TORREVELL &PARTNERS

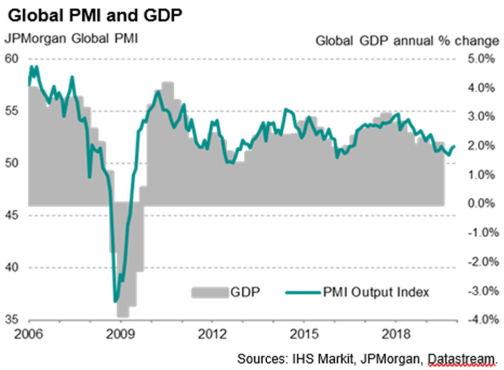
Economic Background – January 2020

When will those dark clouds all disappear[1]

After a tumultuous year of geo-political, political and economic change global growth has slowed to its lowest annual rate since the financial crisis. Growth slowing to 3% and a benign inflationary environment provided the backdrop for global central banks to cut interest rates and provide monetary stimulus. This volte face from the more hawkish stance in 2018 has helped drive the prices of financial assets higher despite macro risks remaining and elevated levels of uncertainty.

Rays of sunshine

We are currently experiencing the longest economic recovery on record. As the decade long expansion came under threat in 2019, we witnessed a resilient consumer and service sector, providing support and offsetting the weakness in manufacturing and global trade. Fears that a lack of confidence in the manufacturing sector would morph into recession for the rest of the economy did not materialise. Monetary stimulus from the US Federal Reserve (Fed), European Central Bank (ECB) and China helped to offset some of the barriers put in place by government policy.



More recently after nearly two years of slowing growth, there have been tentative signs of a pickup in activity. According to the latest IHS Markit Global PMI data, growth 'accelerated', with strong growth in the service sector and an easing of the drag from the manufacturing sector. Employment, new order inflows and business expectations all showed signs of improvement. Growth was led by the US but data for the UK suggested the UK economy was contracting, with concerns as to the outcome of the general election accompanying uncertainty around Brexit. Whilst far from over, the worst case scenarios of two of the largest contributors to global uncertainty appear to be averted. US and China appear set to agree a trade deal and there is clarity at least between the UK-EU as to the timing and direction of travel regarding Brexit.

Chance of thunderstorms

The UK is set to withdraw from the EU on 31 January following the large Conservative victory in the December general election. The EU (Withdrawal Agreement) Bill was passed with a majority of 124 (having failed to be passed 3 times before) and the UK will now enter the transition phase in which it will retain access to the EU Single market and negotiate new terms ready for a final exit date in December 2020.

The scale and nature of the Conservative election win has enabled Chancellor Sajid Javid to pledge to level up the economic performance of northern England and the Midlands with an 'Infrastructure revolution'. In his March budget he is expected to promise billions of capital to spending on new projects. This money is derived from the Conservatives pledge to raise net capital spending from 2% to 3% of gross domestic product through increased borrowing, generating £100bn of additional investment. Whilst this increased spending over the next five years will provide a boost to the economy, it remains to be seen whether it can offset the estimated worst case economic impact of the UK leaving the EU in 2021.

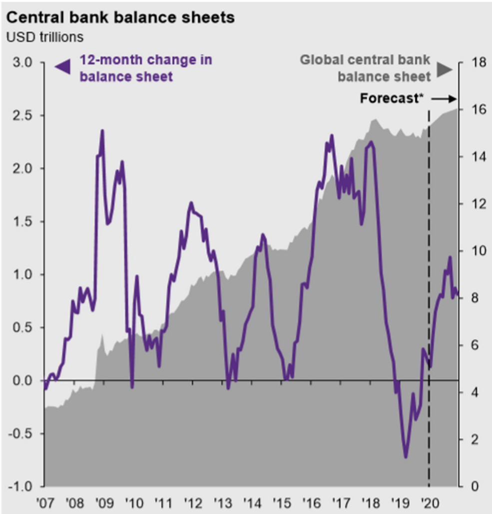
Whilst some layers of uncertainty have been removed, the core risk of a "No-deal" Brexit still exists. The UK government has done little to exclude the possibility, having amended the EU Bill prohibiting an extension by law. It is obviously in both sides' interests to get some form of an arrangement agreed by the end of 2020. How deep and comprehensive an agreement this will be remains to be seen, given

[1] Angie. Rolling Stones, 1973.

the time allowed. Posturing or otherwise, the Conservative government has confirmed it wishes to restore the UK's regulatory and judicial autonomy and pursue an "ambitious free trade agreement" similar to that of Canada and the EU.

