Market Commentary

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CAPITAL TOWER

The Right Advice At The Right Time

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Why don’t you ask him if he’s going to stay?

Why don’t you ask him if he’s going away?

Why don’t you tell me what’s going on?

Why don’t you tell me who’s on the phone?

Why don’t you ask him what’s going on?

Why don’t you ask him who’s the latest on his throne?

Don’t…

Why don’t you ask him what’s going on?

Why don’t you ask him who’s the latest on his throne?

Don’t say that you love me

Just tell me that you want me

Tusk

Just say that you want me

Just tell me that you

Tusk

Tusk

Tusk

Fleetwood Mac – ‘Tusk’

"Independence is the recognition of the fact that yours is the responsibility of judgment and nothing can help you escape it."

Ayn Rand (1905 - 1982), Atlas Shrugged

As we approach the final episode (or is it merely the end of the beginning??) let's start with Brexit and the Eurozone. With Donald Tusk expressing his contempt for certain of the UK, Fleetwood Mac's 1979 song about infidelity seems appropriate; but will that strong tone ultimately last to the end or could we see some necessary last-minute bargaining still done?

In the rest of Europe there are problems aplenty as Artemis explain in their recent Hunter's Tale:

Mighty Germany has announced quarter of quarter growth of 0.0% in Q4. This equates to an increase in GDP of €150 million over Q3. So, using the usual definition of two consecutive negative quarters, Deutschland was only €150 million short of recession. That would buy you about one and a half Airbus A320s – or just over a third of an A380 superjumbo. Today's EuroMillions is for €144 million. Win that and you would be worth the increase in output in Q4 of 82.5 million people. And the Rhine is too low. That is hampering the distribution of raw materials to German manufacturers and slowing the shipping of their finished goods to Rotterdam.

Perhaps the probable paradigm for Europe is to the east. This week marks the 20th anniversary of the Bank of Japan cutting rates to 0% and starting two decades of extreme monetary policy. At 236%, debt to GDP is the highest in the developed world. The Bank of Japan holds 43% of all Government Bonds. Core prices in Japan are virtually identical to where they were 20 years ago; and the yield on 10-year JGBs has fallen from 2.21% to -0.03%. Somehow, nonetheless, the show goes on.

With Italy already technically in recession and France on the edge the inconsequential UK is now 3rd in the table of G7 GDP annual growth.

US: 3% Q3 Canada: 2.1% Q3 UK: 1.3% Q4 France: 0.9% Q4 Germany: 0.6% Q4 (was 1.1% end Q3) Italy: 0.1% Q4 Japan: 0% Q3

Of course, there are successful economies with the Eurozone with Denmark and Netherlands showing strong GDP growth figures but how they are affected by recession in Germany at the same time as potentially losing the UK's eurozone contribution remains to be seen.

An interesting aside: even though Mr Trump is having problems building his wall, Denmark is cracking on with a wall along its border with Germany. However, it's not to keep out immigrants but wild boar. Worth about £13.5 billion each year, pigs are big business. The Danes hope that this will protect their 12 million pigs from the (as yet) incurable African swine fever, which is common in eastern Europe.

Meanwhile in the UK we see record low unemployment, jobs being created, wages rising, low and stable inflation.

In the three months to December, the UK economy added 167,000 jobs. This took the calendar year growth to 444,000 and the total in work to 32.60m, a record high. Wage growth was constant at 3.4%, matching the highest rate since 2008 and providing a welcome boost to consumer finances. Furthermore,

> "Most people get interested in stocks when everyone else is. The time to get interested is when no one else is. You can't buy what is popular and do well."
>
> ***Warren Buffett***

the makeup of the jobs market continued to improve with the vast majority of jobs added being full time, rather than part-time roles. The labour market continues to oppose the UK political uncertainty and slowing global economy.

Furthermore, income from taxes beat public spending by £14.9bn in January, the largest monthly surplus since records began in 1993. The bumper surplus beat economists' forecasts of £10bn, and, was £5.6bn greater than January 2018.The year to date borrowing was also lower than last year and put the government on target to undershoot the Office for Budget Responsibility's (OBR) most recent forecast. With two months remaining of the fiscal year, the January figure will likely unlock additional flexibility for the chancellor when he comes to his next budget and may lead to further tax cuts or spending increases.

All potentially good news for the UK economy and yet Europe thinks we are the ones with problems.

Now, as promised last month, more from Terry Smith and his annual letter to Fundsmith shareholders.

