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# Investment update

## Back on track

Winter 2020

**Faith in UK being restored**

**New opportunities slowly emerging**

**Low interest rates still beneficial**


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# Overview

## It is encouraging to end 2019 on a more secure footing than at the same time last year.

Thankfully, markets did not turn cold turkey as they did over last year's festive period, and so the solid investment returns achieved in 2019 are in the upper part of the all-time league tables, and in most cases the best since 2013. The US stockmarket has, once again, led the pack of developed market returns, but assets right across the risk spectrum have also made surprising headway, in some cases by much more than one would have expected at the start of the year, given the uncertainty over world trade and the monetary policy outlook in particular. These headwinds have continued to cause uncertainty on a number of fronts, requiring caution to be exercised in terms of the allocation of capital. The ongoing push-me-pull-you trade spat between the US and China, together with the uncertainty for businesses, has undoubtedly been a big factor in the slowdown in global economic growth seen during 2019, making life difficult for central banks and at times introducing bouts of sudden volatility that have kept investors' nerves twitching. Political uncertainty, frequently mere background noise for markets, has also influenced investor sentiment more than usual.

But the year-end's more positive tone comes principally on the back of the expected policy pause, where central banks keep rates lower for even longer, and the relaxation of global trade tensions. Markets are already viewing 'phase one' of a trade pact between the US and China as helping to lift manufacturing activity and lessening the likelihood of a recession in 2020. In the UK, the fear of a Labour government has been swept away by the Conservatives' convincing win, finally unlocking the Brexit impasse and allowing the agenda to move forward after months of political bickering. Things are far from sorted on several fronts, but we start the new decade with slightly more optimism and less uncertainty than that which prevailed for the latter part of the one just ended.

We are not expecting an emphatic economic recovery in 2020. Far from it - global economic growth, particularly in the western world, is still likely to be rather underwhelming. However, a combination of continued central bank aid and a de-escalation of trade war tensions and political uncertainty should mean a year where various financial assets can continue to disconnect from the rather anaemic macro backdrop to produce returns which, when assembled in a portfolio context, are capable of outstripping inflation. There will be a need to remain vigilant during 2020, and we should perhaps expect returns to be more modest this coming year compared to last. But as things currently stand there are neglected situations and new investment opportunities being revealed that are worthy of consideration, particularly in this current weather window where the investment skies are, for the moment, looking a little brighter.

**2 January 2020**

# Faith in UK being restored

Now that the UK's political gridlock has been broken, the government's clear majority should allow the Brexit process to proceed at some pace.

Whilst there are still some considerable hurdles to overcome, not least squeezing the negotiation process on future trade arrangements between the UK and the European Union into just one calendar year, the potential path to liberate economic growth further down the line is now a little clearer.

The UK's economic progress is still likely to be restrained by Brexit, but the removal of some uncertainty and a slightly clearer path should allow for a re-boot of business investment and spending, allowing disenchanted investors in both the market and currency to return. This had already been seen in the run-up to the general election, with increasing optimism over a Conservative majority leading to a sharp (but still partial) recovery in domestically-orientated stocks, most notably in the mid-cap space, as well as a brief rally in the pound. The election result itself has lifted UK stocks even more, particularly those perceived as being at most risk from some of Labour's manifesto pledges. Sterling has subsequently retreated a little from its 'highs', probably a reflection of the unfinished Brexit business and the still weak state of the economy.

Overall, however, the election result does appear to have removed some elements of uncertainty for UK-centric businesses and in combination with the government's spending plans should lead to a narrowing of the 'Brexit discount' that has tarnished many UK stocks since the EU referendum in 2016. It is still early days, but we can probably expect a rebound in merger and acquisition activity as value opportunities are exploited. Meanwhile, there are already signs that global investors who had previously sidelined the UK market are returning to close their underweight positions. A stronger pound should also reduce the previous tailwind for UK-listed, international large-cap stocks - we see this shift as giving active managers a clearer edge over passive strategies going forward.

Like the renowned 1970's Heineken advert, the improved UK backdrop seems to have refreshed the parts of the market that other initiatives couldn't reach. This has given us more confidence to invest in those areas that stand to benefit most from the reduction in uncertainty and which also offer good value. We have therefore taken the opportunity to move away from our previous general neutral stockmarket stance by increasing our UK allocation. Specifically, we have targeted domestically-orientated smaller and mid-sized companies via an active fund with an above-average dividend yield. Even for more growth-seeking clients we feel that introducing an income overlay adds an extra dimension of return and a 'quality' discipline, both of which can be useful during more volatile market periods.

