Market Review as at 31 December 2019

Market Review – The final quarter of 2019 has been a very good period for all investors, with markets experiencing a more traditional 'Santa Rally' as thoughts turned to the outlook for 2020, with a stable UK government and a stage one trade deal between China and the United States.

The FTSE All-World index rose by 8.6% in Q4. The Dow Jones index rose by 6.0%. The FTSE-100 index rose by 1.8% and the (domestically-oriented) FTSE-250 index rose by 9.8%. The Real Estate sector rose by 11.2%, whilst the British Government Stocks index fell by -4.4%, with cash deposits returning 0.2%.

We are delighted to report that our investment strategy significantly outperformed against benchmark for the quarter and for 2019 as a whole. In addition, we remain considerably ahead of benchmark post the June 2016 'Brexit vote' and our use of cash as a tactical allocation has given us the flexibility to take advantage of market movements, to purchase new investments at attractive entry prices.

October – Financial markets welcomed signs of an easing in geopolitical tensions in October, with risk assets generally outperforming traditional safe havens. The US and Chinese authorities moved closer to agreeing a partial deal on trade, while the UK once again edged back from the precipice of a no-deal Brexit. Global central banks reiterated their dovish stances and the US Federal Reserve cut interest rates for the third time this year.

In the UK, to the surprise of markets, Prime Minister Boris Johnson was able to agree a new Brexit deal with the European Union (EU). This was made possible after Johnson agreed to put a customs border in the Irish Sea and for Northern Ireland to remain more closely tied to the EU than Great Britain, thus avoiding the need for a hard border on the island of Ireland. The new deal gained more support in the House of Commons; however, members of parliament refused to approve rushing through the legislation process in order to leave the EU on the 31 October deadline. This meant an extension to the departure deadline was agreed to 31 January 2020. A general election would now be held on 12 December, as the prime minister sought a new parliamentary majority to pass his deal.

On the data side of things, the UK labour market showed signs of weakening – employment in August fell by -56k, with the unemployment rate rising 0.1 percentage point to 3.9% and the number of vacancies continued the steady fall that began in early 2019. Retail sales excluding fuel rose 0.2% over the previous month in September, and consumer confidence fell -2 points to -14 for October. Inflation for September remained at 1.7% y/y. The outlook for the Bank of England remained highly Brexit dependent. If uncertainty for businesses and households be prolonged, a rate cut would be on the cards.

In the US, the US-China trade war pendulum, which had been swinging between escalating tensions and a more constructive outlook, swung back in favour of the latter, with the announcement of what President Trump called a "Phase One Trade Deal". The deal involved China committing to significantly increase purchases of US agricultural products, accelerate the opening up of its financial sector, and more transparency regarding the currency markets.

While financial markets welcomed the announcement of a potential trade agreement, data out of the US continued to suggest that the US economy was losing momentum. The weakness remained most pronounced in the more trade-dependent manufacturing sector, with the Institute for Supply Management's manufacturing purchasing managers' index (PMI) indicating that the manufacturing side of the economy was contracting. The more concerning development was, however, that the manufacturing weakness seemed to be gradually seeping into the broader economy, with cracks appearing in the US consumer.

Consumer confidence fell -0.4 points to 125.9 in October, while the pace of job growth also slowed—on average, 160k jobs have been added each month this year, compared to 220k per month in 2018. Real GDP growth for the third quarter was more positive, showing that the US economy hadn't slowed as much as had previously been expected and grew at an annualised pace of 1.9%.

However, slowing economic momentum led the Federal Reserve to cut interest rates by 25 basis points (bps) for a third time this year, which should help lending conditions in the economy to remain supportive. The key question was then whether easier monetary policy will be able to support the consumer and labour market from deteriorating in the same way that manufacturing already had.

The US earnings season for the third quarter of the year was well underway, with companies doing better than expected. Earnings per share and sales were growing at 1% and 4% year on year (y/y) respectively on the S&P-500. However, US companies continued to give lower guidance for next year's earnings, with the trade dispute an ongoing theme.

