## Economic Background – 2018 in review

### Overview

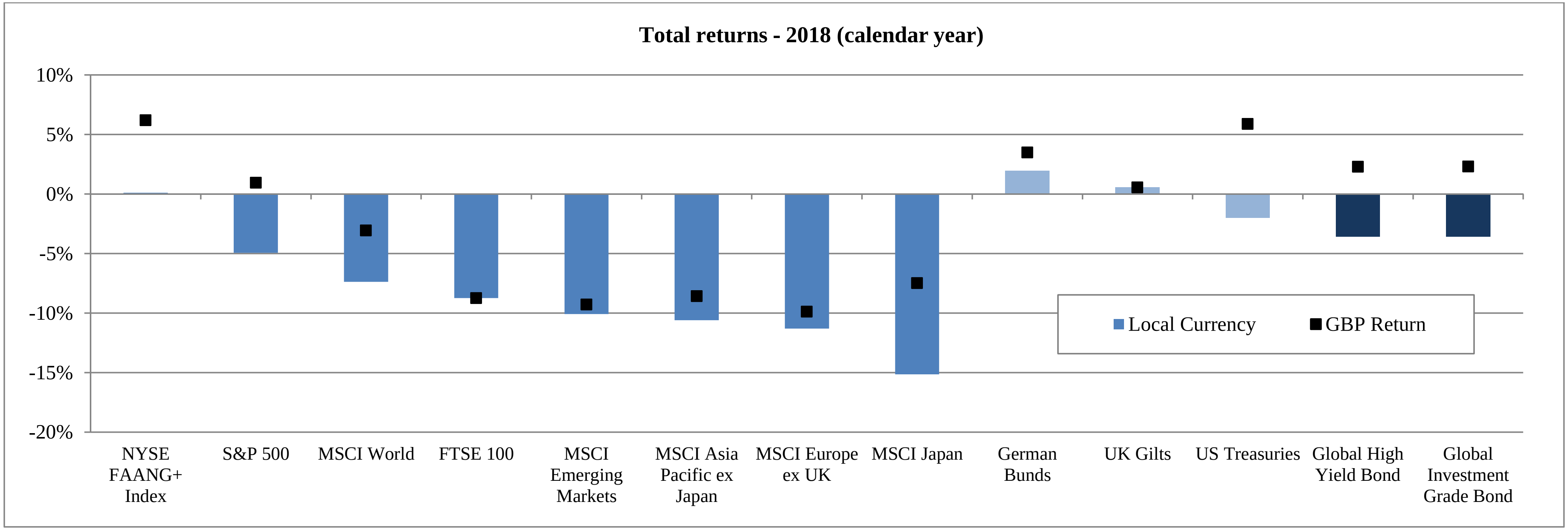
2018 was a difficult year for investors with falls in all major stock markets and many other asset classes. Cash was amongst the best performing asset classes for US investors, and the same would have been true in the UK if the fall in Sterling had not enhanced the returns generated by overseas assets. Hedge fund and property indices fell over the year.

The FTSE 100 index fell by over 1,000 points or 12.5% (in capital terms) to end the year at 6,728 (having started the year at 7,688). Dividends remained strong and once these are taken into account the FTSE 100 index lost 8.7% over the year on a total return basis.

Many other global equity markets fared worse; the MSCI indices for Europe ex UK, Asia Pacific ex Japan and Emerging Markets were down by 11.3%, 10.6% and 10.1% respectively in local currency terms (losses in Pounds Sterling were slightly lower).

The MSCI Japan index fell by more than 15% over the year, although the strengthening Yen reduced the loss to 7.8% in Sterling terms. American stockmarkets also fell with the S&P500 index down by 4.9% over the year, but currency movements converted this into a gain of just under 1% in Pounds Sterling.

As equity markets fell we have seen a rebound in traditional safe haven assets including gold, Japanese Yen and government stocks. The price of gold rose by nearly 5% in December and is up by 9.8% over the last quarter (in Sterling). The Yen rose by around 3.7% against Sterling and the US Dollar in December and has appreciated against most major currencies over the last quarter, despite the Japanese Central Bank continuing to adopt an ultra-loose monetary policy.



