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Investment update

Autumn 2019

Bumps in the road

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What next?

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Overview

It has been another roller-coaster quarter, with the summer months characterised by some further sharp twists and turns for markets.

Oscillating rhetoric on the trade war in particular, and the visible impact it is having on economic activity, has agitated various asset classes. Central banks, once again, have been required to restore confidence in financial markets to ensure things do not come off the rails. Investment returns for the quarter itself may be quite modest, but it is pleasing to see that healthy gains built up during the year are still intact.

Markets seem content, for the moment at least, with more of the same and what has become familiar territory for them - i.e. central banks to the rescue (again) and oscillations caused by the on-off US/China trade war increasingly becoming part of everyday life. But we still need to stay vigilant and alert to the fact that something, sometime, may have to give. Being neutrally positioned feels appropriate, although for most clients this is balanced with varying allocations to fixed interest investments, alternative investments and cash. These should provide the stabilisers and elements of non-correlated return that can help reduce overall portfolio risk.

Where Brexit goes next is still anyone's guess. It continues to create deep divisions among the so-called political elite and, more importantly, within the UK population. It feels like we are inside a kaleidoscope: lots of moving parts, colourful language, and mirrors reflecting different political opinions with no consistent pattern emerging - it has been, and continues to be, almost impossible to make sense of. We have, however, taken what we consider to be the appropriate steps by reducing exposure to both the UK stockmarket, economy and currency over the past few years.

Whether the approaching Halloween will trick or treat us remains unclear. We are also operating in a complex and uncertain world where economies and markets are finely balanced. But we feel as well prepared as we can be if market confidence does become more spooked by slower growth and the unfolding Brexit saga, or instead continues to take more comfort from the helping hand of central banks.

2 October 2019

All change

As this year has unfolded, central bank language has altered quite markedly, with the US Federal Reserve ('Fed') resuming interest rate reductions in recent months.

Having gone from hike, to pause, to cut in under a year, it is no wonder that markets have been on edge and volatile at the end of last year and throughout much of this. But markets have certainly been given a further leg up from easier policy, which still remains exceptionally low.

So, why are interest rates now turning down again? In a nutshell, global economic growth has been weakening steadily since the escalation of trade hostilities, which began around 18 months ago. During this period, the Organisation for Economic Cooperation and Development's ('OECD') prediction for global growth in 2019 has been toned down from around 4% to 3%, with some stabilisation around this level expected in 2020. This slowdown is what policymakers have become more concerned about in recent months.

President Trump may think his protectionist agenda is working, but this is not the case - the US balance of trade has actually deteriorated whilst China's has improved over the past year, widening, not shrinking the gap between these opposing economies. We have to remain somewhat optimistic that soon the penny, or rather the cent, will drop and the negotiations with China will become more conciliatory in nature. This will hopefully lead to the relaxation of trade restrictions and a general improvement in the economic backdrop. We should also be somewhat optimistic that, with the 2020 US election drawing nearer, Trump - assuming he is not impeached - will soon want to pull more levers to position the economy, and himself, more favourably. He has been applying pressure on the Fed without much success, accusing it of being too slow and too stingy on rate reductions - now it could be time for him to turn his attention to a more positive solution on the trade front.

With economic growth now expected to be at its slowest pace since the global financial crisis, the 'R' word - recession - has started to rear its ugly head, replacing the previous moderate language of a gradually slowing global economy. Unpredictable international trade policies are clearly damaging industrial output and investments - when companies do not know what tomorrow will bring, they naturally exercise a 'wait and see' policy before they are willing to invest. But lower levels of consumer price inflation, now below 2% targets, are creating some headroom for central banks to act, and whilst they now have less room to manoeuvre than in previous downturns, their power of language can also convey messages that should have a similar effect to help restore some business confidence.

The 'R' word

So, are we heading for a global recession or will it just be a flirtation with one in certain corners of the world?

