TelfordMann
Pensions & Investments

Market Outlook

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"Nothing is so exhausting as indecision, and nothing is so futile."

Bertrand Russell,
The Conquest of Happiness

Brexit: How will it end and how will it affect markets?

Unfortunately at the time of writing we still don't know what sort of Brexit we are going to end up with and so before we consider the possible outcomes, a brief recap is in order.

As 2018 came to a close, UK markets experienced high political drama, with the twists and turns of the Brexit negotiations impacting on asset prices. Government bond yields and Sterling fell to lows for the year as the government withdrew the Brexit bill, which in turn prompted a challenge to Theresa May's leadership. In the event, May prevailed in the leadership vote, but was forced to announce that she would make way before the 2022 General Election. Although this strategy helped her win the vote, it leaves her authority challenged as she continued to negotiate with the European Union (EU). However, a tense set of meetings with them has now deflated optimism around a negotiated compromise.

So, where do we go from here?

As we see it, there are three potential outcomes:

1. Theresa May's Withdrawal bill passes: There is still a chance that both the UK and the EU can navigate the current impasse in order that both the UK and the EU Parliament pass the negotiated withdrawal bill and the process then moves on to discuss future trading arrangements. Although we still see a chance of this happening, it is also possible that the impasse remains, and if so, two potential options arise.

2. No deal: The first option is that the UK still leaves the EU on 29 March 2019, but with no deal and therefore moves to trading on World Trade Organisation rules. However, as there does not seem to be a majority of British MPs who would accept this, we see this as a low probability event.

3. Article 50 is extended: We think it is more likely that MPs would either legislate to extend the Article 50 period (where the UK continues to temporarily remain in the EU) or revoke the Article 50 notice, pending greater clarity on the way forward. In each case the status quo would continue.

How will any of these outcomes affect markets?

Outcome 1 - The prospect of the Withdrawal bill (or a version of it) winning Parliamentary backing looks slim; however, should it do so, the markets are likely to react positively to the possibility of an agreement being reached. UK businesses would benefit from a transition period and sterling would rally perhaps by as much as 10%. Government bond prices would fall and with a bit more certainty, growth would pick up its pace and delayed spending, particularly from businesses, would bounce back.

Outcome 2 – A no-deal Brexit would likely cause a considerable amount of disruption in the short term as businesses adjust to the unknown environment, while the longer term outlook suggests a continuation of slower growth, simply because Europe is our nearest trading partner and Brexit puts obstacles in place to slow that trade. Other, faster growing markets will be available to the UK, but since they are farther away it will take time to develop and make up for losses arising in Europe. Sterling would inevitably take another hit – perhaps falling 10% in the short term – inflation spikes and asset prices depreciate. Opportunities in UK equities could arise (similar to what happened after the Brexit vote) given the amount of non-UK earnings in the FTSE, but UK-focused companies would become much more sensitive, especially those in retail and housing. Government bonds would remain strong.

Outcome 3 - We believe that this outcome is the most likely one and that markets are now broadly priced for an extended period of the status quo – under this scenario, the current impasse remains, but the UK remains in the EU. Barring any new developments, markets are now priced for stalemate. Despite the daily volatility we have seen, UK bond yields are little changed from levels prevailing before last month's events, and Sterling is just 0.5% weaker. Markets would become largely unmoved, but growth would continue to dwindle as uncertainty persists.

In summary, although volatility can always throw out opportunities, the extent of the uncertainty surrounding Brexit reminds us of the importance of diversification in the portfolios that we manage. In uncertain times, it makes sense for us to spread the investment of our client's portfolios through different types of assets, such as stocks & shares, bonds, property and other assets. It also pays to diversify geographically as well. We invest in the UK, but also across the USA, Asia and beyond.

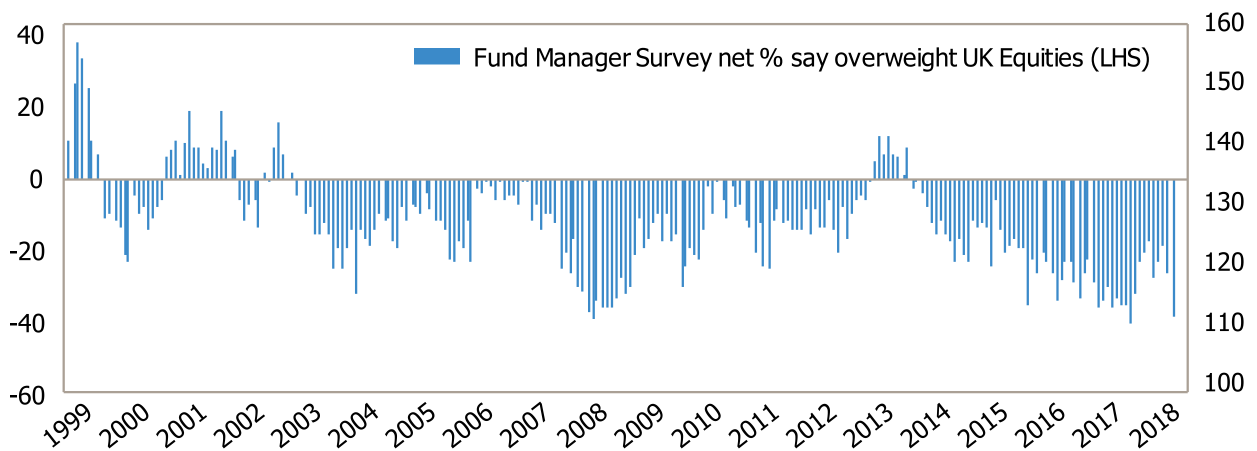
Asset allocation changes

Asset class	Change
Fixed Income	▲
Property	▲
Absolute Return	▲
UK Equity	▲
US Equity	▼
European Equity	▼
Asian Equity	▲
Emerging Market Equity	▼
Commodities	▼
Global Equity	▼

The changes that we have made to portfolios recently could well be described by the old adage: "when and where it feels uncomfortable to invest, is the time to do so". We say that not to worry investors, but there is so much conjecture around what will happen to markets at the moment, that we have tried to look through that and favour those regions who are already out of favour, or those regions where we consider the risks to be less than their more popular counterparts.