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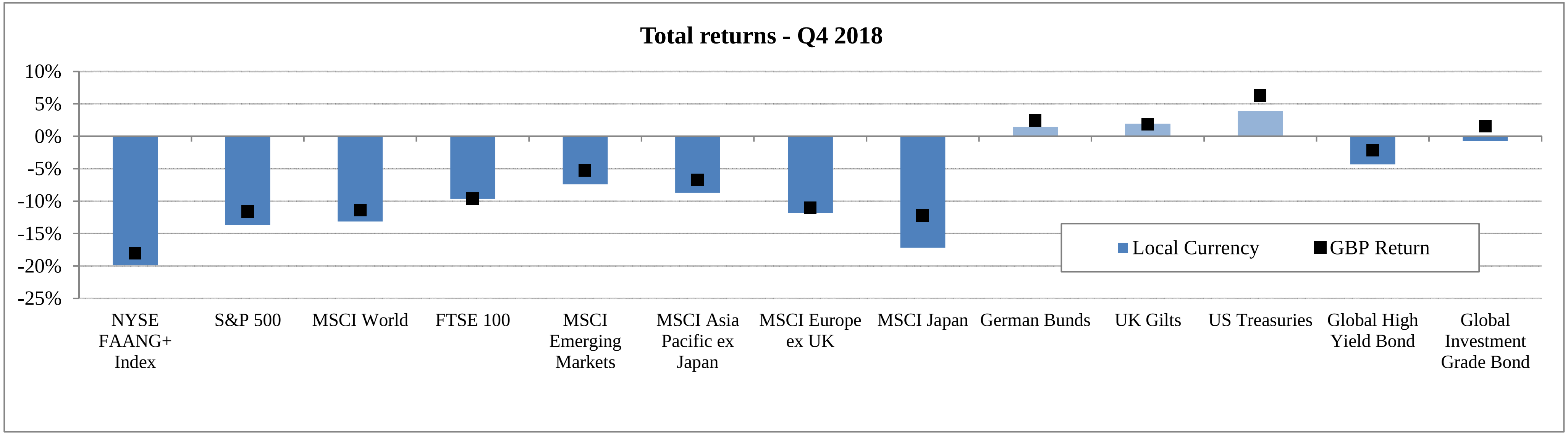
Most of the damage to stockmarket returns was done in the final quarter of the year. The FTSE 100 lost 9.6% over the final three months, whilst the S&P 500, MSCI World and MSCI Europe ex UK, and Japan indices all fell by more than 11%. American stock markets were particularly volatile in December with technology stocks down by around 20%. Falls in US stockmarkets would have been more severe had it not been for a sharp rally of around 7% from 26 December to the end of the year; The Dow Jones index rose by over 1,000 points (or more than 4%) on 26 December alone.




**Fixed income markets**

US Treasury stocks fell in value over the first 10 months of 2018 as the US economy continued to grow and the Federal Reserve steadily raised interest rates. The yield on the benchmark US Treasury rose from 2.4% at the start of the year to 3.2% at the end of October (the price of the Treasury stock is inversely related to its yield). Concerns about the US China trade dispute and its implications for the US economy, and the relative attractiveness of the yield on offer led to increased demand for "safe" Treasury stocks. This increased demand has driven prices up and the yield down to 2.7% at the year-end (and to below 2.6% at the beginning of January). December saw the US yield curve invert for the first time in a decade as demand for long dated Treasuries has driven yields down. Historically this has been seen as a signal that a recession is imminent.

UK government stock yields have followed a similar path although the UK yield curve shows no sign of an inversion and longer term government stocks command higher yields than shorter dated gilts. Yields have fallen over the year with the 10 year UK Treasury Stock yield falling from above 1.7% in October to below 1.3% at year end. This has seen the price of gilts rising over the last three months with the price of 2.5% Treasury stock maturing in 2065 increasing from around £115 in mid-October to just over £125 at the year end. At this level investors are paying a 25% premium for an income of 2% with a guaranteed capital loss of 20% if held to maturity. This would appear to be an extremely high price to pay for a modest guaranteed income given the inherent uncertainty over UK finances, interest rates and inflation post Brexit.

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### Global economic growth

Whilst UK news is dominated by concerns over Brexit, the rest of the world is focused on the relations between America and China. Trade talks are continuing into 2019 and whilst there have been signs that China is willing to negotiate, concerns that the dispute will reduce global economic growth have weighted on global equity markets. Interestingly despite the imposition of tariffs on $250 billion of Chinese goods, America's trade deficit has continued to rise, reaching a 10 year high of $55.5 billion in October. The narrower, but politically important goods trade deficit with China rose to $43.1 billion.

