MitonOptimal

COMMENTARY

1st October to 31st December, 2019

I can see clearly now the rain is gone.
I can see all obstacles in my way.
Gone are the dark clouds that had me blind.
It's gonna be a bright, bright, sunshiny day.

Okay, so our use of Jimmy Cliff's lyrics may represent something of an exaggeration and oversimplification, but in economic terms at least, the agreement of a trade deal between the US and China makes the corporate world a much less uncertain and risky place. The past quarter's movements in financial markets certainly suggest that's the case: rising equity prices, higher bond yields, stronger credit spreads and a weaker US Dollar were all consistent with a "risk-on" environment. A conclusive outcome in the UK's general election - and resulting end to the Parliamentary deadlock over Brexit - added to this positive tone.

Equities

Broad global equity benchmarks moved steadily higher throughout the period under review, with MSCI's Local Currency World Index recording gains over 10 of the quarter's 13 weeks and hitting all-time closing highs on 24 occasions.

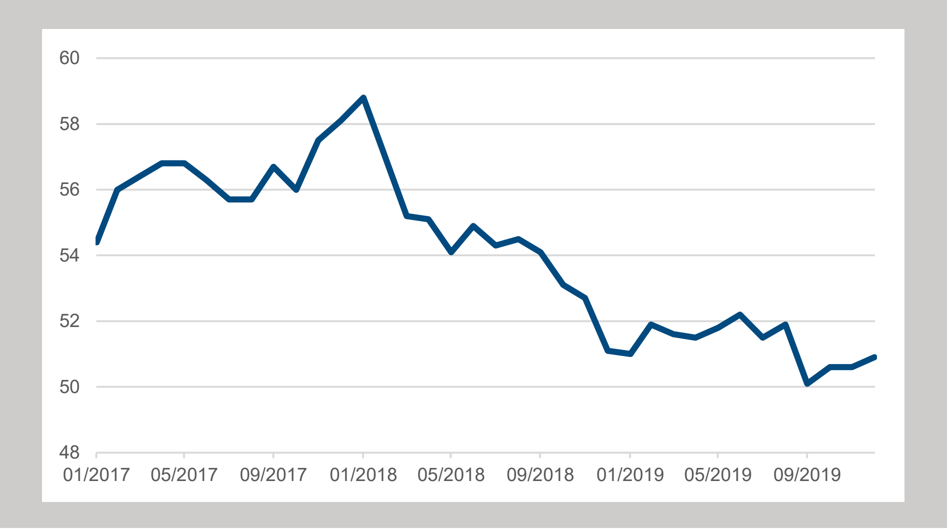
Index	Q4-2019	2019
MSCI World ($)	+8.19%	+25.19%
MSCI World (€)	+5.04%	+27.68%
MSCI World (£)	+0.25%	+20.31%
MSCI World (local ccy)	+7.11%	+24.86%
S&P 500 ($)	+8.53%	+28.88%
FTSE UK All Share (£)	+3.32%	+14.19%
MSCI Europe ex-UK (€)	+5.17%	+24.08%
Japan Topix (¥)	+8.41%	+15.21%
MSCI Asia ex-Japan ($)	+11.41%	+15.37%
MSCI Emerging Markets ($)	+11.36%	+15.42%
MSCI Emerging Markets (€)	+8.12%	+17.71%
MSCI Emerging Markets (£)	+3.19%	+10.92%

Source: Bloomberg

After an early wobble that sent the above-mentioned index 2.7% lower, there was a pronounced turnaround in both sentiment and market direction during the second week of October, as concerns over the economic outlook abated. Rather than any single catalyst for this change, the accumulated effect of reported progress in US / China trade negotiations, macroeconomic data that was, on balance, positive (equally importantly, there were no nasty surprises) and solid corporate results all contributed to the constructive market mood. Although the tone of the statement by Federal Reserve (Fed) Chairman Powell that accompanied October's US interest rate hike was relatively cautious, a rash of high-profile takeover announcements provided further momentum in November, as did better than expected macroeconomic data.

