

Market Review as at 31 December 2018

Market Review . The final quarter of 2018 was very disappointing for all investors, with almost all asset classes showing negative returns, thanks to continued fears of slowing economic growth as a result of increasing US interest rates, US president Trump's trade tariffs on China, the Italian budget deficit, the yellow-vests protests in France and the continuing Brexit debacle inter alia.

The FTSE All-World index fell **-13.0%** in Q4. The Dow Jones index fell by **-11.8%**. The FTSE-100 index fell by **-10.4%** and the (domestically-oriented) FTSE-250 index fell by **-13.8%**. The Real Estate sector fell by **-9.8%**, whilst the UK Government Bonds index rose by 1.3%, with cash deposits returning 0.1%.

During the quarter we raised portfolio cash weightings significantly in order to protect capital values, but due to the high level of price volatility, especially in the final three weeks of the year, our investment strategy underperformed against benchmark for the quarter. More positively, we remain considerably ahead of benchmark post the June 2016 Brexit vote and our high cash allocation gives us flexibility to take advantage of possible market movements as we move into 2019 and the key 29 March Brexit deadline.

October . Markets wobbled and volatility returned despite robust economic numbers. Q3 earnings generally held up well; unemployment continued to fall, especially in the US, where it almost reached a 50-year low @ 3.7%. Higher employment bolstered consumer confidence, which stayed close to record highs. Nevertheless, the S&P-500 gyrated more than 1% almost every other day, finishing the month off **-6.8%** practically wiping out the year's gains. The Global Aggregate Bond Index was also down by **-1.1%**. CPI inflation dropped to 2.3%, yet the US 10-year Treasury yield tipped above 3.2% implying growth prospects remain strong. Emerging markets were adversely influenced by US rates (because of \$-denominated debt), while Asian markets dropped by more than **-7%** average on US-China trade war concerns. Europe was also in the firing line, with the new export orders component of the Purchasing Managers Index (PMI) falling heavily year-to-date, showing how much Germany in particular is nowadays reliant on exports to China. The Italian government presented a provocative budget to the European Commission, proposing a deficit of 2.4% of GDP. Moody's downgraded Italy's sovereign debt (though not below investment grade). Italian bonds dropped **-1.4%** while increased demand for safer euro-denominated debt saw German bunds up 0.6%. In the UK, wage growth was up 3.1%, the highest figure since the financial crisis. Imported inflation fell but domestic inflation firmed, supporting consumer spending, but there was no net progress on Brexit, the main influence currently on both the FTSE-100 and Sterling.

November . Geopolitics weighed during the month, and markets did not recover October's losses. The Organisation for Economic Co-operation and Development (OECD) revised down its 2019 global growth forecasts from 3.7% to 3.5% annual, citing risks from trade tensions. The oil price fell sharply from \$76 in October to \$51 bbl. This was

prompted by the lowered outlook for global demand but also production increases in the US and Saudi Arabia, plus exemptions on Iran sanctions. In the US, core inflation fell to 2.1% and the Federal Reserve left rates unchanged. In the mid-term elections, the Republicans lost the House of Representatives to the Democrats, as (tentatively) expected, but strengthened their hold on the Senate. This could potentially mitigate against any Trump campaign plans for stimulating the economy in the run-up to the 2020 Presidential elections. Meanwhile President Trump ramped up the trade war rhetoric, undermining confidence in global growth prospects and fuelling concerns about tariff-induced price rises holding back the domestic economy. China declared another set of fiscal stimuli to be deployed in 2019, but the G20 encounter between President Xi and President Trump appeared to demonstrate a reluctance to escalate. In Japan, Q3 GDP contracted by **-0.3%**, following typhoons and an earthquake. Emerging market equities seemed to hold up, but are down **-7%** year to date. In Brazil, the appointment of President Bolsonaro was viewed as helpful to markets but instability in Mexico saw its economic outlook downgraded by credit agency Fitch. In Europe, GDP annual growth of 1.7% disappointed and consumer confidence declined. 1.0% core inflation remains too low. The EU Commission rejected the Italian budget, threatening an excessive deficit procedure and the spread between Italian and German 10-year government bond yields fell back below 300 bps. In the UK, a Withdrawal Agreement was agreed between the UK and the other 27 members. Unfortunately, the Irish backstop arrangement topped a long list of conditions which many UK MPs found unacceptable. Sterling fell **-0.7%** over the month; unemployment ticked up to 4.1%, consumer price index (CPI) inflation stabilised at 2.4% (core inflation was 1.9%).

