COMMENTARY

1st October to 31st December, 2018

A sizeable and aggressive risk-off episode, reflecting escalating fears over global economic conditions, transformed an otherwise okay year for most markets into what has been described as an "*annus horribilis*" over the fourth quarter. Developed equity benchmarks suffered their largest falls since the nadir of the Eurozone debt crisis in 2011, feeding through to credit with varying degrees of severity, while oil prices also dropped precipitously. Core sovereign bonds, meanwhile, responded in textbook fashion and rallied strongly from the bottom of medium-term trading ranges. In stark contrast to the volatility elsewhere, the foreign exchanges saw only modest movements in major currencies over the period.

Given that the combination of factors to which it has been attributed - US interest rates, trade wars, Chinese data, the Italian budget, Brexit - has been present and prominent in the market psyche and is something that commentators and investors seem to have been fretting over for most of the past year, it is not only difficult to understand the markets' apparent surprised reaction to a softening in data from the major economies, but also to reconcile the severity of that reaction with the relatively modest nature of the indicated slowdown. Thus, whereas there is certainly some logic to the shift in investor sentiment, the extent of that shift is, in our view, out of all proportion to the likely pace and direction of the global economy.

It is also difficult to pinpoint the precise catalyst for this latest growth scare, which, while echoing those in the first quarters of this year and 2016, exceeded them in terms of scale by some distance. If there was perhaps one straw that broke this particular camel's back, it is the risk of Central Bank policy error, since, with the Federal Reserve both hiking rates and withdrawing liquidity by shrinking its balance sheet, the European Central Bank ending Quantitative Easing and pondering rate rises and the Bank of Japan having scaled back its asset purchases, there is a growing perception that the "goldilocks" economic backdrop is under threat from a shift towards an overly hawkish stance by the world's monetary authorities. Even then, markets' behaviour would suggest that economic conditions will continue to worsen at the same, or a greater, rate despite specific reasons (relating to pre- and post-trade tariff inventory movements) for the declining data reported during the quarter. At the risk of belabouring the point, the shift to pricing in a recession based on the change in a small sample of data doesn't just strike us as an extreme overreaction on the part of investors, it also assumes that Central Banks would do nothing to arrest the pace of any decline, which again seems highly unlikely.

Indeed, more recent events would appear to bear this out, with markets having reversed direction and bounced vigorously in the final sessions of 2018 and into the New Year after calming words from Fed Chairman Powell on the data-dependent nature of future Fed policy. Moreover, an unexpectedly strong jobs report and solid Purchasing Manager Index (PMI) numbers (53.8 for manufacturing, 54.4 for services and 54.4 in aggregate) suggests that the US economy, is, in reality, in far healthier shape than implied by last quarter's events (Fig. 1).

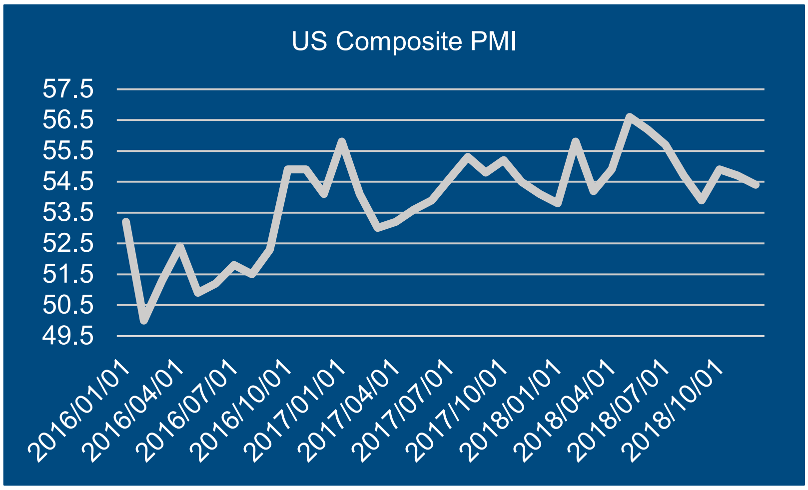

Fig 1: US Composite PMI
Source: Bloomberg

In a similar vein, it is also worth noting that, in spite of an overwhelmingly gloomy narrative from the Brexit news flow water torture that we are subjected to in this part of the world, UK economic indicators continue to hold up surprisingly well, suggesting that the good old "stiff upper lip / keep calm and carry on" spirit is very much alive and well.