China's growth has been reducing for some time, despite efforts by the Chinese authorities to bolster growth by encouraging further bank lending. Chinese and Asia Pacific markets had already reflected this slowdown to some extent but Apple's recent announcement that earnings would be lower than expected as a result of falling Chinese sales came as a surprise to many investors. Apple's market capitalisation has fallen by more than 30% since it became the world's first trillion Dollar company in August.

Economic figures from Germany have been disappointing. Whilst the Bundesbank has continued to make positive statements about growth, November's industrial production figures suggested output was down by 4.7% over the last year, the biggest fall since 2009. France has experienced significant levels of economic unrest, with disruption from the "gilets jaunes" now into its third month. Alongside this Italy's budget dispute with the EU has driven Italian government bond yields to their highest level since the Eurozone debt crisis of 2010-12.

Political issues continue to complicate matters. The US government is in partial shutdown following the impasse over President Trump's insistence on funding for his Mexican wall (amongst other things the partial shutdown has reduced the economic data available for the world's largest economy). Special counsel Mueller's investigation into President Trump's actions during the election campaign continues to grow and whilst the impeachment of a sitting President remains unlikely, it cannot be discounted.

UK politics remains mired in discussions on Brexit.

### Stock market sectors

Technology shares have risen sharply over the last few years, with the FAANG (Facebook, Amazon, Apple Netflix and Google) and BAT (Baidu, Alibaba and Tencent) companies generating a high proportion of the growth in global stockmarkets in 2016 and 2017. Chinese technology companies stuttered in the first quarter of 2018, and more recently we have seen significant falls in a number of the original FAANGs and Apple, Facebook and Netflix have each seen their market capitalisations fall by more than a third since the summer. Our investment portfolios have had only limited exposure to technology companies, and where this does exist it has been to more traditional and profitable technology businesses such as Microsoft.

Energy markets are closely linked to expectations of global growth and the oil price has fallen by over a third in the final quarter. Brent crude is down by just over 15% in Dollar terms in 2018 (or by 10% in Sterling). This has had an impact beyond the oil and gas majors with other companies involved in energy production and petrochemicals also seeing their share prices fall. The falling oil price also has implications for high yield bonds as a number of shale gas companies are funded by debt. Our preferred funds have negligible to no exposure to high yield bonds.

Tobacco shares have fallen sharply during 2018 with the UK tobacco sector down by 41% over the year. The global tobacco index is down by around 30%. Whilst the major tobacco companies remain very cash generative concerns over tobacco replacement products have outweighed the attractive dividend yields. A number of our preferred funds continue to have exposure to this area and whilst these exposures have reduced over the last few years we will be reviewing these holdings as part of our regular fund manager meetings.

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### Outlook

We have been arguing that investment markets have been stretched for some time and whilst we have avoided the areas most affected by recent market falls (technology and Chinese markets), the extent of the recent market correction has driven all equity markets down.

Despite these falls we continue to regard equities as an attractive source of long term growth. Statements by the US Federal Reserve over the Christmas period have indicated a significant change in policy and it now seems unlikely that US interest rates will rise as quickly as expected only a few months ago. Jerome Powell (chair of the Federal Reserve) confirmed that the "Fed would be willing to adjust policy quickly… to support the economy" and this more supportive stance was one of the key reasons for the sudden rise in US shares at the end of December. Powell went on to confirm that the Fed would consider using its balance sheet to support investment markets if required. The removal of the "threat" of further interest rate rises and the suggestion of support should help equity markets in the short to medium term

Whilst recessionary risks have increased, economic data from the USA remains broadly positive with growth expected to be around 2% in 2019. The Chinese economy and the potential for the US- China trade relations to deteriorate remain key risks to global growth, but most observers expect some growth to continue.

Brexit remains a major quandary for UK investors. With less than three months until the 29 March date for leaving the EU we have no clarity on what form of Brexit to expect. For understandable reasons global investors have shunned UK shares since the 2016 referendum, and by some measure UK shares, particularly those of domestically facing companies, are significantly undervalued. On the assumption that the uncertainty over Brexit will reduce over the next few months, and provided that the final Brexit process is less than dreadful, there is scope for UK shares to perform well.

We continue to view fixed income investments as expensive, particularly following the recent rally in these areas. Volatility is likely to continue and cash will continue to provide a useful source of flexibility in the short term.