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# Investment update

Winter 2019

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# Overview

## The final quarter of 2018 has seen a great deal of anxiety descend upon global stockmarkets, which have finally begun to reappraise and reprice risk.

Even the mighty US stockmarket, which for much of the year had become increasingly out of step with the rest of the world, has finally buckled, contributing to the first annual decline in global markets, as measured in sterling terms by the MSCI World Index, since 2011. Global bond markets have also found the going pretty tough. Depending on currency influences, 2018 will be recorded in the history books as a year when both extremes of the risk spectrum are likely to have fallen in value - a very rare event.

Markets have been buffeted by a broad range of uncertainties, including the oscillating mood on trade between the US and China, Brexit chaos and a potentially less accommodative monetary framework that has been kind to virtually every asset class over the past decade. It is fairly evident that the global economic growth cycle is past its peak, including in the US where the effects of domestic stimulus are beginning to fade. It is the scale of the moderation, and the damage that might be done by over-tightening monetary policy, that has been causing much recent head-scratching, particularly for those market participants who have continued to throw caution to the wind and hitherto turned a blind eye to some of the escalating risks and pockets of overvaluation. We are hopeful that 2019 might bring a return to more rational and fundamental market thinking - this is not only overdue but will certainly be helpful if some of the year-end challenges faced by markets and economies extend well beyond the new year.

This means staying vigilant and being prepared to retreat to safer havens if necessary, but also recognising that the markets' interpretation of what is, and what is not, fair value may have strayed off course already. Markets have a habit of overreacting to events on both the upside and downside, and we are frequently reminding ourselves that the somewhat arbitrary quarter or year-end temperature checks on market levels and investment values are typically just temporary markers on a longer investment journey. In our opinion some brighter longer-term investment opportunities for active managers to head for should appear on the horizon soon, so it is worth holding a steady course.

**2 January 2019**

# So, what next?

The biggest near-term uncertainties on our own doorstep are Brexit and the fractious UK political situation: quite what the landscape will look like come 29 March 2019, or indeed this time next year, is quite frankly anyone's guess.

The current situation makes it virtually impossible to plan ahead, whether from a business or investment strategy perspective. The only 'deal' we can sensibly predict at this stage is that it will be a big one for the UK economy, but not in a positive way, unless a solution can be found to the current impasse soon. As things currently stand, having a good commitment to overseas markets and corporate revenue streams, as well as a lower than normal exposure to sterling, seems the most logical step, but this approach is not without its risks if Brexit brinksmanship begins to shift in a more positive direction.

But it is still quite hard to see the UK economy picking itself up soon: the damage caused by the UK economy's productivity demise post the 2008 financial crisis, and now compounded by the Brexit stalemate, can be seen up and down the country. The numerous shop closures on the UK's high street are an indication that the consumption side of the UK economy in particular is in poor shape. The collapse of HMV over Christmas is unlikely to be the last casualty. The Organisation for Economic Co-operation and Development (OECD) forecasts growth in the UK economy to be just 1.4% in 2019 and 1.1% the year after - this would place the UK among the weakest of the G20 nations, where economic growth is expected to be around 3.7% per annum on average. Based on this outlook alone, maintaining good exposure outside the UK does still seem wise.


# Interest rates key for bonds

Although the US Federal Reserve has recently modified its interest rate guidance for 2019, markets do not yet seem convinced that its mood has softened or indeed that it has its hand firmly on the monetary policy tiller going forward.

With the US, and global economy generally, in a more transitional phase, it is perhaps understandable that mixed messages are being sent to markets. Whilst a sudden pause in rate hikes by the likes of the US would undoubtedly cause some further uncertainty (i.e. what do they know that we don't?), some subtle central bank messaging could still do the trick, providing the necessary relief to businesses and consumers, which in turn could result in a recovery and further leg up in asset prices.

A modified trajectory on interest rates should also reduce some of the concerns for bond markets, especially at a time when central banks are continuing to reduce their bloated balance sheets following years of quantitative easing. The fly in the ointment, however, could still be inflation: although it is moderating in most of the major developed world economies, and could be helped further by the lag effects of the 30% drop in the oil price since early October, wage inflation is still rising and may therefore tie policymakers' hands somewhat. Although the risk of policy error remains quite high, the threat of significantly divergent global monetary policy does look set to diminish as the natural transition from peak cycle global growth begins to unfold. We have already seen a retrenchment, for example, in 10-year US government bond yields to well below 3%, a signal that the market is not expecting interest rates to spiral upwards and out of control. This has allowed us recently to secure a good short-term return on a US government bond investment.

# The not so mighty dollar?

Softer US interest rate rhetoric, or indeed a pause, is also likely to signal a change in fortunes for the US dollar, the 'go to' investment currency in recent years for many investors.

Leakage from the dollar may be stemmed by even greater weakness of other currencies such as the Brexit-plagued pound, but the dollar's general appeal could reduce unless it becomes a safe-haven currency in a much deeper crisis of confidence. If policy conditions and the US dollar do slacken, this might ease the pressure on Asian and emerging markets and make some of the faster-growing corners of the globe more appealing again. We are pleased to have escaped the worst of the sharp setbacks and volatility associated with emerging markets during 2018, but we recognise that investment in these economies is likely to play an important role in meeting longer-term objectives, particularly if economic growth in the developed world faces more headwinds than in the past few years. Once the current dust has settled, emerging markets are likely to be harbouring some attractive longer-term investment opportunities to which we may wish to make an allocation. At present we are staying fairly neutrally positioned with regards to stockmarket allocations, whilst maintaining some cash and more defensive investments in those strategies where risk appetites are less accepting of market volatility, or where return objectives are lower.

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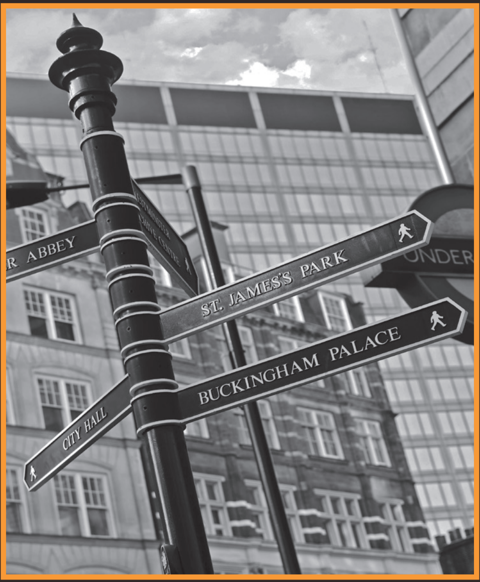


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