# New opportunities slowly emerging

An examination of stockmarket valuations shows that the US is still elevated compared to other developed markets, but not excessively so.

A close eye does, however, need to be kept on the level of corporate profits and revisions to earnings estimates, as on the face of things the market does seem to be anticipating the better times for corporate America, and elsewhere, that should come from an improved global trade backdrop. The recent news of President Trump's impeachment is unlikely to unsettle market confidence given the Republican's majority in the Senate, where the final judgement will be made. In the near term there is not too much that concerns us on the US political front, but of course that could all change quite abruptly. Our commitment to the US market continues to be biased towards active managers who are hunting outside some of the dominant market heavyweights: these managers should be particularly skilled at navigating through a more complicated political scene, if that is where the upcoming presidential election campaign looks as though it is heading.

European stockmarkets have generally closed their large valuation anomaly gap witnessed at the end of 2018, but there is scope here too for corporate earnings estimates to be upgraded, so if anything European valuations are still on the cheaper side of fair value.

Better 'value' globally is beginning to appear within Asia and emerging markets. Several have been clear losers in the trade war and markets have been pinned back by the ricochets from see-sawing sentiment on US policy and the threat of foreign capital being repatriated from the region. But some Asian economies perhaps stand to benefit most from a relaxation of trade tensions, a more stable outlook on US monetary policy, and a cyclical upturn in world growth, even if it is quite gentle. In contrast to the West, the region remains understimulated and has options to redirect tariff-impacted trade through different export hubs or manufacturing centres. On top of this there are some significant structural market reforms taking place. In Japan, for example, aside from it being a clear beneficiary of a global manufacturing recovery, there are signs of a shift in corporate culture where boards are beginning to realise the need to do more for shareholders: share buy-backs have escalated, dividend payout ratios are rising and we are seeing increased merger and acquisition activity, all of which should increase Japan's appeal to value-seeking investors. Reforms in India are also making investors sit up - the recent emphatic election victory for the incumbent Bharatiya Janata Party has given the party a clear mandate for action, with interest rates and corporate taxes being cut, both of which should stimulate growth.

These are just two examples of specific opportunity that are somewhat separate from the bigger longer-term demographic shifts and internal consumption growth trends being seen within the region. As and when we become more confident about the global economic backdrop and de-escalation of the trade war, allocating more capital to cheaper markets within Asia rather than to, for example, a more expensive US stockmarket, does seem more likely.

# Low interest rates still beneficial

Policymakers' actions have, so far, been fairly successful in steering the global economy through quite a narrow channel and with a tide that has been turning against it.

Low inflation, which continues to be anchored well below most key central banks' target rates of 2%, can be partly responsible for allowing interest rate policy to continue its good work of not only keeping the economic patient alive but also extending the life-span of the decade-long upward trend in most financial markets. With inflation forecasts globally remaining muted, key policymakers are unlikely to change their tune in the year ahead, with an expectation that they will maintain their current accommodative policy stance.

Overall, the expectation of a sustained backdrop of 'easy money' should be beneficial for a range of assets. The general environment for interest rates and inflation also points towards a calmer period for fixed interest investors in 2020 than perhaps had been expected a few months ago. Certainly, unless economic growth really surprises on the upside, we see the chances of another 'policy pivot' by the US Federal Reserve as being remote in the near term. We must also place some trust in its Chair's recent reassurance that US interest rates will stay at present levels until there is a significant, and persistent, move in inflation. There could be a bigger challenge coming for bond markets when, eventually, a decade of stimulus is unravelled, but as things currently stand this does not appear to be on the cards, or at least one to concern us at the start of this new decade.

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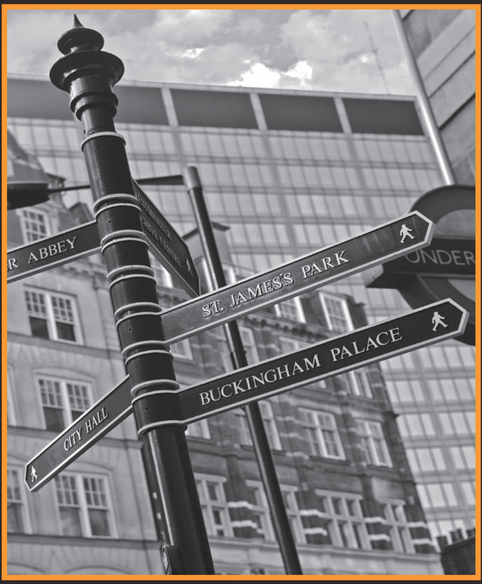


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