# QUARTERLY MARKET OVERVIEW – JANUARY 2019

*"Double, double, toil and trouble; fire burn and cauldron bubble"*

The expression "from hero to zero" springs to mind as I write this.

At the start of 2018, the US Government was in shutdown unable to agree the budget, globally there were concerns over China, Trump, Brexit, trade wars, debt and a global recession. Although some felt 2018 would repeat 2017, we didn't believe the momentum would continue. We thought 2018 would be more volatile and at times uncomfortable.

After a momentous Santa rally, it seemed our concerns were overdone as the markets raced ahead in January. However, in February things started to turn with the first of two corrections of around 10%; the second being in October.

As we start a New Year it is worth reflecting that December 2018 was the worst for performance for the MSCI World index since records began in 1970. The next biggest December decline was in 2002. 2018 was only the third year since 1900 where equities and bonds underperformed cash. The two previous occasions were in 1931 towards the start of the great depression and in 1969 at the start of the Vietnam War and the last time there was a big fiscal stimulus during a period of expansion.

So, stepping into 2019 you can understand our nervousness about trying to anticipate how the next twelve months will go. 2019 has started with the US Government in shutdown and global concerns over China, US, Brexit, trade wars, and a global recession, so these are all the same concerns that 2018 started with.

This might feel like a scene from Shakespeare but there are perhaps reasons to be optimistic. As we highlighted in the annual review many markets have dropped below their long-term averages creating opportunity. It is also worth highlighting that often after a year of big falls markets correct the following year.

Many of the fears that started in 2018 are still there but sentiment has changed, and this is what has driven the markets down. The markets now seem to be pricing a worse case scenario across everything and even a slight positive shift will be potentially good news.

If we look at the concerns most of them can be fixed. China and the US can agree some type of trade deal. But it is complex as it is not just about tariffs but also intellectual property and a fight over who will be the next global tech powerhouse. We shouldn't underestimate the complexities of getting an agreement in place which may need China to back down. The reality is that there will be some compromise which de-escalates the situation, and / or the issues are pushed back until after the next election.

In China, they have already taken steps to respond to a slowing economy by putting the brakes on economic tightening which has seen the reserve rate cut and more spent on infrastructure. In the US the Fed looks set to pause interest rate rises and in the UK although by no means certain, we think when faced with a no-deal Brexit and the potential for an election and / or second referendum it will squeeze through at the last minute.

One manager was asked what would really shock the markets and his three worries were:

1. Eurozone Crisis 2 – by this he meant another Greek style crisis
2. Military action – we have already seen tensions building between China and Taiwan, but there are also concerns with Saudi Arabia and Iran and what happens if tensions grow with North Korea
3. No deal – although globally many do not care about Brexit, the impact of a no deal has the potential to create a contagion effect. Europe could suffer negatively alongside the UK and this could filter out across the world

We should be aware that another event like a Eurozone Crisis 2 or military action is not priced in and this could change things. On paper, markets are below their average; most if not all the worries can be fixed (or pushed back) and although we are mindful of concerns over the Eurozone, military action and a no deal Brexit, we don't see these pulling down markets at this stage.