In Europe, the US-China trade war continued to weigh most heavily in the eurozone, particularly in Germany, due to the region's larger dependence on international trade compared to its international counterparts. The economy looked fragile—flash PMIs for October remained at 45.7 in manufacturing and rose slightly for services to 51.2, to give an only slightly expansionary composite reading of 50.2.

The labour market and consumer were also feeling the effects of the slowdown. The employment component of the composite PMI showed that employment was increasing at the slowest pace since December 2014. Consumer confidence also fell to -7.6 in October, the lowest reading since December last year.

October's European Central Bank (ECB) meeting marked Mario Draghi's final press conference as president. Christine Lagarde, former head of the International Monetary Fund, then took the reins. Lagarde inherited an ECB tool kit that is nearing its limits, with interest rates at -0.5% and quantitative easing of EUR 20 billion per month in place until the inflation target is close to being achieved. With a seemingly depleted monetary toolkit, the challenge will be whether or not Lagarde can convince governments to loosen the fiscal purse strings to stimulate the economy.

In China, the annual pace of real GDP growth eased to 6.0% for the third quarter, down from 6.2% in the previous quarter. Weaker growth was slowing Chinese demand for external goods, with imports falling -8.5% y/y in September. Industrial production and retail sales data for September were more positive, rising to 5.8% and 7.8% y/y, respectively. After last month's 50 bps cut in the reserve requirement ratio, the People's Bank of China implemented a second 50 bps cut, with a third likely to follow, collectively releasing CNY 900 billion (approximately 1% of GDP) into the banking system. Credit data for September revealed a significant pickup in total social financing and new bank loans.

November – Equities continued to rally in November – a relatively consistent feature of markets in 2019, despite the multitude of geopolitical risks that investors have faced this year. Negotiations between the US and China on a 'phase one' trade deal were yet to arrive at a conclusion, but there had at least been an absence of any further escalation in tariffs. Tariffs are scheduled to increase on 15 December, unless a deal is reached or the deadline is pushed back. However, hopes of a deal buoyed sentiment. In the UK, the spotlight had shifted to the upcoming general election on 12 December. So, politics was front and centre of investors' minds as the year drew to a close.

With central bank easing a key factor in market returns this year, investors didn't get much new information from the major central banks (US, UK, eurozone, Japan) in November. Only the Bank of England (BoE) held a meeting, and it made no change to its policy rate. Developed market equities outperformed emerging market equities, with the S&P-500 ending the month as the best performing major equity index. Bond yields moved marginally higher and so the global government and investment grade bond index (Global Agg.) lost -0.8% over the month.

In the UK, the BoE left policy rates unchanged at its November meeting, though there were two dissenters calling for higher interest rates, largely due to the strength of the labour market in the UK. However, data in November suggested there were some signs of weakness, with Q3 GDP growth and wage growth coming in below consensus expectations. The challenge for the BoE is that they cannot yet be sure of the outcome of Brexit, although the election may provide greater clarity.

The UK political parties had been campaigning throughout November. The main three parties all wanted to deliver fiscal stimulus, with public finances having improved and borrowing costs at low levels. On Brexit, the Conservative party were trying to capture the leave vote, while the Liberal Democrats were firmly campaigning to remain in the EU. The Labour Party were looking to negotiate their own softer deal to leave the EU and put that back to the public in a referendum, with remain as the other option on the ballot. Sterling strengthened versus the Euro by over 1% and stayed broadly flat versus the dollar.

In the US, there had been tentative signs of improvement in business sentiment. The November US purchasing managers' index (PMI) pointed to a pickup in activity across both manufacturing and services. In particular, an increase in the employment components of both surveys offered some encouragement that companies might not cut jobs despite the pressure on profits. Optimism around a trade deal, combined with improving activity, filtered through to positive equity market returns in the US. The S&P-500 rose by 3.6% in total return terms, pushing its year-to-date return to over 25% and putting it on course for its best calendar year performance since 2013.