This was initially confined to isolated figures such as the Q3 US GDP print and, most encouragingly, European Purchasing Manager Indices (PMIs), but latterly the macro news flow during December was almost universally favourable, with major reports out of the US, Eurozone and China all providing upside surprises.

Eurozone Composite PMI



Source: Bloomberg

Whilst one might reasonably suppose that a rally driven by expectations of improved (or at least *less worse*) global economic conditions would see an extension of the rotation into value and cyclical companies that was highlighted in our last report, it was not to be. Rather, recent market movements would suggest that investors' appetite for quality growth stocks, be it for their defensive characteristics, attractive dividend yields, or both, remains strong. As a consequence, the likelihood and timing of a reversal in the long-term trend in growth stock dominance seems as unclear now as at any point in the last five years.

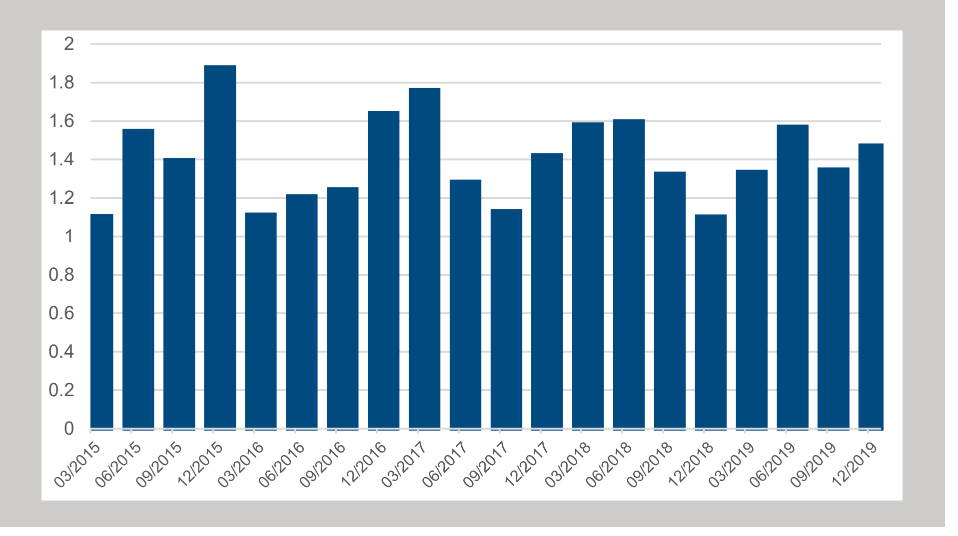
Whereas the growth vs value debate continues to split opinion and generate lively discussion among the members of our investment team, one matter on which we are all agreed is the significance of the US / China trade agreement, the first phase of which is due to be ratified on January 15th.

Although by no means a panacea for all the world's economic frailties, the removed threat of further tariffs and partial roll-back of existing ones does represent a meaningful boost to global economic prospects, both in terms of companies' enhanced earnings potential and the improved clarity and ability to plan that the cessation of trade hostilities brings.

It is entirely possible, of course, that the end of this particular dispute means that the White House's attention will now turn elsewhere – it is after all an election year and protectionism goes down well among Mr Trump's support base – Europe perhaps? For the time being, however, the positive implications of the agreement are sufficient for us to have increased our "house view" tactical risk score and with it the equity weightings across our portfolio models.

That's not the only reason why a constructive view of equities is warranted, however. While it's fair to say that current metrics put the broad market above fair value within a historical context, the presence of structural tailwinds more than offsets any valuation concerns, in our view. Most importantly, global monetary policy remains accommodative, with the Fed, European Central Bank, People's Bank of China and Bank of Japan all engaged in stimulus of varying types; if recent history has taught us anything, it is that cheap money is supportive of asset prices. The healthy level of corporate activity that has been a feature of markets also shows no indication of slowing. M&A deals totalled just over $1.4 trillion during the quarter under review, compared with $1.27trn average for the past 5 years, and with an estimated $1.5trn of uncommitted capital held within private equity vehicles alone, it seems reasonable to expect more of the same (*n.b.* share buybacks are removing a further $1trn of equity from markets per annum). Finally, with the exception of the US, average dividend yields in developed economies continue to offer a significant pick-up in income when compared with government and investment grade corporate debt: though somewhat diminished by recent bond market weakness, the "TINA" argument ("there is no alternative") persists.