There is no precise way of telling what will happen, but when one takes the average rates of growth for the seven years between 2011 and 2018, we find that things are not quite so bleak. In the US, for example, the current OECD growth forecast is above the average seen over the past few years; forecasts for Japan and the entire euro area are both weak, but are not significantly different from their averages of recent years. Only countries like Germany and the UK really stand out as having had a material change in direction. Overall, the picture does not look as bad as some forecasters are painting. Recessions are notoriously hard to predict and in some cases we come out of them before we know we have actually been in them. But one common feature is that they consistently affect a broad range of sectors of any economy. As things currently stand, the run up to the early nineties, early noughties and the 2008 financial crisis recessions all looked much bleaker.

One current area of focus for markets, and probably the Fed, is US manufacturing. For the first time since 2016 we now have the US manufacturing leading indicator hovering just below the critical divide between expansion and contraction. It is becoming more evident that the trade war has finally crept up on this hugely influential economy. The readings in the eurozone, including the UK, also paint a bleak picture.

But the world economy does not just revolve around manufacturing: services play a vital role and this is where some optimism still lies. Although things have weakened, service-orientated firms are still on average indicating expansion.

Our assessment at the moment is that we will get a window of weakness rather than a full blown global recession, and that the period we are now in and going into the year-end will probably turn out to be the economic nadir for most developed economies. There will be pockets of very weak or negative growth in areas of the eurozone, which might technically mean recession in some countries, but it should be relatively short lived: the likes of the European Central Bank, for example, are already taking steps by unleashing more stimulus. Elsewhere, it is evident that economies such as China and India, whilst also seeing slower growth, are still providing encouraging support to the broader economic picture.

Another important point to note is that the last time central banks had to respond in unison to recessionary conditions was during the global financial crisis - this was a reactionary move at a time of great uncertainty, designed to shore up the financial system. It worked (eventually), but was still a reactive rather than proactive move. Today we have an entirely different scenario - global growth has been slowing for the past 18 months or so, but policymakers are already adopting a pre-emptive approach - this should ensure that any recession, or flirtation with one, is short-lived.

What next?

Financial markets are still being assisted by further monetary stimulus.

With the prospect of slower growth, the ongoing trade war, Brexit, oil troubles in the Middle East, and political tensions in Europe, policymakers are likely to continue to err on the side of caution and provide more support to stockmarkets. Lower levels of inflation and the general policy backdrop also paint a more benign environment for fixed interest markets than we had at the start of the year.

Stockmarkets are not particularly overpriced, and are certainly not in the valuation ranges that have prevailed before previous heavy market corrections. We do need to be watchful though of company profits and margins coming under more pressure, as this will ultimately feed through to share prices. It will be those companies whose share prices have been driven to high multiples of their future anticipated earnings, and where the margin of safety is lowest, that are most likely to be at risk if we do get a correction.

We are quite hopeful that the pre-emptive actions being taken by central banks can ensure that the current weakness in global economic activity is temporary, and that it will not develop into a full-scale recession or cause market confidence to slide. But as noted previously, slower global activity has been gathering some momentum over the summer months and it would be foolish to brush this off as not requiring any additional defensive steps to those we have already taken.

Now, more than ever, we believe that active management is particularly relevant and important whilst a more uncertain backdrop persists.

"...active management is particularly relevant and important whilst a more uncertain backdrop persists."

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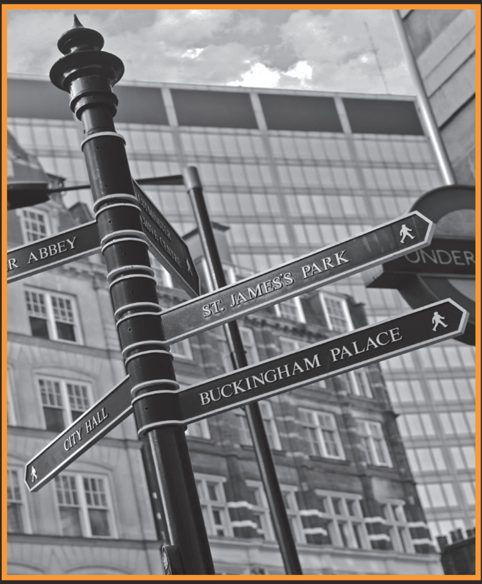

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