The earnings season came to a close, with S&P-500 companies reporting broadly flat earnings relative to the third quarter of last year. As in previous quarters this year, the materials and energy sectors delivered the weakest numbers, with meaningful contractions in earnings. Overall, around 80% of companies beat earnings estimates for the quarter – albeit estimates that had been lowered throughout the year.

The latest estimate of third-quarter US GDP rose, so the pace of growth actually picked up slightly, despite expectations for a continued slowdown. The resiliency in growth might have been attributed to easing from the Federal Reserve (Fed). Housing data improved markedly, with new housing permits reaching their highest level since 2007, while mortgage delinquency rates reached their lowest level since 1995. Despite the Fed's interest rate cuts, consumer confidence was weaker than expected. In comments to Congress, Fed chair Jerome Powell said that "the current stance of monetary policy is likely to remain appropriate". Consequently, the market now expected only one more interest rate cut from the Fed in 2020. Both two-year and 10-year government bond yields moved marginally higher over the month and so US Treasuries lost -0.3% in November.

In Europe, activity was mostly better than in previous months, with the perceived easing in trade tensions perhaps playing a role. The eurozone consumer confidence reading improved, while the November flash PMI business surveys rebounded. In particular, there was better news across the manufacturing sector, as all of the major components of the eurozone manufacturing PMI rose compared to the previous month's level. The improvement in the German manufacturing PMI from a low level was encouraging, while the third-quarter GDP reading confirmed that Germany narrowly avoided a technical recession. Although some rebound in manufacturing surveys appeared to be underway, overall business sentiment was still somewhat mixed. The service sector was still moderating, evidenced by the slowdown in the eurozone services survey and its employment component. Overall, though, markets focused on the improvement in the manufacturing data and Europe ex-UK equities gained a healthy 2.5% over the month.

The European Central Bank (ECB) welcomed its new president, Christine Lagarde. Lagarde would have to wait till 12 December for her first policy meeting, but had already made a few official speeches. She had however avoided any firm statements on monetary policy, and instead had centred her comments on big-picture challenges to the global economy and what governments can do to boost the effectiveness of monetary policy. Bond yields broadly rose slightly across Europe, leading the euro government bond index to fall -0.9%.

In China, the authorities were concerned by weak manufacturing and consumer data. Industrial production and retail sales both disappointed relative to expectations. Industrial production grew by 4.7% year on year compared to the previous month's reading of 5.8%, while retail sales grew 7.2% year on year, compared with a pace closer to 8.5% in the first half of 2019.

Ongoing protests in Hong Kong continued to hinder the region's economy, along with the slowdown in Chinese growth and the ongoing trade uncertainty. More concerning for global investors was if the situation in Hong Kong disrupts the US-China trade negotiations. Emerging market equities ended the month down -0.1%, underperforming developed market indices.

December – Last Christmas, the markets gave investors a fright. This year, to save us from tears, the central banks gave us something special. Equity markets delivered fantastic returns in 2019. The FTSE All-World Index was up 24%, led by US equities (+22%), with UK FTSE-100 equities (+12%) and UK FTSE-250 equities (+25%) in hot pursuit. Despite this roaring return from equities, government & corporate bonds also delivered good returns.

From the beginning of the year to September, government bonds reacted as one would expect to weaker economic data, with bond yields broadly tracking the manufacturing surveys lower. The surprise was not the strong performance of government bonds but the strong rebound in equities against this backdrop of deteriorating data.

After the sharp falls in equities during the fourth quarter of 2018, the first four months of 2019 brought a strong rebound, as central banks signalled that rather than raise interest rates, they would provide yet more stimulus to try to keep the economic expansion intact. Equities clearly believed the central banks would succeed.

Then, from the end of April to the end of September, global equities broadly traded sideways with some bumps in the road, as investors digested the ebbs and flows in the trade negotiations between the US and China, and the continued deterioration in macroeconomic indicators.

