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INVESTMENT OUTLOOK

In retrospect, it was wise to take a cautious stance at the start of the last quarter. October had begun badly as we reported and markets weakened through to the end of December. Global equities, led by the US, fell over 10% in the quarter, offsetting the rise of Q3, and were 8% down for the calendar year. The UK market mirrored the broader picture. Something of a rally has started in January as the US Federal Reserve has indicated some moderation in the future path of interest rate increases. That mitigates in part the major monetary tightening implied by the end of QE in most economies, especially the US, with estimates of some $1 trillion drained so far from central bank balance sheets and thus from financial markets,

While global recession does not appear on the cards for 2019, there are increasing concerns over the European economy which has slowed sharply and over the credit led expansion in China where the authorities are attempting to reverse the slowing of the economy through central bank intervention. At the same time, there are hopes of better US-China dialogue on trade issues which have helped sentiment.

The Italian budget deficit situation has not escalated as feared but Brexit remains an ever present threat to UK and European markets at least. Parliament's rejection of Mrs May's EU agreement has created major uncertainty of course but recent parliamentary manoeuvres have raised hopes that a disorderly no deal exit can be avoided, the best indicator of which is the recovery of sterling against the dollar. While the current global equity rally may extend further, we would remain cautious in the light of all these risks until the impact on the global economy is clearer.

ECONOMY

The second half of 2018 has proved weaker than expected. In the US, the stimulus of the Trump tax cuts, which extended the long upswing in the business cycle, appears to be losing momentum but the economy has still been growing around 3%, which would be welcomed in the UK or Europe. A slowdown rather than recession can be expected for 2019. The Fed increased rates four times last year and has now indicated only two rises should be expected this year which will mean the federal funds rate not hitting 3%. While the economy is at full employment, inflation has not proved a problem at only 2% and the Fed, as ever, is sensitive to the reaction of financial markets to its draining of liquidity.

In Europe, Germany reported negative GNP in Q3 and is close to repeating that in Q4 so remarkably it is flirting with recession. Its reliance on the export sector is now hurting , notably through the major reduction in car sales in China. Growth in the Eurozone is still expected to be around 1-1.5% this year but the slowdown presents a challenge to the ECB which stopped its bond buying QE programme at the end of 2018. With the ECB balance sheet equivalent to some 40% of GNP, it can be seen what a substantial support the European economy has received. It hopes the current slowdown is a pause rather than the start of recession when it may be forced to resume the strategy.

Thanks to the consumer, the UK economy has held up reasonably well despite the adverse sentiment of the Brexit situation. It is hard to make economic forecasts when the political situation is so unclear but the consensus is for growth of some 1.0-1.5% this year, similar to Europe. A disorderly no deal exit could clearly threaten that, through confidence effects on spending and supply side disruptions impacting production. Good news though is that inflation is falling back to the 2% policy target while unemployment is now down to 4%, a considerable achievement and one now being reflected in real wage growth again with wages rising at 3%. Sterling is the best barometer of the expected economic consequences of Brexit. Currently back to $1.28, market forecasts range from $1.15 for a no deal exit to $ 1.35 in the event of a second referendum.

In China, the authorities are yet again trying to mitigate the effects of the slowdown they were previously trying to engineer by providing liquidity to banks and relaxing reserve requirements Basically, China is in a credit bubble with overall debt to GNP doubling to 270% in the last ten years. Bad debts are inevitably rising and bank provisions escalating, all of which could be tolerable if growth continues at 6% pa but not if it slows. This carries a risk to the rest of the world because China has been building up vast overseas surpluses. If it were forced to bring this back to support the domestic economy, this would act as another drain on global liquidity.

Finally, the dollar. This has been strong for the last year because of Fed tightening but the dollar is now beginning to trade sideways. This may help emerging markets, not just because of large dollar debts incurred by governments and corporate borrowers but it may assist capital flows back to emerging economies, subject to events in China described above.

MARKETS

As the introduction pointed out, last year was a bad year for risk assets with global and UK equities falling some 8% and Japanese and emerging markets falling close to 15%. Q4 saw US equities retreat 14%, making it the worst performing market but this partly reflected the major sell off in the so-called Fangs, the major IT stocks which fell some 20%. Credit markets also suffered globally with negative returns in both Q4 and for the year as a whole as credit spreads widened out. Government bonds like gilts rallied strongly in Q4 to produce slightly positive returns for the year.

Last quarter , we reported how in the US , both equities and bonds sold off together in October with 10 year treasury yields back to a more normal 3.25%. That has changed with bonds rallying and yields now down to 2.8%, reflecting partly changing perception on Fed strategy but also the usual flight to perceived safe assets. Much the same could be said of the UK where gilt yields are back down to some 1.15%.

While equities have recovered somewhat in January, we are not out of the woods yet. We have had another correction in this long bull market, the second of last year but it hardly has the feel of a bear market in terms of duration and extent. Growing perceptions of a major economic deterioration would take markets lower or a credit event in the US or China or even, conceivably, a disorderly no deal Brexit. At present, markets are divided on the former but inclined to take an optimistic view, are seemingly unconcerned about the second and uncertain how to jump on the third.

In the background, of course is this draining of global liquidity caused by the end of QE. That means there will be no buyer of last resort in credit markets in the event of bad news so risk assets have more downside risk than over the last few years. That said, valuation is not excessive as earnings have caught up with market prices to some extent but markets are assuming that GNP growth and earnings remain on an upwards path. With all these uncertainties, it seems wise to remain cautious.

That must surely be the case with UK assets. UK equities have the best dividend yield of all markets and could be said to be inexpensive compared to other markets but there is a reason for that. Markets have to assess the outlook for the domestic economy which will determine the outlook for small and mid-cap stocks but also for sterling which will impact FTSE 100 stocks with their large overseas earnings. Too hard to call! Yet again, though, UK commercial property has outperformed as an asset class with a return for 2018 of 6%. The outlook is for a lower return but still positive as the high yield offers protection against any slippage in capital values.

ASSET ALLOCATION

There have been no changes of significance since the last review although some cash has been raised out of our equity portfolio , reflecting a desire to trim overweight positions in the transition to pooling. No changes have yet been made to the liability hedge though that remains under review but some start has been made on the new private asset pool allocations.

FOR FURTHER INFORMATION

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