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Economic Background – March 2019

A positive start to the year

After the sharp falls in the final quarter of 2018 global equity markets have rebounded strongly since the start of the year. At the end of February the US S&P 500 index was up 11.4% (in US Dollars) whilst the MSCI indices for Europe ex UK and Asia-Pacific ex Japan (in local currencies) had risen by 10.7% and 9.7% respectively.

UK investors have seen these gains offset by the recent strength of Sterling. Despite concerns over Brexit the Pound hit a 21 month high against the Euro at the end of February, and has risen against the Dollar and Yen since the start of the year. These foreign exchange movements have reduced the year to date returns for UK investors to 6.6% for the S&P 500, 6.3% for the MSCI World and around 5% for European and Asia-Pacific stock market indices. The strength of Sterling also weighed on the overseas earnings of the FTSE 100 index of the UK's leading companies which generated a return of just over 6.0%. The broader FTSE All-share index rose by 6.6%.

The recovery in share prices in January and February has been sufficient to offset most if not all of the sharp losses incurred by global stock markets in December. The FTSE 100 index is now showing a modest positive return of 2.3% over the last quarter and the S&P 500 index (which was down by 15% in late December) is showing a positive return of 1.3% in Dollar terms (although currency movements translate this into a loss of 2.9% in Sterling). Whilst global stock markets remain lower than they were last summer, UK and American market indices are now showing gains over the last 12 months despite the recent turmoil. Other global equity markets have not recovered as strongly and European, Asia-Pacific, Japanese and Emerging Market indices are showing losses over the last 12 months in both local currency and Sterling terms.

Whilst equity markets have seen increased levels of volatility, global debt markets continue to show signs of significant distortion. Over the course of last year we saw yields on global government debt drift upwards with a corresponding fall in prices; the benchmark US Treasury yield rose from 2.4% at the beginning of 2018 to 3.2% in November (a five year high). We saw this move a healthy readjustment to more "normal" and sustainable levels of yield and US government bond prices fell back to more reasonable price levels.

December's volatility saw a sharp increase in demand for these perceived "safe haven" assets (as well as other government bonds, gold and Japanese Yen) and yields fell with the 10 year US Treasury yield ending the year at 2.7%. Yields on most government bonds have followed a similar trajectory; Swiss and Japanese 10 year bond yields have fallen back below zero (guaranteeing a negative return for investors who hold the assets to maturity) and the UK equivalent Treasury Stock yields just 1.2% despite uncertainty over Brexit.

Over time we expect these yields to rise and prices to fall as the extraordinary period of loose monetary conditions following the Global Financial Crisis comes to an end. Corporate credit markets offer higher yields but with additional risks. There are disturbing signs that the quality of covenants accepted by investors of corporate debt is reducing as fixed interest investors place more importance on current income levels rather than any protection against default.

The importance of the Federal Reserve and the emergence of the "Powell Put"

Stock market movements over the last quarter have illustrated the importance of the Federal Reserve to US and global investment markets, and there is little doubt that the recent recovery in global stock markets is largely due to the US Federal Reserve's change in policy in late December.

Jerome Powell was appointed chair of the Federal Reserve in February 2018 and continued to increase interest rates throughout 2018 as the US economy performed well. Statements from the Federal Reserve consistently reiterated the need to move away from emergency levels of interest rates to more "normal" levels.

> *"The really extremely accommodative low interest rates that we needed when the economy was quite weak, we don't need those anymore. They're not appropriate anymore ..." J Powell, October 2018*

In the final quarter of the year investors became convinced that the Federal Reserve was determined to increase interest rates even if this risked driving the US economy into recession.

On 18 December, despite widespread concerns (including some very pointed and personal criticism from President Trump), the Federal Reserve increased interest rates by a further 0.25% (to a range of 2.25% – 2.50%). Equity markets fell further in response and by 24 December the S&P 500 index was down by 15% since the start of the month.