Remarkably, by the end of September, the 20+ year Treasury index was up 20%, while the MSCI World was up 18%. The flood of central bank liquidity had lifted all boats. Such strong returns for both traditional risk-off and risk-on assets, at the same time, is unusual. By the time October began, both the bulls and the bears had been very well fed.

However, the fourth quarter has decided the year in favour of the bulls. Global equities rose nearly 9% in the last three months of the year, while developed market government bonds gave up some of their gains.

Several factors helped drive equities and bond yields higher in the final quarter. First of all, the US and eurozone manufacturing business surveys picked up slightly from September, although they remain weak. Second, the service sector business surveys in the US and Europe also picked up. Most importantly, despite headlines involving large job cuts at some companies in Europe, overall employment has held up well, and in the US over 200,000 jobs were added in November. The pick-up in the service sectors, and the resilience of overall employment to the weakness in manufacturing, has helped restore market confidence that a recession is not imminent.

The fourth quarter also saw two significant political risks avoided, at least for now. US tariffs on China were scheduled to increase on 15 December but a phase one trade deal avoided that outcome and provided a significant relief for equity markets. The fact that the US also didn't impose tariffs on European Union auto exports also helped support equities. How long the trade peace will last is anyone's guess but the market ended the quarter cheered by the fact the worst-case scenario for trade had, at least for now, been avoided.

The large majority for the Conservative Party in the UK election in December removed the threat of nationalisation for some utility companies. The utility sector in the UK rallied 6% following the election result. In addition, the election meant that the UK could pass a European Union withdrawal bill, activating a transition period during which little will change, until the end of 2020. The combination of these election implications helped lift

UK stocks and sterling over the quarter. However, sterling's initial rally after the election result soon faded when it was announced that it would be made law that there would be no extension to the transition period beyond the end of 2020, giving the UK government a very short period of time to agree a free trade deal that avoids a hard Brexit.

The fourth quarter was also notable for personnel changes at key central banks with Christine Lagarde taking over from Mario Draghi at the European Central Bank (ECB) and Andrew Bailey being announced as Mark Carney's successor at the Bank of England. In terms of policy action, both the Federal Reserve and the ECB started to expand their balance sheets again and the Fed cut interest rates for the third time this year.

So, it's been a great year to be invested, almost irrespective of what you were invested in. Next year is unlikely to be so indiscriminate and such high returns are likely to be harder to come by. If the global economy reaccelerates, equities should rise, although higher starting valuations might limit the extent of the upside. In this scenario, government bond yields should also move higher, rather than fall as they did in 2019.

However, if growth continues to slow and profit pressures cause companies to cut jobs, then 2020 could be another good year for government & corporate bonds, and a more challenging year for equities and credit. Either way, with the Brexit trade negotiations and the US election to contend with, 2020 certainly won't be a quiet one, with plenty of uncertainty likely to linger.

Investment Strategy – While 2019 shows that uncertainty doesn't have to be the enemy of investors, to navigate this prolonged political uncertainty amid a late cycle economic backdrop will be no easy task. As we start the year, we continue to think a broadly neutral, balanced portfolio of UK & International - equities, corporate bonds and defensive alternatives - still makes sense until both the economic and political outlook is clearer.

Globally we remain overweight to the US and Japan. Technology disruption remains our favoured long-term theme, across multiple sectors, but we have reduced our healthcare exposure. We continue to look to increase holdings in Asia and Emerging Markets which appear nicely positioned as the dollar 'rolls over'.

Our diversified bond strategy continues to work well and our allocation to alternative assets continues to grow, with the addition of a closed-ended supermarket income fund and a second student accommodation fund. Tactical cash holdings are now @6% and we continue to be patient for stocks and funds to meet our target entry prices, to ensure that we obtain the best risk / reward metrics.

Best wishes for a healthy and prosperous 2020.

Sources – J P Morgan, The Financial Times, Ionic Information, Reuters

Balkerne Asset Management
1 Balkerne Hill, Colchester, Essex CO3 3FG
Freephone 0808 200 0808