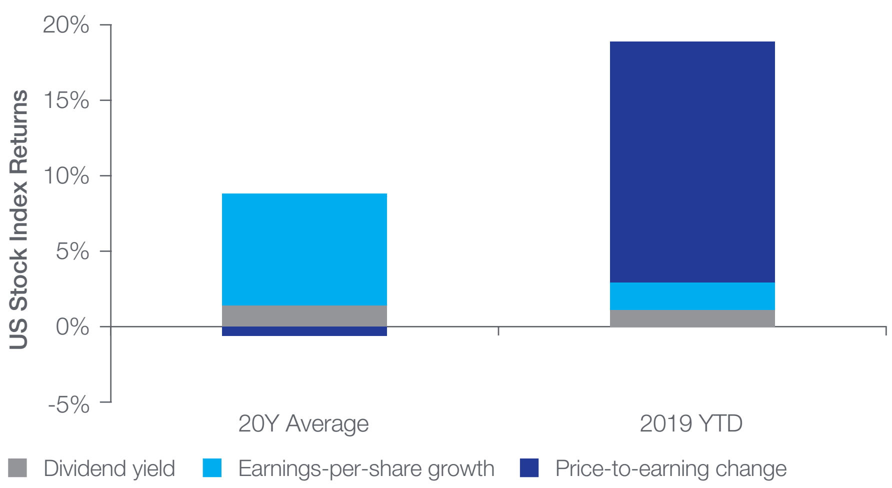
Another feature of 2019 has been the outperformance of shares with strong growth characteristics (high long-term earnings growth forecasts) versus those with value characteristics (less certain growth, with less demanding valuations).

Why is this? We identify two reasons. First, at times when global growth is weaker, investors are more willing to pay a premium for those stocks that have good structural growth characteristics because global growth will not offer a cyclical tailwind to earnings growth across the broader market. Second, at times when interest rates and yields are falling, the discount rates used to value stocks fall also. A lower cost of capital means that the present value of future earnings are worth more today (so stocks with high long-term earnings growth justify higher valuations).

What are the implications of these dynamics? One result is that leadership of markets has been somewhat narrow – investors mostly own sectors and stocks that have these quality-growth characteristics, while stocks with more cyclical exposure are under-owned. Another is that a larger proportion of return than usual has been delivered by multiple expansion – investors pricing the same amount of earnings more highly – rather than growth in retained or distributed earnings (see Figure 2).

This makes these growth stocks more vulnerable if they do not deliver on earnings. It also means there is a risk of a sector rotation if economic growth decidedly improves from here and investors move to own more of the unloved, more cyclical parts of the market.

Figure 2. Components of total return.



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

Where do we go from here?

So what should investors expect in the final months of 2019, and into 2020?

The current economic cycle has endured for a record length of time and, in light of this, it is only natural for investors to question how much longer this cycle can last. Bull markets and expansions do not die of old age, but, rather, when certain conditions are present. Typically, excesses bring on contractionary or recessionary activity.

Are we then headed for a recession or are there signs that economic data is improving? As importantly for investors, what will the impact be on asset markets?

High uncertainty, prudent positioning

Since outcomes remain uncertain, we advocate remaining cautious until we see real evidence that policy uncertainty has cleared and that economic data is, as a result, improving. Any improvement in manufacturing, trade and business investment would be signs that growth is coming and that the expansion has further to run. However, in this scenario, we are also mindful that any improvement in economic growth could cause bond yields to move higher and this would not be favourable for long-duration bond positioning. Bonds with longer maturities and lower coupons are most sensitive to such moves.

Conversely, if trade tensions linger and manufacturing weakness begins to take a toll on the services side of the economy, the risk of a recession could rise from here. Central banks will do whatever it takes to prevent this from happening, but we must be cognisant that global weakness can have self-reinforcing negative effects. Could it be that monetary policy becomes less effective at the low levels of interest rates that we have today?

Given this uncertainty, we like a barbell approach; remaining exposed to areas of the market which might benefit from a recovery or improvement in growth, while counterbalancing that exposure with assets that will perform well in more turbulent or weak markets from here. This has different implications for asset classes.

In equities, this means that we will remain close to neutral, more cautiously positioned than we were earlier this year, but still keeping us in a position to benefit from rallies and upside surprises on policy and growth. Within equities, we still favour high-quality US growth companies, which have performed extremely well, but also maintain an exposure to Europe and emerging markets, areas which would do better if trade tensions are resolved and manufacturing growth improves. We remain cautious on the UK, as Brexit and its resolution are still unclear. Having said that, it is possible we may be edging closer to the end game, and thus we have added to domestic exposure in the UK, which should benefit from any reduction in uncertainty and possible fiscal support to the UK economy.

Within bonds, we remain underweight and continue to favour short-duration, investment grade corporate bonds, where we can still find attractive yields with less interest rate risk than long-term government debt. This conservative positioning means that we have the flexibility to respond to interest rate changes as the growth and economic picture become clearer in the months and quarters ahead.

Finally, we have added to alternatives and invested in a range of strategies (mandate dependant) which we think may offer a diversified source of return and risk, where exposure can act as ballast to the portfolio in times of heightened volatility. There are three buckets which we currently favour for our alternatives exposure:

1. Within commodities we currently like precious metals, which can act as a hedge against political and geopolitical risk;
2. Absolute return strategies which have little or no correlation to equities and thus can offer a solid return with low levels of volatility;
3. Asset-backed instruments and funds which aim to deliver a solid income of circa 4%-5%, and can often be inflation protected, by investing in physical assets.

We think these assets can continue to offer diversifying benefits to clients' portfolios at a time when there is both perceivable downside risk and upside potential for both bond and equity markets from here.

Conclusion

Investors have benefited from the strong performance in all asset classes during 2019. We still believe that risk assets remain attractive and that equities should outperform bonds; indeed, valuations of equities remain attractive relative to bonds as measured by risk premia globally. High levels of risk aversion are also a positive. But, we also recognise that policy and economic risks could worsen.

Hence, as multi-asset investors, we take a barbell approach. We like exposure to growth themes counterbalanced with portfolio investments that provide resilience and ballast. Our base case remains that 2019 will remain a positive year for returns – likely even greater than long-term averages – and one where we can continue to add value through our global research and quality 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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