Strong winds

Global financial assets were supported by significant monetary easing throughout 2019, with more than 15 central banks reducing rates. Concerned about slowing growth, trade uncertainty and a desire to prolong the economic expansion central banks have employed a range of measures to increase inflation. Increasingly central bankers are openly willing to accept higher inflation, highlighting the limitations of monetary policy and encouraging governments to release the fiscal purse strings.



Source: JP Morgan

Central banks of the US, European Union, China and India have all lowered interest rates during the year, with some regions restarting quantitative easing programmes. While the UK and Japan did not cut rates this year, they did not dial back on their respective stimulus efforts. A challenge that this new round of stimulus presents is the possibility that bankers will have little room for additional easing in the event that economies require more stimulus. Mark Carney, the departing Bank of England governor, is the latest to highlight the point, describing how the global economy is heading towards a liquidity trap, where monetary policy loses its effectiveness.

> "It's generally true that there's much less ammunition for all the major central banks than they previously had and I'm of the opinion that this situation will persist for some time"
>
> Mark Carney, Governor of the Bank of England, January 2020

Whilst not exclusively a European issue, the European Central Bank has been more vocal than most, particularly targeting countries like Germany with the budget capacity. German politicians are so far unmoved. To highlight Germany's conservative nature, holdings in cash and current account deposits rose 8.5% in 2019 to a record €8.5tn despite negative interest rates, equivalent to 27% of Germans' financial wealth.[2]

The change in direction from central bankers at the beginning of 2019 has had a profound effect on global bond yields. The US Treasury 10 year yield moved from 2.7% at the start of the year to a low of 1.4% in the summer. During this time the entire government debt market was trading in negative territory and even Greece was able to issue 3 month debt at a negative (-0.02%) yield.

Changing environment

Slowing global growth, trade and other uncertainties have had an impact on corporate profitability and a slowdown in earnings growth in 2019. Analysts' earnings expectations for 2020 are substantially higher than for 2019. Despite tepid growth in earnings, equities have delivered strong returns over the year derived in the main through multiple expansion. In particular the US S&P 500 index (the best performing market of the year) hit new all-time highs. 90% of the index return can be attributed to the market moving from 16x to 19x multiple. Whilst this expansion may appear large it has merely counteracted the contraction experienced in quarter 4 2018.

S&P 500 valuation metric	Current	Historical percentile
US market cap / GDP	199%	99th
Enterprise value / Sales	2.5x	99th
Enterprise value / EBITDA	12.7x	93rd
Price / Book	3.6x	90th
Cyclically adjusted P/E	27.8x	89th
Forward P/E	18.4x	88th
Cash flow yield	7.2%	85th
Free cash flow yield	4.1%	53rd
S&P earnings yield - 10Y UST	362 bps	28th
Median metric		89th

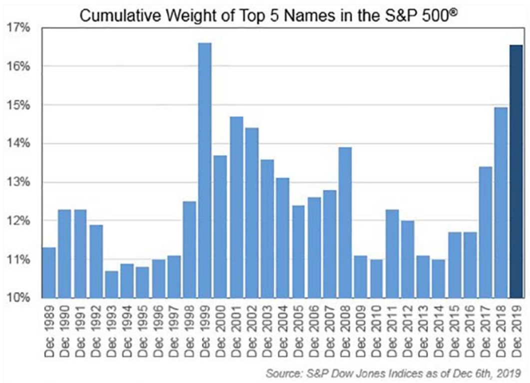
Source: Goldman Sachs Investment Research. EBITDA = earnings before interest, tax, depreciation, and amortization. December 16, 2019.

The largest contributors to S&P500 performance last year were the large (Mega Cap) Information Technology companies, with the top two (Apple and Microsoft) generating 15% of the total market return. At the end of the year, Apple's market cap was greater than the entire S&P 500 Energy sector. The cumulative weights of the top 5 companies in

[2] Financial Times, DZ Bank. 2 January 2020

Economic Background – January 2020

the S&P 500 (Apple, Microsoft, Alphabet, Facebook and Amazon) are at similar levels to that in 1999. Believers say 'this time it's different'. Many of these companies have evolved significantly over the last 20 years, but the political and regulatory risks have undoubtedly increased. We recognise that broad US valuation metrics are expensive relative to its history and to that of its international peers.



The table below shows that although investors and markets often act as though they know the future, history suggests that they do not.