That is not to say that everything is rosy out there in the big wide world. Manufacturing data for the Eurozone in particular has declined meaningfully, with the latest (December 2018) print for the regional PMI of 51.4, comparing with a high of 60.6 as recently as December 2017 and although a number above 50 indicates expansion, the prevailing trend (also mirrored in the service sector) is clearly a cause for concern. Chinese activity has also seen a downturn: the latest composite PMI of 52.6 also continues to show growth (albeit with manufacturing in decline), but the direction of travel is also negative.

As we've already referenced, there are specific and one-off reasons for at least some of the downturn in these geographies. The key question with which investors are clearly wrestling, therefore, is to what extent and for how long the slowdown we have seen is set to continue, or whether it is no more than a dip within what is already, chronologically speaking (but not terms of magnitude), an extended economic cycle. It is most likely, in our view, that this will be determined by policy at both Central Bank and government level. In this regard, recent pronouncements suggest (and official meeting minutes confirm) that the Fed is committed to a far more flexible and pragmatic approach to normalising US interest rates than markets had (irrationally in our view) come to fear. The People's Bank of China, meanwhile, has signalled its intent by reducing banks' reserve asset ratio during the first week of the New Year and we would not be surprised to see it take further action taken in due course. While there remains a sizeable body of bearish opinion when it comes to China's prospects, evidence from that last quarter of a century would suggest that you bet against Beijing at your peril. As for geopolitics, despite the volatile and unpredictable style of the current US leadership, our expectation is that, ultimately, common sense should prevail. On balance, therefore, our inclination is to stick with the view that the global economic cycle remains intact and that fears of an impending - by which we mean as soon as 2020 – recession are some way wide of the mark. It would be fair to say, however, that any meaningful deterioration in data or news flow over the next few months could change that.

Equities

Index	Q4-2018	YTD
MSCI World ($)	-13.74%	-10.44%
MSCI World (€)	-12.52%	-5.98%
MSCI World (£)	-11.74%	-4.97%
MSCI World (local ccy)	-13.47%	-9.15%
S&P 500	-13.97%	-6.24%
FTSE UK All Share	-10.97%	-12.95%
FT Europe Ex-UK (€)	-11.78%	-13.20%
FT Europe Ex UK ($)	-11.09%	-12.23%
Japan Topix (¥)	-17.78%	-17.80%
FT Pacific Ex-Japan ($)	-11.13%	-15.43%
MSCI Emerging Markets ($)	-7.85%	-16.64%
MSCI Emerging Markets (€)	-6.54%	-12.49%
MSCI Emerging Markets (£)	-5.71%	-11.55%

Source: Bloomberg

In terms of equity market movements, the headline-grabbing number from the period under review is that the US market suffered its worst December since the Great Depression in 1931. The S&P500 Index (which didn't actually exist in 1931; the Dow Jones Industrial Average was the bellwether market index back then) dropped 15.74% from peak to trough before ending the month down 9.18%. An intra-quarter fall of 19.63%, meanwhile, took it within a whisker of the 20% threshold that signifies an official bear market - *N.B. other prominent benchmarks such as the Russell 2000, -27.22%, and Nasdaq Composite, -23.03%, broke through that barrier*. Elsewhere, this move was replicated on a currency adjusted basis throughout the major markets, with, in order of capitalisation, Japan Topix -19.68%, UK FTSE All Share -15.58%, France CAC 40 -17.57%, Canada TSX -19.45% and Germany's DAX -16.57% in USD terms within the quarter. Against this backdrop, the performance of emerging markets was notable, in that the broad MSCI EM Index fell significantly less both within and over the quarter, having avoided much of the damage seen elsewhere during the latter stages.