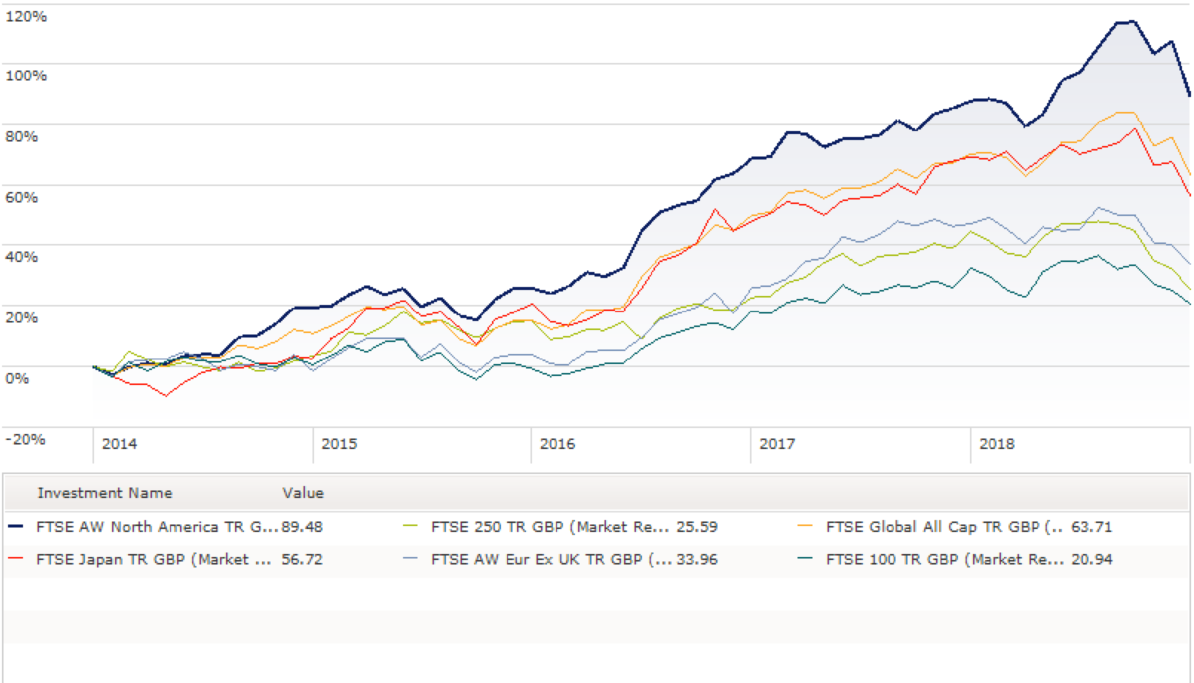
So, hold on tight as it will be volatile, there will be twists and turns but if history repeats, we could see positive numbers in 2019. As with every look into the future there are always things around the corner which can change things very quickly. Ultimately, with investing it is about the long-term goals and there will always be periods like this.

*George Ladds*

George Ladds, Director, January 2019

# DEVELOPED MARKETS

Five year returns 1 January 2014 – 31 December 2018

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Although the US economy powered ahead in 2018 investors didn't see any benefit from this. The pull back across the markets in February, October and December saw high valuations shift to more normalised levels and below their long-term averages.

We believed that Trump would get a deal with China before the mid-term elections using this to help secure victory across both houses. The success of the deal with Canada and Mexico obviously made Trump feel untouchable, but China thus far has been a harder nut to crack. We have sympathy with tough action against China which we will touch on further in this update, but they are not going to be an easy target.

The only "victory" Trump can claim was a delay in the trade war at the G20 Summit, all eyes will be on what happens on 1 March. Getting a full deal is complicated as it covers tariffs, intellectual property rights as well who be the next global tech powerhouse. A deal is more likely to be some form of de-escalation of tensions and pushing out any agreement perhaps beyond the next election. A full agreement would need China to back down and this is unlikely to happen.

There are cracks showing with Teflon Trump. The mid-terms saw the house fall to the Democrats, although the Republicans held on to the senate. The period of unified rule for Trump is over.

Shutdowns are not unusual even when you control both houses and we can expect more spats between the President and the Democrats. The budget will be passed eventually and even a small concession will be seen in the Trump camp as a massive victory.

There are positives with the economy; wage growth, strong employment figures and there is no doubt the tax cuts have helped earnings but there are also considerable dangers.

It is expected that there will be fewer rate rises this year as the Fed acknowledges market jitters. Hopefully they can see that the sugar rush of the fiscal stimulus will fade. This added about 1% to GDP growth in 2018. This will go in 2019 and the focus will turn to the consumer. However, it is expected that rates will eventually rise to around 3% but at a slower pace. The argument long-term is that with higher rates and quantitative tightening the US will have the firepower against any potential slowdown.

Some however argue that raising rates and unloading the balance sheet is a dangerous combination. QE left economies addicted to a highly potent drug and the reality is that any withdrawal cannot be done without pain. In Q4 2017 the Fed, ECB and BoJ's combined asset purchases were $100 billion per month, in Q4 2018 this dropped to zero and by the end of Q1 2019 this is expected to be -$20 billion. The measures which drove us out of a financial crisis could just drive us back in to it!

This is a worse case scenario, and there doesn't appear to be any evidence the US is heading towards a recession but the easy ride that Trump has appeared to enjoy is no longer there. There is an argument that a strong labour market, wage growth and high costs connected with trade tariffs will impact the top-line for US businesses but tax cuts are providing a cushion.