Global M&A quarter-on-quarter USD Trn

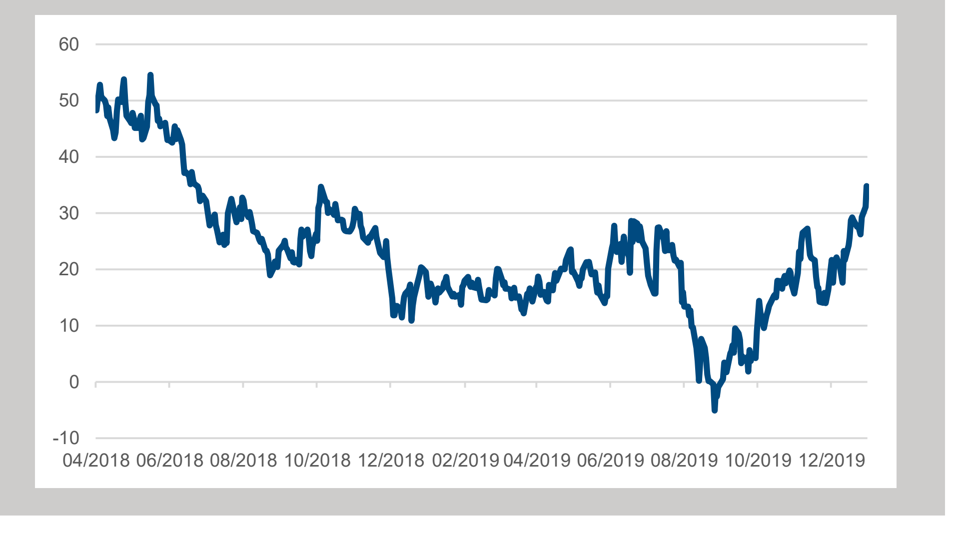


Source: Bloomberg

Bonds

Core sovereign bonds behaved in textbook fashion for the first time in quite a while, as yields tracked equity markets higher throughout the quarter. The yields on ten-year Treasuries, Bunds and Gilts ended the period up 25, 39 and 33 basis points (bps) respectively at 1.92%, -0.18% and 0.87%, which in market terms left Bloomberg's US, German and UK Government (all >1yr) indices -0.79%, -3.17% and -4.18% lower. In the case of the Bund market, this was the worst return over a calendar quarter for almost five years, with the four consecutive negative months being its longest losing streak since the early stages of the Eurozone debt crisis in 2011. Concurrent with this sell-off, there were significant changes in the shape of the US and German yield curves, which saw big declines in rates at the very short end (1 year and below), resulting in a conventional upward sloping profile right across the curve for the first time in almost a year. Meanwhile, the spread between two- and ten-year US Treasuries – widely viewed as a reliable recession indicator – traded at its widest level (35bps) for more than 14 months, implying, as seen elsewhere, that immediate risks to the global economy are much reduced.

2 year vs 10 year US Treasury Yield spread



Source: Bloomberg

Movements within the credit space were also in keeping with the prevailing "risk-on" market backdrop, with yield spreads tightening across the ratings spectrum. This was not enough to push broad Investment Grade indices in the Eurozone (-0.50%) and UK (-0.19%) into positive territory for the quarter, whereas the corresponding US benchmark was up 1.18%.

With average credit spreads heading towards the bottom end of historic ranges, generic Pan-European and US high yield benchmarks were also positive, recording gains of between 2.12% and 2.77%, depending on which index provider one used. Similar returns were to be found from Emerging Market debt: the JP Morgan EM Bond Index ended the period up 2.09% in US Dollar terms, as the average yield premium of its constituent components declined to a level not seen since July 2014.

As we have stated on many previous occasions, though fixed income as an asset class should by no means be viewed as a no-go area, nominal and real yields near historic lows and credit valuations at the rich end of long-term ranges means that fixed income investing requires an approach that is far more considered and nuanced than simply owning "the market".