Quite what that's telling us about the sell-off is difficult to say. On the one hand, one might argue that, after a period of relative underperformance earlier in the year, it's entirely logical that emerging markets should suffer less. Conversely, being a higher beta asset, it's odd that emerging markets should outperform during what appeared to be such a broad-based risk-off episode. In fact, the picture is perhaps clearer when viewed within a wider context and longer time-scale, as it brings the emerging market universe closer into line with the non-US world on a twelve month view and, perhaps more tellingly, over the period since Mr Trump won the keys to the White House (Fig. 2). That both highlights the US's huge influence in the overall scheme of things (it is, after all, 60+% of global market capitalisation) and points to a bifurcated equity market in which it behaves separately from the rest of the world.

Fig 2: Source: FE 2019, 08/11/2016 – 31/12/2018

According to the revered investor Sir John Templeton, "Bull markets are born on pessimism, grown on scepticism, mature on optimism and die on euphoria". Whereas it can be argued that we have witnessed a localised "melt-up" in US and Chinese internet stocks (the "FAANG"s and "BAT"s), that final - euphoric - phase of the cycle has been notably absent from the broader equity market picture. It's therefore entirely possible that we haven't yet seen the end of the market cycle. Indeed, we'd go as far as to say that if the risk of recession that has spooked markets doesn't materialise, you can swap the "possible" in the previous sentence to "likely".

Does that mean that we are strapping on our buying boots after such a sizeable correction in markets? After all, as a consequence of the adjustment brought about by the last quarter's movements, even after allowing for a (prudent) downgrade in earnings expectations, the broad market is trading on the cheapest price / earnings rating since 2012, with other valuation metrics not far behind. Well, no, not exactly. As the foregoing comments suggest, while our considered view is that those recessionary fears are unfounded, it is an outcome - with perhaps a 35% or even 40% possibility - that cannot be entirely ruled out, particularly if the Sino / US trade situation worsens or policy error becomes more likely. Moreover, in arriving at this decision to "stick" rather than "twist", we have taken into account the fact that those of our favoured managers with a value-oriented or tactical approach have significantly reduced cash levels within their funds' portfolios, thereby increasing the beta of our models' equity component. As such, our assessment is that, for the time being, our equities exposure offers sufficient upside in the event of a favourable outcome that we do not need to increase weightings from current levels.

Bonds

Fixed income markets behaved exactly as one would expect in a risk-off environment, with core sovereign debt prices rising and credit spreads widening. Ten-year (yr) benchmark yields for US Treasuries, German Bunds and UK Gilts declined by, respectively, 38 basis points (bps) (to 2.69%), 23bps (to 0.24%) and 30bps (to 1.28%) over the period, with the corresponding Bloomberg >1yr Government Bond Indices posting gains of 2.57%, 1.58% and 2.13% for the quarter. The investment grade corporate and high yield space, saw a widening in credit spreads across the ratings spectrum that, in notional terms, was almost identical to that seen during the 2016 growth scare mentioned earlier (Fig. 3).