Initially the trade tensions didn't touch the US but now there is also evidence that some businesses are holding back from investing, waiting on the outcome of trade talks. A positive outcome could see businesses investing which will help the economy.

One outside bet for the US in 2019 is that Trump doesn't stand for a second term!

There is no doubt from an investment view that the UK is unloved. There were glimmers of light last year and a strong employment market led the Bank of England to raise rates for the first time in a decade. But there is no doubt that Brexit uncertainty and chronic political chaos is hampering the UK economy.

Getting a deal was no easy thing and what is on offer is the best you can get (well it is easy to say you can get a better deal when you are not trying to get it). The backstop agreement seems to be the sticking point, but the reality is that this will never come into play.

It is worth adding that wherever you are in the world if you want to trade with Europe you have to trade on their terms. This would be the same if you traded with any other country. If that country did a separate deal with you everyone would want to negotiate their own.

40% of our trade is with Europe and you would be crazy to cut the hand that feeds you….but politics remains largely about self interest and not necessarily what is right for the country.

As it stands there seems to be a binary outcome – a deal would likely lead to higher interest rates (not necessarily good for house prices), stronger currency and a moderation in inflation expectations. No deal would lead to political turmoil, a sharp fall in sterling and a monetary policy dilemma.

There seems to be a strong belief that we are heading towards a no-deal scenario, others are pushing this a step further and feel a no-deal will bring down the current government and bring in a Corbyn government.

From a logical viewpoint it is worth looking at the facts. May is in a better situation, Corbyn not so much. If Corbyn backs May then he losses votes, if he doesn't and the UK crashes out more of the blame will be levelled at him. If May gets it through Parliament she wins, if we crash out Corbyn is likely to take more of the blame.

For all the bluster and bravado Corbyn has to be worried about an election. Labour have no clear policy on Brexit and opinion polls should show a sizeable lead but in fact show the exact opposite.

For what it is worth my view for the UK is this; logic will prevail, and the deal will go through before we run out of time and we crash out. As we get closer to the deadline and a second vote, we think the Tories (and others) will realise a no-deal will likely lead to an election or second referendum both of which are worse than a no-deal. This will force them to get the deal through at the last minute, having saved face that they did 'all they could' not to back the deal.

This should then give confidence to companies to start investing and the UK could be the outside bet for a good run in 2019. Winning the UEFA Nations League in the Summer and Cricket World Cup will push consumers to spend and the outlook going into 2020 will be very nice…..well we can all dream! Oh, and team May will step down as PM and win I'm a Celebrity with Amber Rudd as our new Prime Minister.

Turning to Europe, (Brexit aside) there are always political tensions; having seen slowing growth itself and there is no doubt it is suffering from a slowdown in China, given trade tensions. Its asset purchase programme is coming to an end, the currency is weak and there is a dilemma over interest rates. They have no firepower should a downturn come, and this will concern them. Removing concerns over Brexit must be uppermost in their minds and it is a game of chicken. One thing to watch is the end of Mario Draghi's tenure and the markets reaction to the successor.

We saw tensions between Italy and the European Commission where the EC rejected their budget proposals and threatened to begin the process that would eventually lead to penalties. Italy eventually backed down and a compromise was agreed with the commission. This was seen as positive in Italy with business confidence rising towards the end of the year.

In France Macron has seen his popularity tumble as many see him as only interested in helping the rich. Tensions grew to a point where protestors took to the streets and eventually Macron caved into populist demands by lowering taxes. This has to have weakened his standing and the long-term position is far from clear. Business confidence has fallen significantly, and this is something to watch.