"2018 was a year in which we saw considerable anxiety from some market participants due to:

*The threat of a trade war between the USA and China.
*Brexit.
*The rise in US interest rates.
*The US mid-term elections
*The Italian budget squabble (Italy is the third largest government bond market in the world)
*The US government shutdown

The response to this was a series of market jitters. The MSCI World Index (£ net) fell by 5.4% in October and after a rally this was followed by a fall of 7.4% in December. Despite the hysterical headlines this, in my opinion, falls well short of turmoil — a word frequently used to describe these events.

October has been a notoriously bad month for stock markets in recent decades. An example of what might reasonably be described as market turmoil was so-called Black Monday 19th October 1987 when the Dow Jones Industrial Average Index ('Dow Jones' or 'Dow') fell 22.6% in a single day. That felt dramatic. I should know as I was in work that day on the trading floor of the investment bank BZW and when I went home I received a slew of sell orders from a large US client who rang me. I had to be careful writing them down as I only had candlelight since the power still had not been restored from the hurricane, which struck on the previous Friday, adding to the dramatic effect.

I can only imagine with some amusement how some of the commentators, 'investors' and market participants who are reeling from the events of this October and December would have performed in October 1987. A December 2018 Financial Times headline referred to 'Wild market swings' and whilst the author might like to blame the headline writers for hyperbole — they are trying to sell papers/pixels after all — the article described a recent one day fall in the Dow of 3.1% as 'eye-popping'. The fall of seven times that scale in 1987 would surely have led to them to exhaust the lexicon of hyperbole. Who knows what might have popped then?

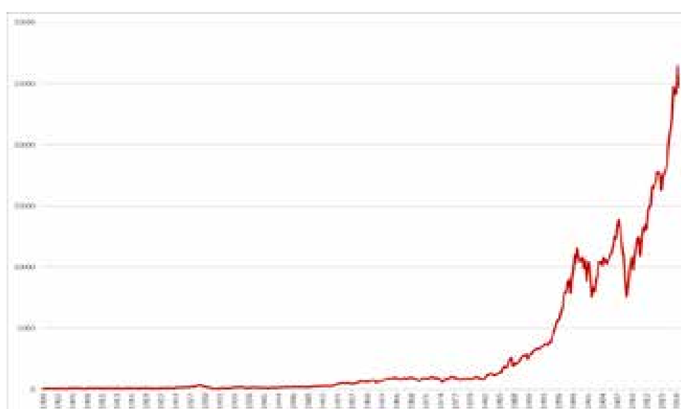
Tumultuous, turmoiled or turbulent Black Monday may have been, but did it really matter? Take a look at the chart below of the Dow Jones and see if you can spot Black Monday. You will need good eyesight or reading glasses to do so.

> "There are many ways of moving forward, but only one way of standing still."
>
> ***Franklin D Roosevelt***

In the long term, it did not matter.

However, this does not stop advisers and commentators predicting crashes and bear markets and suggesting you take preventative action which ranges from reducing your equity holdings, buying or 'rotating' into lowly rated so-called 'value' stocks, through to selling everything and holding cash to safeguard the value of your assets or buying Bitcoin (down 80% in 2018).

My guiding principles for dealing with such events and predictions are as follows:



1. No one can predict market downturns with any useful level of reliability. Forecasts of what may happen in the market are about as reliable as Michael Fish's infamous denial that there would be a hurricane in the BBC weather forecast on 15th October 1987.

2. However, when one of the repeated warnings proves to be accurate the forecasters will ignore the fact that if you had followed their advice you would have forgone gains which far outweigh your losses in the downturn. I can now trace back six years of market commentary that has warned that shares of the sort we invest in, our strategy and our Fund would underperform. During that time the Fund has risen in value by over 185%. The fact that you would have forgone this gain if you had followed their advice will, of course, be forgotten by them if, or when, their predictions pay off for a period. I suggest you don't forget it.

3. Bull markets do not die of old age so ignore warnings which are based on a phrase such as 'This bull market has gone on for a long time.' They usually die from some event, often but not always rising interest rates.

4. Bull markets climb a wall of worry. The troubling events you can readily see unfolding are rarely the cause of a bear market. Alan Greenspan had already described the market as irrationally exuberant in 1996, so we were in a worryingly well- developed bull market. This was followed by the Asian crisis of 1997, Russian default and Long Term Capital Management collapse in 1998 which all looked scary, but ironically they made the Federal Reserve hesitate to raise rates which gave the bull market a new leg which lasted until 2000. Maybe the possible trade war with China and market jitters will have a similar effect.