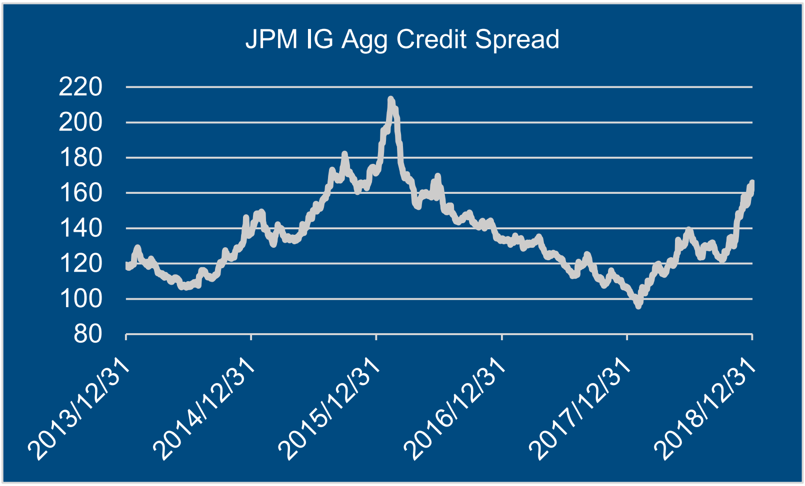

Fig 3: JPM IG Agg Credit Spread
Source: Bloomberg

As has been the case for some while, the big talking point as far as bond markets are concerned continues to be a gradual flattening US yield curve, which the textbook tells us is an indicator of a slowing economy. Moreover, that same textbook suggests that when a yield curve becomes inverted - i.e. the return from short dated bonds exceeds those with longer maturities - it is often an indication of a forthcoming recession. It should perhaps come as no surprise, therefore, that the beginning of December's equity market sell-off coincided exactly with the point at which the 2yr Treasury yield fell below that of the 5yr; nevertheless, the timing strikes us as uncanny. Cause or effect? That's anyone's guess….

Either way, it is worth commenting upon the predictive power of that yield curve's inversion, since, depending upon who one listened to during the past month, one could be forgiven for thinking that a recession in the US is now a foregone conclusion. As ever, there's a fair bit of daylight between perception and reality. Looking at the period since 1976, for example, whereas the US economy has experienced five recessionary periods, that 2yr / 5yr yield differential has been negative on 19 separate occasions, equating to a rather underwhelming 26% "success" rate. Even in the case of the more statistically reliable 2yr / 10yr spread (which, it must be noted, despite expectations to the contrary from those of a bearish persuasion, remains stubbornly positive), that hit rate is still less than 50%, with 11 inversions during that time. Since experience suggests that bond markets tend to behave far more rationally than those of other asset classes, the yield curve movements in the US and elsewhere are certainly something to which we are paying close attention. As the foregoing figures suggest, however, even what are perceived to be the most consistent of predictive indicators aren't necessarily as reliable as one might think.

The positioning in bonds within our portfolio models, both with respect to the modest level of aggregate weightings and the relatively defensive nature of that exposure, remains unchanged and reflects our view that the gradual normalisation of Central Banks interest rate policies is an unfavourable environment for conventional fixed income assets. Nevertheless, there continue to be managers whose skill-set and strategy offer the opportunity for attractive risk-adjusted returns, as well as specialist areas of the market in which we are happy to invest.

Currencies

In contrast to pretty much every other area of financial markets, the foreign exchanges saw little net movement over the quarter and, save for a brief bout of volatility in early December, activity remained relatively calm. Measured by the DXY Spot Index, the US Dollar gained 1.09% on a trade-weighted basis over the period, settling into the middle of a relatively narrow short-term trading range after hitting a 17-month high in early November. In some respects this is surprising, given that the US currency is invariably a beneficiary of market distress. This time around, it was another perceived safe haven, the Japanese Yen, that saw strength during December's upheaval, gaining 3.66% (from ¥/$ 113.7 to ¥/$109.69) over the quarter.

As highlighted elsewhere, another notable feature of Q4 was the relative performance of the emerging markets; indeed, among the 16 categorised by Bloomberg as "major" currencies, the Brazilian Real was the strongest of all, gaining 4.51% in USD terms. At the other end of the scale, the common characteristic shared by the weakest over the period (Norwegian Krone -5.63%, Canadian Dollar -5.35% and Mexican Peso -4.74%) was the importance of oil / gas production to their economies.

It is clearly too early to judge based on the evidence of a single episode, but it's possible that the past quarter's forex market movements are an indication that a period of strength in the Dollar that has seen the aforementioned DXY Index gain more than 10% between February and November could be coming to an end (Fig. 4). The implications of that, should it prove to be the case, both from a wider perspective, but in particular with respect to emerging market economies, are positive in our view.

