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INVESTMENT REVIEW

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QUATERLY INVESTMENT REVIEW

2018 was a brutal year for financial assets. A chart issued by Morgan Stanley shows all 17 major asset classes down for the year. Fixed income and equities in both Developed and Emerging Markets, and Commodities all fell. The indices disguise the true extent of the damage. The index heavy weights held up relatively well, while many smaller stocks were ravaged, but the year was epitomised by the 60% fall of General Electric, perhaps the most iconic company of the twentieth century. This performance was the more surprising as the US achieved strong economic growth and companies' earnings growth were further boosted by the tax cut. It is unusual that equities decline when the US is doing well, or that bonds and equities decline together. The final quarter saw the stock market fall at its most intense. This seemed odd. If one had been told on 1st October that over the next three months the Federal Reserve would indicate a lower trajectory of interest rate rises, that the oil price would drop 40%, and that there would be less confrontational news on the US-China friction and the Italian budget stand-off, one would not have anticipated such a plunge. By year end the World Index had fallen 10.44%, while the US index fell 6.24%, of which 9.18% was in December alone, and China had fallen 24.59%. The yield on the US 10-year bond rose from 2.40% to 2.68% during the year. Bitcoin which was at the centre of speculation a year ago fell 75%.

What has caused this upheaval? Probably the most significant factor has been the rise in interest rates and winding down of the policy of quantitative easing. Liquidity is the life blood of markets and its steady withdrawal in 2018 created a hurdle for all markets. Adding to this pressure was the rise in the oil price from $60 to $76 from January to September, though this reversed violently in the final quarter. There is increasing evidence that the interest rate cycle has turned and the pressure on rates is upwards. After 30 years of capital being dominant over labour, the combination of strong employment and populism gives labour a stronger hand to obtain a larger share of the pie. Other issues have changed in the last year which don't look like reversing soon. Most obvious is the change in the atmosphere in Washington resulting in bi-partisan pressure against China with global ramifications. The last 20-30 years has been remarkable for the global co-operation on trade, regulation and ideas. By year end we had reached the point where it was a relief that Trump wasn't raising tariffs to 25%. A year ago any increase in tariffs seemed almost unthinkable. More generally in politics the rise of populism and nationalism is not going away soon. A further change is that the US has weaponised its legal and financial systems, for example the threat of sanctions on Iran, and the arrest of the CFO of the Chinese company Huawei. Such constraints on world trade represent a further headwind for profits and increase uncertainty. During the second half of the year it was as though the market was trying to work out what might be the best strategy in this environment, hence the violent sector rotation that has made life so difficult. Thus the oil price and technology stocks were both very strong and then suddenly collapsed. Such markets give multiple opportunities to lose money because one always tends to be late, and the goal posts keep moving so it is hard to invest with confidence.

The background problem for world economies and markets is debt. Debt levels are significantly higher than they were at the time of the financial crisis in 2008. The long disinflationary period that started in the early 1980's was due to a combination of western economies being restructured, a billion people entering the labour force as a result of globalisation, and latterly technology. The consequence was a long period of low interest rates which encouraged people and companies to borrow in ever greater amounts. The only way to reduce this debt is via repayments, write-offs, growth or inflation in some combination. Structurally the problem is that inflationary pressures are becoming evident as labour markets tighten, a situation exacerbated by the

shrinking demographics of working populations. Rising trade barriers are coming at a bad moment. Evidence of this include Amazon increasing its minimum wage to $15 an hour for its 350,000 US employees, Spain increasing its minimum wage by 22%, and France giving households tax concessions of €10 billion, while French firms are starting to offer pay rises and bonuses (Total just agreed a 3.1% wage rise and €1500 bonus for all its French employees). It is remarkable that even with full employment governments feel the need to bow to social pressure to remove austerity. As inflation creeps up so interest rates will slowly rise, and that will curb the growth of debt. It is likely this is the start of a multi decade process. As interest rates rise indebted entities will be forced to change their behaviour, and pay down their borrowings. A sign of the future may be the issue by Unicredit (one of Italy's better banks) of a US$3bn five year senior bond, in which the coupon was 7.83%, about 5% above the Sovereign rate. Structurally rising interest rates will be a headwind for property, credit or bonds. It is concerning that corporate credit quality is far worse than it was in the last business cycle. In 2008 approximately one quarter of US, UK and Eurozone investment grade bond indices were comprised of the level one notch above junk; today it is over half. This is the situation in a period of reasonably benign economic growth, and begs the question of what will happen when growth deteriorates. Fixed income, therefore, may not provide the shelter that it has historically. Moreover the current tech boom is different to previous ones in that it is not feeding broad growth. It is a disruption boom in which the tech giants disrupt traditional sectors and eat into rather than expand the economic pie. This disruption further undermines the credit worthiness of many companies as their balance sheets become vulnerable to innovation. An additional problem is that a lot of credit is held in baskets like ETFs, which are often held by people looking for yield. They may be weaker holders in a crisis than the more specialist investors in the past.