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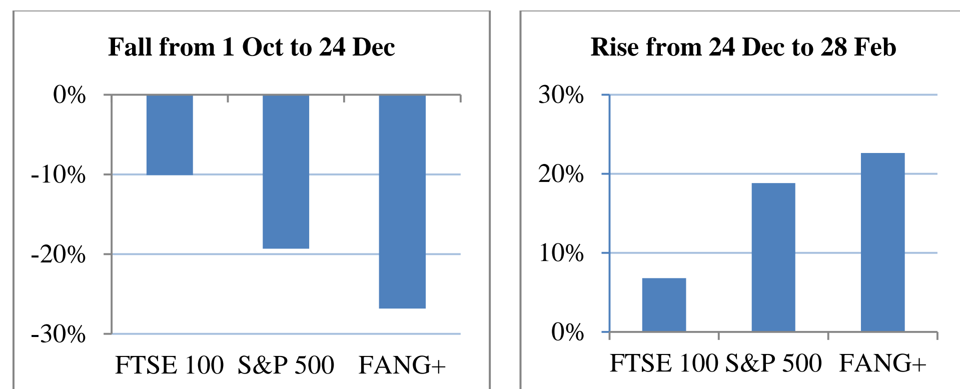
Over the Christmas period the Federal Reserve abruptly changed direction, with announcements that future interest rate increases were far from certain and that the central bank would take whatever measures were required to help protect the (US) economy. Some members even went as far as suggesting that this might include a further asset purchase (quantitative easing) programme if required. At a conference in Atlanta Powell stated that:

"We will be prepared to adjust policy quickly and flexibly and use all of our tools to support the economy should that be appropriate," J Powell, January 2019

The charts below show the fall in UK and US stock markets over the last quarter of 2018 (to Christmas Eve) and the rebound in the period to the end of February. The figures are shown in local currencies and UK investors will have experienced less extreme movements in value as a result of Sterling's strength. The FANG + index is an index of global technology companies listed in the US.



This active approach to supporting markets during periods of turmoil is not new. Alan Greenspan was chairman of the Federal Reserve from 1987 to 2006 and reduced interest rates following the 1987 stock market crash and injected liquidity in response to the savings and loan crisis, Asian financial crisis and the bursting of the internet bubble. Ben Bernanke adopted a similar approach following the global financial crisis and the European Central Bank (ECB) chairman, Mario Draghi, helped stabilise markets during the European debt crisis in 2012 with his comments that they would do "whatever it takes" to preserve the Euro.

This pattern of behaviour became known as the "Greenspan put", and whilst these actions have undoubtedly helped to reduce the impact of these events they have been criticised for creating a moral hazard, whereby investors are encouraged to take on increasing levels of risk in the belief that central banks will bail them out if something serious goes awry. It remains to be seen whether the "Powell put" will be called upon, but the rally in US and other global stock markets suggests that investors have taken a great deal of comfort from the Federal Reserve's more accommodative stance.

The Federal Reserve's change of direction removes a major headwind for the global economy as the US central bank was the only major bank looking to raise rates back to more "normal levels". Japanese and Chinese central banks are continuing to stimulate their economies and whilst the Eurozone's asset purchase programme was due to end in December it is likely that the ECB will be encouraged to find additional ways to inject some growth into the slow moving European economy. In addition to this ongoing financial support, inflation remains low with few signs of inflationary pressures and interest rates remain at historically low levels. These factors could help support asset prices for some time to come.

Global economic growth is slowing

Whilst the support of central banks has helped investment markets recover there are signs that global economic growth is slowing. UK (and EU) politicians appear to be incapable of finding a mutually attractive form of Brexit, and as the 29 March deadline approaches the risks of economic instability have increased.

At the same time there are concerns about the longevity of China's credit fuelled growth. A dramatic reduction in Chinese imports has had a major impact on countries such as Germany, and a wider slowdown has implications for commodity prices.

Brexit

The U.K.'s long-term economic outlook is heavily dependent on the outcome of Brexit. Whilst more than 2 1/2 years have passed since the Brexit referendum, it is still far from clear whether a Brexit agreement can be reached ahead of 29 March, the date on which

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the UK is scheduled to leave the European Union. The last few months have seen a series of defeats for the government's proposals, but political posturing from all of the major parties has prevented the emergence of a viable alternative.

An untidy or unplanned exit from the EU presents a major risk to the UK economy and is likely to have significant implications elsewhere. The consensus view is that a "hard" Brexit would lead to a significant fall in Sterling, either as a result of capital flight, or in the expectation of actions the government and central bank could take to insulate and protect the country during the period of adjustment. Despite the lack of apparent progress, Sterling has strengthened as we approach the 29 March deadline as traders have scaled back their expectations of a "hard" Brexit.