December . Volatility rose once more during the last month of the year as politics continued to bear down on sentiment. The US Federal Reserve raised rates again in defiance of President Trump's complaints, and continued winding down the balance sheet. With the Christmas Eve rout, the S&P-500 was down **-19.8%** from the September 20 high, the worst fall since the recovery from the global financial crisis (GFC) which began in March 2009. The Russell-2000 index of small-cap stocks, the Nasdaq composite index, and emerging markets index fell more than **-20%** to qualify as bear markets. Markets that have been fuelled for a decade by cheap money remain nervous about liquidity. The \$1.2 trillion US high-yield credit market all but dried up in December. This late cycle behaviour happened last in 2008. US tariffs began to bite in China, with manufacturing PMI confirming weaker domestic demand and job creation figures also down. The Chinese government cut taxes to support the private sector and increased infrastructure funding, while the central bank said it would lower the required reserve ratio for commercial banks by 1% in the New Year. Developed markets outside the US, on average, fell **-17%**. On Christmas Day, the Japanese Nikkei 225 was down **-20%** from the 27-year high reached on 2 October, but fortunately recovered partially to avoid finishing the year in a technical bear market. Meanwhile in Europe, the Italian government fudged a deal with the EU, avoiding for now any fine by the Commission, agreeing to delay their minimum basic income programme and accepting a clause to increase VAT if revenues fall short in 2020/21. In Paris the Gilets Jaunes continued their protests despite Emmanuel Macron caving in to demands to suspend the proposed eco tax on fuel. The French budgeted "10 bn to pay for this, meaning they will breach the EU's 3% deficit limit next year. The EU said they would permit this as a one-off. In Germany, Annegret Kramp-Karrenbauer was elected as the new leader of the ruling Christian Democrat Union party, and is apparently set to become the next Chancellor in 2021. In UK, Theresa May ran into big trouble over her Withdrawal Agreement and was forced to delay the meaningful vote until after the Christmas recess.

Q4 Summary . Markets experienced a major reset during the last quarter of 2018. This was for a variety of reasons: the US tariff increases leading to weaker growth in China; the Federal Reserve's monetary tightening - exacerbated by Donald Trump arguing against it - and as the year drew to a close, the US government shutdown. Highly-priced global technology started the sell-off in October, and other cyclical sectors e.g. financial services and consumer goods also fell over the quarter. In the UK, industrial stocks performed worst, the sector falling **-17%**. No regional equity market had a positive return. Japan fell most in sterling terms, sliding **-12.9 %** over the period. No particular investment style did well: value held up best, losing only **-8.6 %** (cf growth **-12.6 %**). Gilts rose on the risk-off flow out of equities, and were up 1.3% over the quarter. Sterling High Yield, however, produced an average loss of **-4%** reflecting its high correlation to equities. Yet global economic data overall remains broadly positive, so what we have seen may best be described as a normal market correction.