While potential credit problems have been discussed for some years, the trade dispute between the US and China was a new development in 2018. For China this trade war comes at an inopportune time, as it complicates the already difficult transition of its economy from being less debt driven to more consumption based. In this context it is important to understand that China's foreign reserves help to determine commercial bank lending limits through reserve requirement ratios. The American attack on its trade surplus thus has direct implications for China's economy. Whilst these limits can easily be amended by changes in the ratio, monetary policy becomes more erratic when that monetary base is unstable. China's problem is that the existing growth model is suffering from diminishing returns and is more dependent on ever larger amounts of debt. More acutely the growth is dependent on investment that is less productive, and backed by a dwindling pool of domestic savings. Meanwhile China's credit growth remains formidable: China's M2 money supply is equal to that of the US and Eurozone combined. Capital controls trap this money inside China which props up domestic assets, and it is important to China that this liquidity stays at home. Slowing growth could prompt capital to leave China (legally or otherwise) which would undermine property values and risk a financial crisis. One solution would be a currency devaluation but that would risk exacerbating the trade war and encouraging capital flight. Another would be liberalising the economy but, while reforms are slowly happening, President Xi has preferred a dirigiste centralised model. In many ways China is a 21st century economy with a 19th century financial system. While there is a big investment opportunity in closing this gap, it means that as China juggles its domestic issues in the face of combating a pugnacious US foreign policy, China is likely to be a source of volatility for the next few years. In any event there is a limit on what they can do to appease the US. Trump's position is inherently irrational – the US is unlikely to have a shrinking trade deficit when it is having a massive fiscal expansion. It is unlikely that a clear resolution will emerge between the US and China soon given the entrenched antagonistic position each side has taken, but the two economies have become so intertwined over the past 25 years that any serious decoupling would create such damage that it should force the politicians back from the brink. This situation is of paramount importance as the health of China's

economy has become increasingly vital to the world. It is the most important country in a number of sectors, and easily the largest contributor to world growth over the last decade. Any serious threat to its longer term growth would have repercussions for all markets.

Europe was again the most disappointing of the major regions. Post the 2008 crisis few of the needed institutional and political reforms that are necessary were taken. Instead years of austerity have opened the breach for strongly nationalistic forces to take power in Italy, Hungary and Poland. The anger is generated as much by income inequality and job insecurity in the middle classes as by poor GDP growth and unemployment. Populist politicians are succeeding not because they are offering convincing solutions, but because mainstream politicians are failing to offer any vision. The European elections are in May and, depending how many seats the populist parties win, will determine how Europe's problems will be tackled for the next five years. The Brexit situation will at least have more clarity by the end of the first quarter. If there is no deal the UK faces a year of significant disruption. Longer term what will be interesting is how the economy adapts outside the Eurozone. If it flourishes it will place more pressure on the current configuration of the EU, as countries that are struggling under the present set up will wonder whether life will be better outside the POW camp.

It is a sobering fact that the MSCI World ex-US Index is at the same level as it was at the end of 1999. Fans of index investing should be given pause by the fact that the leading indices in Europe, UK and China are at twenty year lows. The US has been the exception not the rule; elsewhere there has been little or no capital return for getting on for two decades. The recent mania for ETF investing leads to the uncomfortable possibility that investors may have been herded into relatively illiquid investments which offer far less diversification and protection than was thought. Even in the US where the index has performed strongly it has been disguised by the stellar performance of technology stocks, epitomised by the FANGs. The problem with the FANGs was that many investors bought them late without regard to valuation. They became overvalued as they were buoyed up on a tide of liquidity and were one of the sectors to be hit hardest when the liquidity receded, at the same time as they faced a more challenging regulatory environment. The US/China spat can also hurt the FANGs because tech may stop being a global ecosystem and bifurcate into east and west pools, making the sector more complex and harder to evaluate. The FANGs Achilles heel is that much of their employee compensation is paid in stock options which require a constantly rising stock price. If the share price stagnates the company either loses the employee or has to pay cash to retain them. Their ability to take over other companies using their stock as currency will also be reduced. Tech stocks would also suffer from rising bond yields because it reduces the value of future cash flows. Equally danger could be looming for some 'defensive' companies whose revenues don't change much but could be impacted by rising input costs such as labour or discount rates, and therefore whose profits are vulnerable. Many investors have hidden in companies with reliable earnings stream and steady dividends. If we are in the early stages of an interest rate change then that may no longer be a safe strategy. On the positive side rising bond yields should bias stock selection away from momentum chasing and towards fundamental value. Markets follow fashions and can push ideas to an extreme both ways. Ten years ago David Einhorn was lauded by the investment community as the man who spotted that Lehman would fail. He has consistently followed a value strategy. In 2018 his quoted investment vehicle fell 58% and trades at a discount of 37% (it used to trade at a premium). Meanwhile Terry Smith, an equally lauded guru who follows a growth strategy, launched an Investment Trust for mid cap stocks with the aim of raising £100m. The issue took in £800m, and subsequently issued more stock at a premium. It ended the year trading at a 6% premium. Even more incredibly this fund is not even managed by him. Both investors

have exceptional track records over the longer term, but it is hard to avoid the conclusion that investors have tilted too far away from value in favour of growth. Morgan Stanley's share price fell 25% in the year despite earnings estimated to rise 35%. Some stocks declined by 40% in December alone on no news, which suggests a complete capitulation. Both Japan and Emerging Markets have seen prices experience thudding declines which do not appear to be justified by the results that the companies have reported, creating value in both debt and equities. The UK market has the backdrop of the Brexit negotiation shambles, but even the FTSE 100 index has a yield of close to 5%, and many companies are trading at decades' low levels. Such a divergence of fundamentals and valuations begets opportunity.

As we start 2019 the two big risks for investors are a slowdown in China or further rises of interest rates, most likely caused by the blowing out of the US budget deficit or inflationary pressures. In any event balance sheet strength is going to matter more going forward than it has the last few years. The dramatic fall of the price of oil in the last quarter has the effect of a giant tax cut for western consumers worth over $1 trillion at current prices, and if the economy avoids recession and US ten-year bond yields remain below 3.3% that is a constructive environment for many stocks. After such a disappointing performance in markets in 2018 the opportunity set has improved, but it will probably be realised more on an asset by asset basis than by specific sectors. Selectively equities can prosper but that is unlikely to be at the index level, it will require careful stock picking and an ability to withstand considerable volatility.

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