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INVESTMENT REVIEW

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QUARTERLY INVESTMENT REVIEW

Equity markets staged a strong rebound during the first quarter, following the precipitous sell-off in the last quarter of 2018. From mid-September to mid-December global markets had fallen almost 20% as investors chose to see the worst in all the long list of troubling issues: the trade wars, US government shutdown, rising debt levels, Brexit and Italy. However it has become clear that the most important factor driving the markets down and then up was the tightening of liquidity by Central Banks that took place last year, and the easing measures that they have put in place since then. Last year's tightening was severe. It is estimated that the combination of the Federal Reserve's interest rate rises together with its program of quantitative tightening was equivalent to a total interest rate increase of 5% in the US last year. China was also implementing a more restrictive policy. The effects of this overwhelmed the steady economic growth and reasonable corporate earnings that were announced. Investors should expect that if liquidity tightens again then the effect will be something similar to what we witnessed at the end of last year. The main difference is that Central Banks are more alert to markets' fragility than they were six months ago. The Federal Reserve has indicated that they will keep interest rates where they are till the end of this year, and significantly reduce their quantitative tightening program. Meanwhile the economic backdrop has become much more subdued this year. US growth has slowed and has become increasingly debt dependent; for example last year while US economic growth was 3% US national debt increased by 7% of GDP. Germany is close to recession and China's growth has fallen to the lowest since 1990. The fragile nature of the world was perhaps best indicated by the shocking sight of foodbank lines in Washington DC just one week after the government shutdown there began. The pictures of government workers lining up for aid so quickly show how precariously the middle class live in the world's major economy. It was a stark image of the reality of the squeezed middle class, and a reminder of the reasons for the resentment against the establishment, the rise of populism, and the backlash against capitalism and globalism. This is forcing politics to be more isolationist and nationalist and inward looking. There is also a sense that we are seeing the end of the post-1945 world order.

Debt markets rallied hard during the quarter with the benchmark US 10-year rate falling from 2.68% to 2.40% in response to a slower growth outlook. At the end of the quarter Germany issued a bond with a negative yield, and the total of negative-yielding debt surpassed $10tn. In February a two year bond was issued in Japan for the Japan Student Services Organisation with a yield of 0.0000188%. It was 4.5x oversubscribed. This despite some evidence that some wage inflation appears to be taking hold in the US and Japan, and the US fiscal deficit is expanding at a point in the economic cycle when it should be contracting. US private sector wage growth in 2018 reached 4-5% in many sectors. Where are the *gilets jaunes* of the bond market? As the various Central Banks peddle back on their quantitative tightening program the financing needs correspondingly grow. Buyers will need to be found at a point when competition for debt is rising. Global debt has climbed by $100 billion since the financial crisis and sits around $240 billion. China has been a big buyer of US Treasury bonds in the last two decades but as its economy slows and reorients from an export model towards one more focused on domestic consumption it will want to keep its savings at home and will have less surplus funds to invest abroad. Likewise the energy-producing Middle East has a demographic boom, and with oil prices lower and an expanding social welfare budget it is having to come to the capital markets for financing, becoming a competitor for funds rather than provider of them. Perhaps the greatest risk in debt markets lies in the corporate sector. US companies have been prolific issuers of new debt, much of it poor quality. The 'investment grade' market is far larger today than it was heading into the 2008 crisis. When a recession eventually arrives a lot of this debt will turn sour.