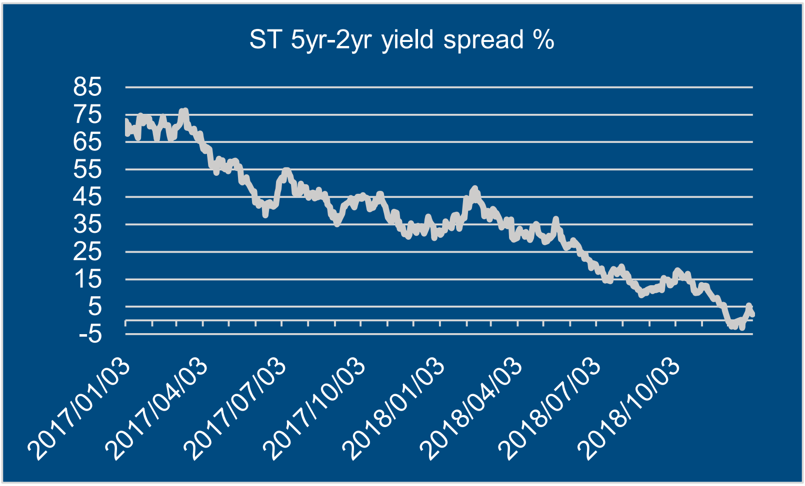

Fig 4: ST 5yr-2yr yield spread %
Source: Bloomberg

Commodities

The sizeable losses recorded by broad commodities benchmarks - the Reuters / CRB Index was down 12.99% - were largely attributable to the weakness in its largest component, Crude Oil. Against a backdrop of unchanged output from OPEC and increased US shale production resulting in rising inventory levels, added to concerns over the effect of slowing economic activity on future demand, oil prices dropped steadily and sharply throughout the period under review. By the end of December, the front-month futures contract a barrel of West Texas Intermediate had fallen a whopping 38%, from $73.25 to $45.41 having recorded both a for year high and an 18-month low in the space of a single quarter (Fig. 5), while the equivalent Brent price was 34.01% lower at $53.80 bbl. As elsewhere, subsequent market movements have seen a partial reversal of these losses, although not to the same extent as in other asset classes and prices remain at the bottom of mid-term ranges.

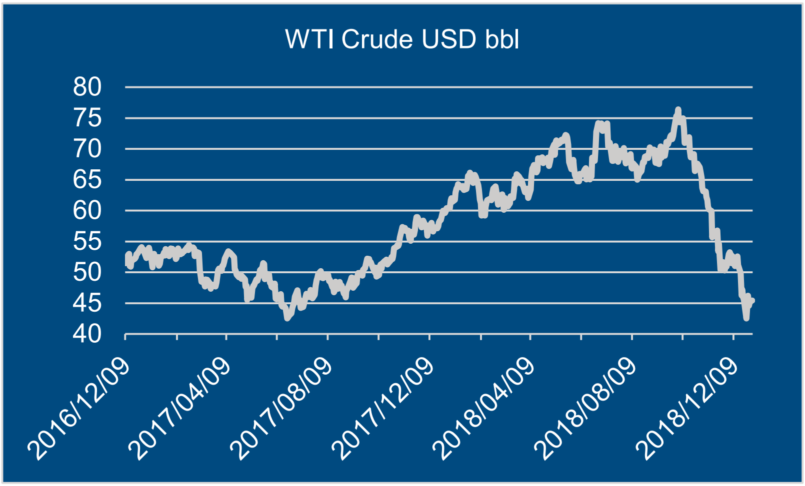

Fig 4: WTI Crude USD bbl
Source: Bloomberg

The consensus among the specialist managers whom we follow is that, based on the current combination of demand / supply side dynamics and OPEC policy, the equilibrium price for Brent Crude is around $60 bbl. Geopolitical events and economic sentiment clearly have a part to play in this, but that suggests the potential for modest rises from current levels over time.

Gold was among the small number of commodities exhibiting strength over the quarter under review, gaining 7.77% to close the year at a spot price of $1285.15 per ounce. In comparison with the 2016 growth scare that we have cited elsewhere, this represented a relatively subdued response to market events for what is traditionally seen as a “go-to” asset in times of distress. While this could suggest that gold is no longer viewed as being among the best vehicles through which to protect or hedge risk within a portfolio, it may also be that participants in the gold market do not take the threat of a recession as seriously as equity market movements would have us think.

We wish our readers a healthy, happy and peaceful 2019.

Shaun McDade
Joint Managing Director (Guernsey)
and Head of Portfolio Management (International)