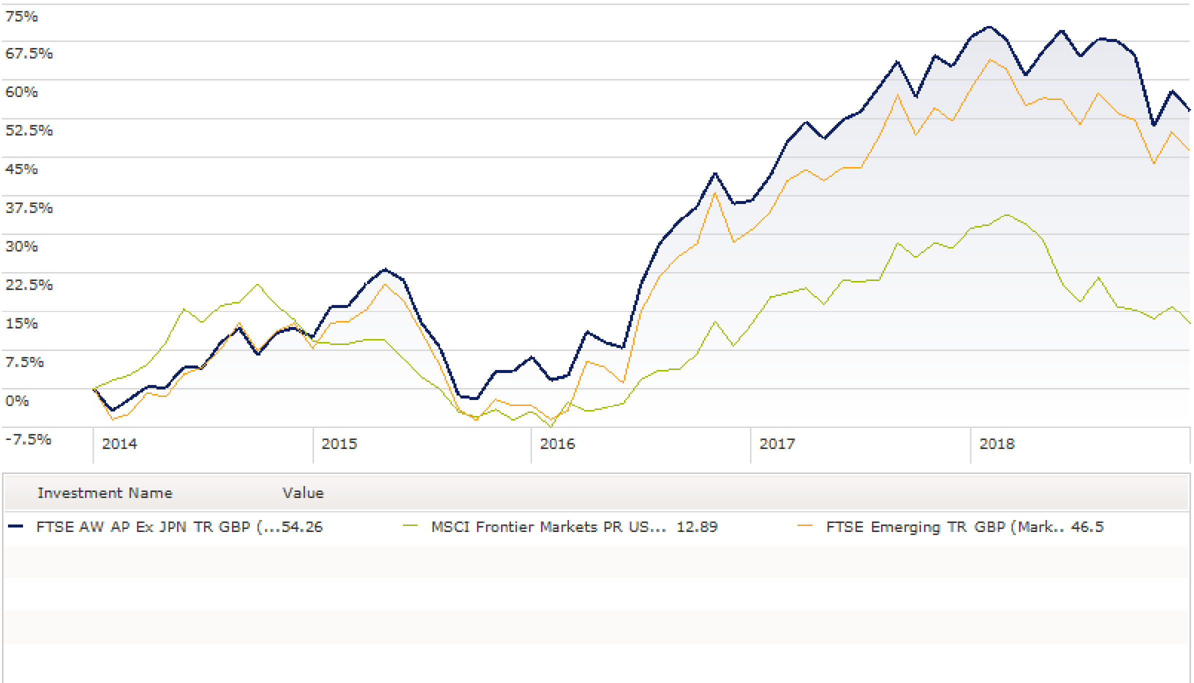
Germany saw Merkel "step-down" and be replaced by Kramp-Karrenbauer. Merkel will see out her term whilst Kramp-Karrenbauer will form her vision for her potential leadership.

In summary, political tensions weigh heavily in Europe. A change in Germany after many years of strong leadership will be something to watch. The darling of reform, Macron, is struggling to impose authority on a country that doesn't want change; Italy will fight all the way, Mario Draghi is being replaced, trade wars naturally hurt Europe and Brexit is not easy for the EU. Added to the mix is the significant fall in the manufacturing index and the European Elections in May. Europe faces an uphill challenge in 2019.

So where does this all lead? The US and China are two of the biggest powerhouses in the global economy. If they slow, we all slow. The US isn't at that point. In the UK a lot can change in a short time. If logic prevails then this could be positive for the UK, which this will feed into Europe. European politics are always a concern, and little can be done. The reality across all markets is that they are below their averages; they seem to have priced in a worse case scenario so any positive news this year could be good.

# EMERGING, ASIA AND FRONTIER MARKETS

Five year returns 1 January 2014 – 31 December 2018

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Investing in Emerging Markets, Asia and Frontier Markets was uncomfortable in 2018. Chinese debt, and slowing growth, trade wars, currency, Argentina, Turkey etc.

Let's start with China, which was one of the worst performing stock markets: down 28%. Apple, General Motors, Ford and Fiat Chrysler have all issued warnings about the slowdown and impact of the trade war.

But before we panic, growth is running at 6.5% p.a., significantly higher than many developed economies but half that of 20 years ago. It is expected to "slow" to around 6%. The problem is that many tend to focus on the past rather than the future and assume that Apple's profit warning is an indication of the health of the economy.

There are companies doing well in China; Nike has seen sales increase by 24% and Lululemon also reported strong sales. A better measure is this: China now accounts for 19% of global economic activity and industry is closely integrated into international supply chains.

Half of the world's steel, copper, coal and cement goes to China as well as half of the world's pork output and a third of its rice. If this slows or if they are not buying, prices fall, which is a more accurate measure.

The government are managing their economy well, cutting their reserve rates and spending on infrastructure. The real challenge for China and why we have sympathy with the US is its lack of regulation that sets doing business with them apart from the rest of the world. This includes "shadow banking", cyber espionage and lax protection of intellectual property rights. As indicated, tariffs are only part of the escalation of tensions, intellectual property rights and being the next global tech powerhouse are significant parts of the mix.