5. Bull markets do not broaden as they age — they narrow. The current bull market started in 2009 when shares rose indiscriminately. Then amongst developed markets, the US took the lead. Then the technology sector in the US. Then just the 'FAANGs' (Facebook, Amazon, Apple, Netflix and Google). The idea that in the late stages of a bull market investors can make gains by switching into the stocks which have lagged the market flies in the face of experience.

6. As for buying so-called value stocks, if you wish to pursue this strategy it is best done after the bear market has struck, not before. If you approached any of the famous value investors and suggested they

buy some of the assorted value stocks in the FTSE 100 Index as a value play, I think they would just laugh at you. A 'value' stock like Imperial Brands (formerly Imperial Tobacco) was on an historic P/E of 8.1x at the end of 2000 in a bear market. It is now on an historic P/E of 16.5x. An aim for a value investor might be to buy 'value' stocks in a downturn when their yield is higher than the P/E.

7. A bear market will occur at some point. We may indeed already be in one. The best stance is to ignore it since you can't predict it or position yourself effectively to avoid it without impoverishing yourself by forgoing gains. But you have to possess the emotional and financial stability to stick to this stance when it strikes.

Plenty of food for thought from Terry Smith.

SUMMARY

This months summary detailing the prospects for all major assets as at the end of February 2019 is provided by Schroders Investment Management

Asset classes

Equities
The improvement in investor sentiment following the recent change in the Federal Reserve's (Fed) policy stance is supportive, but we still expect equities to trade within a range, albeit with heightened volatility.

Fixed Income
Weaker economic growth supports Government Bonds overall, despite some expensive valuations. Our score remains neutral. January saw an unusually strong and uniform rally across credit sectors. Continued policy tightening has seen most credit categories recover significantly from their lows at the start of the year.

Commodities
Gold should benefit from lower interest rates, while energy remains volatile.

Now looking at each asset class in more detail:

US Equities
With the recent change in the Fed's policy stance, worries over "recession in 2020" have softened and are likely to support investor sentiment in coming weeks.

European Equities
European equities appear cheap but this is warranted, in our view, given the political and cyclical challenges facing the region.

UK Equities
Downgraded, as UK equities are likely to see the support from a weaker sterling decline.

Japanese Equities
Japanese equities have underperformed global equities in recent months, despite improved valuations and stable economic growth. Lack of confidence - particularly among international investors - remains a challenge and is likely to take time to resolve.

Pacific ex-Japan Equities
Asia would benefit if trade war tensions fade. However, many countries are seeing weakness in their housing markets with a knock-on economic impact.

Emerging market Equities
EM forward valuations are now back to 2015 levels after the large sell-off in 2018. The Fed pause and Chinese stimulus are likely to provide support for EM equities while investors continue to wait for resolutions of US-China trade conflicts.

Government Bonds
US bond yields look fairly priced after the recent dovish move by the Fed. The bond market is not pricing in enough hikes for the UK. There will possibly be a hike, as indicated by the Bank of England, if there is a Brexit resolution. European data continues to disappoint, and our view is that German growth is being suppressed by fears of a European recession.

Investment Grade (IG) Corporate Bonds
Spreads in the US do not yet appear excessive when compared to recent historical highs, although we remain concerned about the deterioration of credit quality. European investment grade spreads offer better short-term value, particularly if our "muddle-through" scenario for the eurozone is right.

Oil
The oil market in 2019 looks largely in balance but we expect heightened volatility.

Gold
Despite the equity market rally, gold has not given back the gains it made through the equity market

tumble in December thanks to a dovish Fed and weaker US dollar.

Agriculture
Agriculture remains the preferred way to gain exposure to the political premium of US-China negotiations, supported by favourable valuations and weather risks.

US dollar
We remain neutral on USD as both global and US growth are slowing down, causing the Fed to pause their hiking cycle and loosen liquidity conditions marginally.

UK sterling
The outlook is uncertain whilst awaiting the Brexit negotiations to be concluded.

Euro €
We see the euro staying range-bound, hemmed in by both the dovish Fed and the European Central Bank, which is turning less hawkish as economic growth weakens in the eurozone.

Overall, it is likely that the current economic cycle has further to run and the risk of recession remains low for now. Monetary policy normalisation and politics are two of the major uncertainties facing investors. With uncertainties continuing, volatility will likely remain elevated. On balance, we remain cautiously optimistic….

"To know the road ahead, ask those coming back."

Chinese Proverb

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