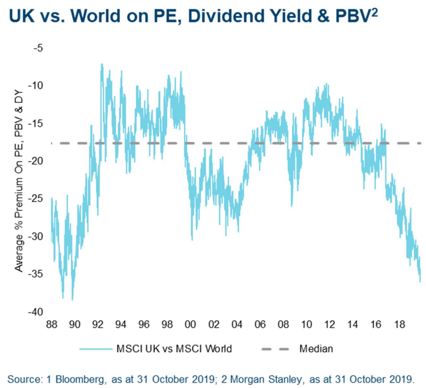
The 10 largest global stocks from each decade

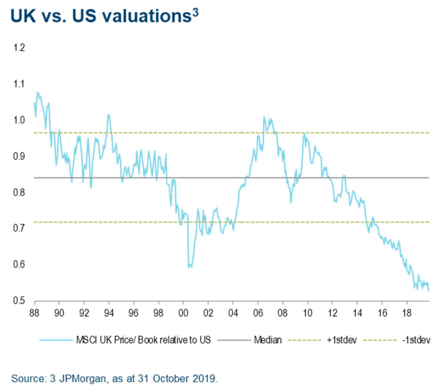
1980	1990	2000	2010	2019
IBM	NTT	Microsoft	PetroChina	Microsoft
AT&T	Bank of Tokyo-Mitsubishi	General Electric	Exxon Mobil	Apple Inc.
Exxon	Industrial Bank of Japan	NTT DoCoMO	Microsoft	Amazon
Standard oil	Sumitomo Mitsui Banking	Cisco Sysems	ICBC	Alphabet
Schlumberger	Toyota Motors	Wal-Mart	Wal-Mart	Berkshire Hathaway
Shell	Fuji Bank	Intel	China Construction Bank	Facebook
Mobil	Dai-Ichi Kangyo Bank	NTT DoCoMO	BHP Billiton	Tencent
Atlantic Richfield	IBM	Exxon Mobil	HSBC	Alibaba Group
General Electric	UFJ Bank	Lucent Technologies	Petrobras	Johnson & Johnson
Eastman Kodak	Exxon	Deutsche Telekom	Apple Inc.	JP Morgan Chase
The future winners from the Oil boom?	The future winners from the Japan boom?	The future winners from the internet boom?	The future winners from the BRIC boom?	The future winners from the age of disruption?

Source: Torevell Partners, Schroders, Research Affiliates LLC.

The 'winners' in one decade provide little guidance on the 'winners' of subsequent ones. With hindsight investors' enthusiasm for Japanese stocks in the 1990's looks misplaced, as does the excitement about the BRIC economics in the 2010's. Undeterred investors have invested $570bn[3] into index tracking vehicles during 2019. The past decade has been seen a rise in assets of index tracking products from $2.3tn to well over $10tn, by the end of the year. This substantial reallocation of capital has certainly helped the share price of larger growing companies in their respective indices, with momentum strategies amplifying this. However this wall of money attracted by the cheapness to invest is insensitive to company outlooks and valuation. History suggests that a build-up of capital focussed on a few leaders will reverse in time.

As economic data has started to pick up we have seen a market rotation in the leading sectors, factors and market capitalisation. Markets continue to show wide disparities in valuation, with the UK trading at significant discount, especially to the US.





Source: Columbia Threadneedle Investments

The defeat of Jeremy Corbyn's Labour party has removed one source of uncertainty for investors in the UK market. The wide ranging programme of nationalisation and redistribution of wealth within the Labour party manifesto had been a cause of concern for many. Following the election result at least £1bn has been invested into UK focussed equity funds by year end. With the risks diminished, small and mid-cap stocks have out-performed their larger brethren and more domestically focussed UK companies have returned to favour. As we move into this decisive year, much will depend upon the outcome of negotiations as to whether this momentum is maintained.

[3] ETFGI, January 2020.

Economic Background – January 2020

Summary

In a year of geo-political uncertainty and change the global economy has slowed, but continues to grow. Central banks have crucially provided support, averting recession fears. The US consumer and service sector appear strong and confident, offsetting the weakness in manufacturing and trade. More recently we have the tentative signs of a pick-up in activity, with the worst geo-political fears abating and with central banks set to remain accommodative there are positive signs. Geo-political risks remain elevated, despite certain tail risks being reduced. As we move closer towards the US election the probability of surprises increases, especially if the incumbent appears to be behind.

With a Conservative party majority in the House of Commons the probability of a 'No Deal' Brexit scenario remains, but there appears to be more clarity from the UK as to what it wants from a future relationship; hopefully pragmatism will win out.

With central bankers running out of (QE) ammunition it appears inevitable that fiscal policy will play a bigger role in the coming months and years ahead if the economic expansion is to be maintained. Whilst this is a positive, the possibility of a policy mistake rises also.

Company earnings have been under pressure during the year, but markets have provided good returns, underpinned by supportive central banks. There is optimism for earnings to improve during 2020, particularly if we see a rebound in global trade and manufacturing. If we do see this, the recent rotation into 'value' and more cyclical sectors is likely to continue.

Chris Davis
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