Trade tensions are a concern as they filter across all sectors. Japan and Europe are suffering from the uncertainty; US companies which import components are paying more and the reality is that although China suffers the ripple effect is greater. The US hadn't really suffered at the start of the tensions but when Caterpillar indicated that this was damaging their forward profit guidance it became clear that they were. We are also seeing US companies holding back from investing. Trump will not find an easy solution, but we think something will be agreed even if it pushes it back.

It is not just developed economies which suffer during trade wars and a Chinese slowdown; it impacts other emerging market economies. This is something to watch as some economies have suffered from a slowdown in global manufacturing and higher funding costs where they have large US dollar liabilities.

Looking across the regions, Turkey raised its interest rates to 27% and its stock market was down 57%. On the reverse Brazil was down just 0.2%. The victory in the elections of Jair Bolsonaro was seen positively by the markets as he defeated the established parties on an anti-corruption platform. Brazil is now expected to implement pension reforms, run a sensible budget policy and growth should start to pick up.

Mexico was another bright spot seeing its currency strengthen by 6% against the US dollar. Most investors were pleased with the swift outcome of the NAFTA deal and the political outlook looks positive.

India continues to benefit from reforms but the main thing to watch is the central bank after the resignation of Urjit Patel.

Across EM most currencies fell against the US dollar, and as indicated trade worries weighed heavily on the region. With tightening liquidity globally, this may also have an impact. However, again the valuations across the region are below average. Like the UK, emerging markets could make a comeback in 2019.

The concerns we have are really no different to those in 2018. China's slowdown has been talked about for a while, we know about the trade wars and continuing political issues. The potential unseen risks in the regions are war or threat of military action. We have already started to see some of this between China and Taiwan; Saudi Arabia and Iran are also ones to watch. Not on the radar at the moment but if tensions with China calm down, Trump will need something else to go at…North Korea is an easy target.

In summary, we shouldn't be over concerned by the slowdown in China, but we should be watching commodities, pork, rice prices as that is a better indicator. Developing economies did suffer in 2018 from many factors, currency, trade wars etc and often at times when markets are nervous investors flee what they perceive as risky areas. This leaves the region relatively cheap and a small shift in sentiment could mean 2019 is a good year for emerging and frontier markets.

# CASH

Five year returns 1 January 2014 – 31 December 2018


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On a positive note cash was the one stand out area for investors outperforming bonds and equities. But returns are significantly below inflation meaning the net return is negative.

If there is a positive outcome for Brexit, then we can expect interest rates to rise which will give some relief to those investors holding cash.

At this stage there is little more to add but looking forward to the end of the year, then we should have more a resolution on Brexit. The UK will start to breathe again and the Bank of England will respond. How much rates will rise is difficult to say but certainly we would expect one or perhaps two rate rises in 2019. Assuming they are 0.25% then we could expect rates to be between 1% and 1.25%. It’s not exciting but for cash investors it will be some relief.

If Brexit doesn’t happen then expect rates to remain at 0.75% or less for some time to come.

# CONCLUSION

Despite the concerns we have raised in this update the worries we had for the global economy are no different to where we were at the start of 2018. There are challenges, and these have created two corrections and a big fall last year. Markets are below their long-term average.

Sentiment is weighing heavy on the market and you only need small shifts to make a big difference. The two areas which could do well in 2019 are the UK and Emerging/Frontier Markets.

The UK is so unloved, and everyone is assuming the worst. What happens if the worst doesn't happen? The currency strengthens, companies start to invest and if we win the UEFA Nations League and Cricket World Cup consumers will feel a bit happier and will hopefully spend more.

China has challenges, but the slowdown is not as bad it seems, we expect some agreement with the US and this could change things very quickly across the region. If the dollar weakens slightly then this will also benefit some economies. Any deal will likely benefit US companies in terms of spending. If the Fed holds back this should help the consumer, especially with lower oil prices which are often seen as a hidden tax benefit.

In summary, there appears to be a lot of 'issues' bubbling around, but we think a lot of them will fade as the year goes forward. Perhaps the tension points are on trade and Brexit. In the short term we expect volatility to be similar to 2018 but long-term things will iron themselves out and there will be new concerns and worries!

**Source: Charts have been sourced from Morningstar. Other data sourced from BBC, Schroders, JPM, L&G, Visual Capitalist and Investment Management Associates. Any reference to a fund or share is not a recommendation to buy or sell that asset. Past performance is no guide to future performance and investments can fall as well as rise.**

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