Despite structural obstacles, we continue to find ways to generate attractive returns from our models' bond component by allocating to core positions in strategic funds that are run by some of the most experienced, talented and best-resourced managers in the business, alongside exposure to specialist areas away from the mainstream where opportunity and nuggets of value can still be found.

Currencies

Measured in DXY Spot Index terms, the Dollar gave up 3.01%, sliding from a 28-month high to post its worst quarterly performance for more than 2 years, as all but one of the 16 major currencies listed by Bloomberg - the Japanese Yen - strengthened in USD terms.

Leading the long list of gainers were the South African Rand (+7.86% in USD terms) and New Zealand Dollar (+7.52%), which reversed their losses over the preceding period. One of the principle reasons for that decline in the DXY was the surge in Sterling following the decisive outcome to the UK general election that paves the way – finally! – for the next stage of the Brexit process: Parliament's ratification of the withdrawal agreement. In terms of its own trade-weighted index, the Pound's 4.84% gain was its biggest since Q2 of 2009.

BoE GBP effective exchange rate

Source: Bloomberg

Another notable feature of the period under review was the strength in the Chinese Yuan, which moved back through the CNY/USD 7.00 threshold that was breached in August, much to the disapproval of the White House and US Treasury Department, who accused Beijing of "weaponizing" its currency as part of the countries' ongoing trade conflict. Given the subsequent direction of negotiations and FX movements, it's difficult to argue with their position.

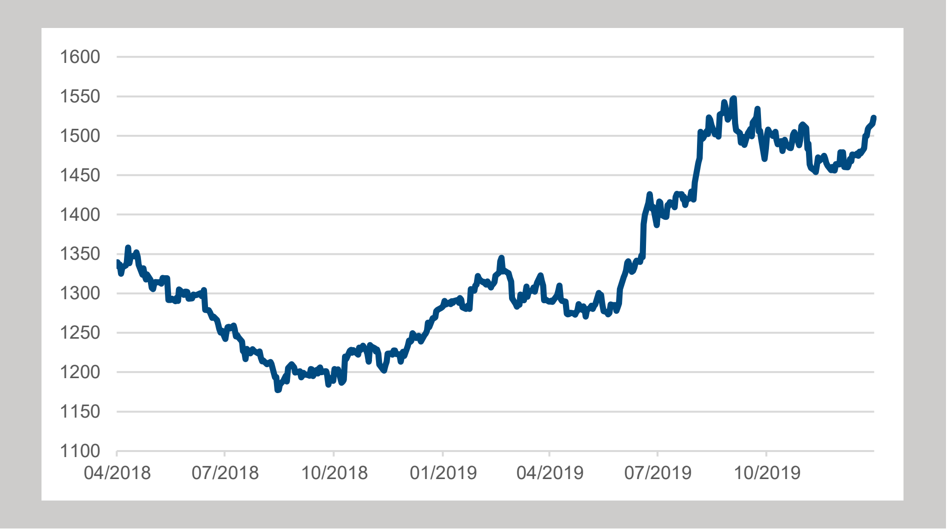
Commodities

Movements within commodity markets echoed the buoyant conditions within other asset classes, with the Bloomberg Commodities Index up 4.42% in USD terms for the quarter.

As a sample from the league table of returns from that index's constituents attests – Coffee +28.23%, Brent Crude +15.72%, Wheat +12.71%, Copper +8.06%, Silver +4.53% - there were healthy gains across most of the complexes. While, numerically speaking, losers were very much in the minority, there were nevertheless some sizeable negative moves (Nickel -17.97%, Natural Gas -17.79%, Lean Hogs -15.31%).

Gold's somewhat muted showing - the bullion spot price closed up 3.55% at 1,522.81 per troy ounce – was nevertheless significant in that, being a fifth successive quarterly increase, it marked its longest winning streak since 2011 and topped off the best year (+18.82%) since 2010. Among the many schools of thought as to precisely what drives the gold price (in reality, it's more than just one thing, especially over the short term), one of the more persuasive is a negative correlation with US real yields. This would certainly go a long way towards explaining why it has risen consistently within a period of markedly varied market conditions over the period we have highlighted.

Gold Spot USD per oz



Source: Bloomberg

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