Notwithstanding the uncertainties of Brexit, the UK's underlying economy appears to be moving forwards. Most economic forecasts are suggesting that the UK will slow down in 2019, but January saw the UK Treasury record the highest surplus on record boosted by increased revenues from Income Tax, Capital Gains Tax and Corporation Tax. Income Tax and Capital Gains Tax receipts were up by 11% from the prior year. VAT revenues also rose by 5% on the prior year suggesting that consumer spending continues to grow. Labour market figures have also been encouraging figures with unemployment down from last year and recent estimates of the labour market suggest that 440,000 additional jobs were created in 2018. With earnings growth expected to outstrip inflation this should provide a real boost to consumer spending.

Global growth

Economic figures from the rest of Europe appear uninspiring, with Italy in recession and industrial production and exports falling sharply in Germany. Europe also has to deal with ongoing unrest in France through the "gilets jaunes" protests, and the potential collapse of the Spanish coalition government driven by concerns over Catalan independence. Despite these problems Eurozone GDP is expected to grow by 1.3% in 2019, slightly higher than the recent estimates for the UK, but not significantly so. A hard Brexit is also expected to lead to job losses in many European countries.

In contrast the US economy continues to perform well. Growth in the final quarter of last year was lower than in 2017 but the annualised growth rate for 2018 of 2.9% was higher than expected. President Trump's insistence on tariffs appears to be counter-productive as the initial imposition of tariffs on Chinese goods has helped the US trade deficit to widen to a 10 year high of $621 billion. Recent reports have suggested that the US and China might be close to reaching an agreement on trade that would allow the US to reduce or remove tariffs but we wait to see the fine detail of this. It is also concerning that President Trump is considering additional tariffs on European and Japanese car imports.

Japanese growth and inflation remain well below the targets set by the Bank of Japan and the 2019 budget shows increased spending and additional tax cuts in a further attempt to stimulate the economy. The Bank of Japan continues to actively purchase debt and shares within the Japanese investment market. Despite this Japanese stock markets have performed poorly over the last year with the Topix index down by 9% over the past year.

China remains a major source of uncertainty. It appears accepted that the rate of Chinese growth is slowing but it is unclear what real levels of growth are. This month is likely to see the latest growth target announced at the Annual People's Congress. The expectation is that the target will be set somewhere between 6.0% and 6.5% p.a., but most independent observers put real growth as significantly lower than this.

The Chinese authorities have taken a very active approach to managing their domestic economy and on occasions have injected extraordinary levels of stimulus to avoid a major slowdown. This has typically been in the form of additional lending or bank liquidity and there are signs that much of this lending has not been spent productively, with several indications of a property bubble. Debt relative to GDP has risen from 140% in 2008 to 250% in 2018. A recent report by Autonomous Research estimated that 24% of all bank loans will not be repaid and several studies have highlighted high levels of vacant properties in Chinese cities. China's management of these high levels of debt and asset bubbles over the coming years will have major implications for the global (and their domestic) economy.

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Summary

In short, whilst the US Federal Reserve's change of direction has produced a useful boost for investment markets, asset prices remain dependant on the tacit support from the world's major central banks. For the time being it does not appear to be in anyone's interest to upset this balance, but it is important to recognise that current valuations involve significant levels of risk.

At the same time global growth appears to be slowing and there are major questions about the sustainability of China's debt fuelled economic growth. There have been encouraging signs that US/China trade negotiations may help avoid the imposition and extension of trade tariffs between the world's two largest economies, but there is no guarantee that the talks will reach a successful outcome. The recent breakdown in talks with North Korea illustrates how quickly talks can fall apart.

Brexit remains a major source of uncertainty for the UK economy and for UK investors. Recent movements in Sterling suggest that markets are anticipating that it will be possible to agree an acceptable deal with the EU, or even that the UK will not leave the EU at all, potentially by means of a second referendum. Both courses are fraught with political danger, with the second option including the possibility of a change of government which could have major economic implications.

Increasing economic and political uncertainty is likely to result in further investment volatility.

Against this backdrop we continue to recommend that you hold sufficient cash reserves to take a long term view with your investments. Fixed interest investments offer a combination of low income and the risk of permanent capital loss if held to maturity, and we regard them as fundamentally unattractive at current prices.

Whilst equity markets are likely to remain volatile in the short term we continue to focus on funds run by experienced managers investing in profitable companies with low levels of debt. We believe that this approach offers the possibility of attractive real returns over the longer term with lower volatility than wider equity markets.

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