The US equity market recorded a strong quarter despite earnings growth showing signs of fatigue. The recovery has been broad based and overcame two warnings at the start of the quarter from Apple and Tesla, which have been talismanic stocks in the bull market of the last decade. Markets started the year from a point where they had been substantially de-rated, so the performance was partly a correction of the previous overreaction. But with economic activity slowing growth stocks performed much better than value. The FAANGs bounced strongly. Their power can be seen by the fact that they spent $94 billion on research and development last year, or 20% of the total in the private sector. However their size now means that their growth is increasingly tied to the economy, and competitively they are bumping into each other. It will be hard for them to outperform going forward, particularly as governments threaten their monopolistic positions, and it can be argued that they have reduced competition as they buy out emergent competitors. This practice is a concern for investors as bull markets require fresh blood in the form of young companies that can generate strong future returns. The likes of Microsoft in 1986, Google in 2004 and Facebook in 2012 provided this. Investors need a new batch of young and innovative companies with strong growth prospects so they can participate in their success. Many such companies have disappeared as the giant technology companies swallowed them at an early stage. It may be a bad sign that the companies that are planning to list are heavily loss making companies like Uber, Lyft and WeWork before investors' appetite for financing these heavy losses fades. Their arrival on the market will also lead to more scrutiny of companies that have never shown a profit, as it is starting to do with Tesla. Tesla's stock price is trading at a two year low, which is one sign that investors are less forgiving of 'blue sky' companies. Meanwhile there is little sign that investors are re-orienting towards value stocks, and the probability is that there will need to be a pick-up in interest rates before they do. Yet value investing has trounced growth over the past century. There have been three periods when value stocks have fallen badly behind growth: 1929 – 1939, 1998 – 2001 and 2009 to now. Eventually the current bias against value should change, and if so a large opportunity is forming. More generally the challenge in the US is whether current conditions - extreme fiscal stimulus, exceptionally low interest rates, and strong employment growth – can improve much. If they do it may not be viewed positively as it will start to hit output limits, particularly in regard to employment. Much of the US market is richly priced and it will need to see a convincing case that earnings will rise to move up from here.

China's financial markets also enjoyed a good quarter while its economic growth was much slower. China's growth has been decelerating since the middle of last year, as reflected in declining car sales and a drop in property sales volume, as well as a loss of momentum in capital expenditure by both private companies and government related affiliates. The primary driver of this slowdown was the tightening of liquidity which was part of the deleveraging campaign. At the start of the year the authorities eased back on this tightening and that lifted sentiment. Ironically, the trade war actually supported export growth as manufacturers rushed to fill orders to beat the feared imposition of new tariffs in January, but this leaves a nasty gap in likely export activity in the first half of 2019 even though additional US tariffs have been postponed and there are hopes for a constructive trade deal with the US. What is interesting is that as the focus of the talks is increasingly on the battle for supremacy in technology, the Trump position is being quietly endorsed by OECD policymakers from London to Tokyo. There is considerable sympathy for the concerns he raises, but abhorrence for the disregard he pays to traditional diplomacy. Nonetheless the venom that was evident for much of last year has retreated, and there is a more constructive debate. However if China is coerced into changes these will come at an awkward time for them as their economy is already undergoing several changes. China's consolidated debt has more than doubled in the last decade to 300% of GDP. Much of the debt has ballooned in the shadow

finance sector. Yet despite the rally there are a number of attractive opportunities in Chinese equities. More generally in emerging markets the performance has continues to lag that of the US. However the valuations are far more compelling. As one illustration the entire market cap of Indian equities is equal to that of just three US stocks – Microsoft, Apple and Amazon.

European growth has also deteriorated. If short term interest rates do not rise above -0.4% at the top of the cycle, you know you have a very sick underlying economy. Concern is mounting that Europe is getting stuck into the kind of slump that endured in Japan for over twenty years. The problem is most acute in Italy. The Italian economy has grown just 0.5% over the last decade. A combination of a shrinking working-age population and increasing spending obligations will further squeeze Italy's investment in productivity enhancing areas, such as education and digital infrastructure. Since 2009 government investment spending has shrunk 30%. Similarly, in 2016 Italian public spending on education was just 3.9% of GDP, the fourth lowest in the EU. Relative to total government spending, it was the lowest of all. Eventually Italy will default, though it may be presented as a restructuring. The most likely catalyst is a US or global recession because Italy is sensitive to global demand. With a debt burden six times the size of Greece this will be a significant event. It would not be surprising if Europe sees more social unrest. In France protests extracted €10bn from the government. Sometimes it pays to riot. Nonetheless the outlook for European domestic equities remains problematic. It is hard for them to do well with so little growth.

Investors face a problematic environment. Bonds are unattractive, and in some cases unsafe. This leaves equities as the best option, but the emphasis on careful stock picking has increased. Markets have had a strong quarter so a consolidation period should be expected. There is attractive value in a number of areas but this will require patience to unlock. With the US market richly priced the longer term opportunity should be in Emerging Markets, but this is unlikely to be realised until the US China trade dispute has a resolution.

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