2018/19 Outlook . The world's longest bull market may be technically at an end, but it is not yet over. Markets abhor uncertainty, and that is what we have wherever we look presently. The consensus view however is that recession will not occur before 2020/21 after the next US presidential elections. The business cycle is most advanced in America but the economy is still growing nicely. It is hard not to suppose that President Trump will do all in his power to ensure markets make progress in the run-up to the next elections in 2020. Fed Chair Jerome Powell has re-affirmed there is no pre-set path for monetary policy and suggested he had no concerns regarding inflation at this time. He also said we will be prepared to adjust policy quickly and flexibly and use all of our tools to support the economy should that be appropriate to keep the expansion on track. Interest-rate futures have thus moved from discounting 2-3 rate hikes during 2019 a little over two months ago to expecting none at all - there is even talk of a rate cut. There is also speculation surrounding the Fed's balance sheet unwinding, which shows us just how far market sentiment has moved. Powell's comments suggest to us a pause in rate hikes has a high probability. However, the current government shutdown may hinder the issuance of economic data and policy error cannot be ruled out.

The US/China trade dispute remains the largest concern globally and it seems unlikely this will be resolved soon. It plays well for President Trump and it would not do for President Xi to seem too compliant, so the situation could get worse before it gets better, and that risk is now being factored into the outlook. Unless relations deteriorate very badly, however, there is a good chance some sectors will recover ground in the first half of 2019, and perhaps do even better as the year unfolds. In China there has been some policy loosening which may bode better times for some (e.g. raw materials suppliers).

There are risks in Europe: for Germany if China continues to slow, but concern over the Italian budget has been kicked down the road. As to the UK and Brexit, this is a minor issue in global terms, but here at home the effects of panic are real enough. Mrs May has likened herself to Geoffrey Boycott, conjuring images of dogged defence of a bad position. Sterling volatility seems inevitable, but what Mrs May does not want is to be held responsible for a collapse (i.e. no-deal). That is still the default outcome however. Minor concessions from the EU may save her Withdrawal Agreement, but delaying Article 50 also remains a possibility. With the support of the DUP the Prime Minister should be able to defend a motion of no confidence. A second referendum is an outside chance. At this point it is anybody's guess. Companies and markets - including ourselves - are holding back.

Investment Strategy – With the prospect of slower global growth and higher volatility we are continuing to reduce risk and build resilience into portfolios. As a Brexit resolution of some kind looms, we continue to lower our allocation to UK equities, raising cash to take advantage of the opportunities which will arise, in the weeks to come, to buy good quality companies, with resilient profits and dividends, at sensible prices.

It is possible that interest rate rises will occur in the US, Europe and in the UK (Brexit outcome allowing), over the next few quarters and we retain a distinct preference for equities over fixed-interest/bonds. However, we do see some value in inflation-linked, floating-rate and short dated corporate bonds.

Geographically, we still favour US and Japanese equities and are now looking seriously at Emerging Markets to increase diversification, as the US Dollar begins to soften. We are being selective in Asia and remain cautious on Europe, despite the apparent value on offer. We retain our overweight to disruptive technologies, financials, pharmaceuticals and global smaller companies.

In the alternative arena we are increasing allocations to infrastructure and alternative energies covering off inflation and liquidity issues with global diversification.

We continue to hold minimal exposure to commercial property and are fully aware of the terrible high street retail situation and its likely negative effect on traditional bricks & mortar property funds.

Looking forward, valuations are now cheaper and complacency lower, as enthusiasm for risk assets has chilled. Prices have reset, recession risk remains contained, outflows are slowing, as cash builds and macro-prudent policy remains a focus of global policy setters.

Growth in the US remains robust, the Fed is data driven and the path of US interest rates is now flexible. Japan continues with Abenomics and looks good value for a late-cycle equity play. As the US Dollar softens, Emerging Markets start to recover and with China likely to stimulate its economy to fight off the Trump Tariff drag, we are now finding value.

In the UK the continuing Brexit debacle overhangs UK equities and increases volatility, especially in domestic-orientated stocks, however, weak sterling is good for many UK companies who export or derive sales overseas and again we are finding good value.

Corporate balance sheets remain robust, earnings and dividends are growing and valuations are more attractive than they have been for some time. As negative news flow dissipates, we expect share prices to move forward again.

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