Take the UK as an example, we have increased our weighting to UK equities. This may seem an unusual step in the wake of the Brexit uncertainty, but the UK is currently one of the most underinvested regions of the world, as global investors have withdrawn from the UK precisely due to Brexit concerns. The chart below demonstrates anecdotal evidence from overseas investors on the views towards UK investment and in the words of JO Hambro, UK equities are not just unloved by investors, they are loathed.

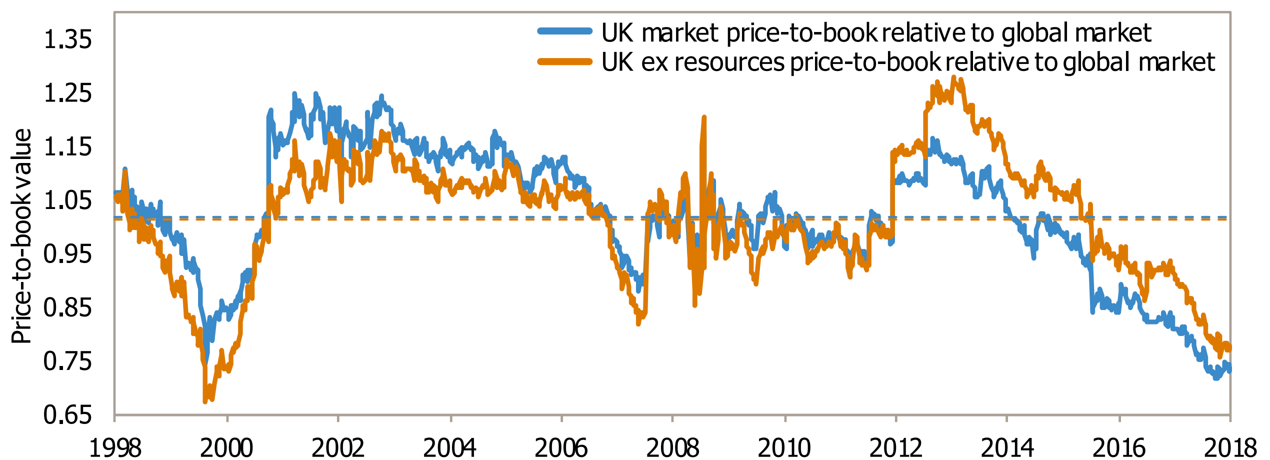
Record lows for UK equities allocations



Source: BofA Merrill Lynch Global Fund Manager Survey.

The UK stock market has already suffered a significant devaluation, far greater than its US or European counterparts. Yet so much of the UK stock market is actually a proxy for overseas exposure and those companies are trading at much lower valuations than their equivalents overseas, so whilst domestic UK may feel exposed to a Brexit outcome, those unloved, "boring" UK businesses which have lagged the growth trend in recent times, now look like being rewarded. The chart below shows how the UK stock market is trading at near 20 year lows versus global stock markets (with the black dotted line representing global stock markets).

The unloved UK Stock Market



Source: Credit Suisse as at 17 December 2018.

According to Richard Colwell, Head of UK Equities at Columbia Threadneedle, UK equity price to book ratios (a valuation measure) are at a lower level relative to US equities than the extreme level they reached in 1999 at the peak of the ecommerce bubble. The impact this may have on investors, is that if we do experience more extended periods of volatility over the next few years, then owning those assets which have already been devalued and which have proven resilient in previous market downturns should help protect investment returns.

It would be easy to follow the trend and avoid the UK market, but we feel that the uncertainty over the Brexit vote, makes market timing in the UK a mugs game. We have added the JO Hambro UK Equity Income fund to our growth portfolios. This fund has featured in our income portfolios for some time, however, the value bias of the fund, together with the investment strategy makes it an obvious choice to bring into the growth strategies. JO Hambro felt compelled to produce some research at the start of the year setting out 5 reasons why valuations in the UK and more specifically in the fund, offer a valuation opportunity almost unprecedented in the life of the fund. Their focus is very much on the unloved domestic UK market. With overseas earners trading on price to book valuations of 20 times earnings, low rated cyclicals, domestics, financials and commodities are trading on equivalent valuations of 5-12 times earnings. An example of such a stock would be Barclays bank, which has seen a 34% drop in the value of its share price since its 2017/18 high. It trades on a price/earnings value of 6.9 times earnings, yet still offers a yield of 5% on limited 33% payout ratio. It is hard to conceive of Barclays not withstanding any Brexit or global recessionary pressures and so whilst the tilt towards the UK market in portfolios may seem out of line with popular thinking, the holdings we have purchased are core UK names and those which have withstood previous market volatility.

In our ethical strategies, we have added the Schroder Responsible Value UK Equity fund. This fund is managed by the same team as the Schroder Recovery, Income and Global Equity Income funds which have formed key parts of our portfolios for a long time. The team took over the Responsible Value fund in 2018 and reshaped the strategy and underlying holdings. The fund is run in conjunction with an ethical screen which screens out tobacco, alcohol, gaming and businesses involved in predatory lending practices. In addition there are strict criteria applying to other sectors one would expect of an ethical fund. Most ethical funds are growth driven, rather than value biased so the Schroder fund adds diversity to the portfolios. An example of a change the management made to the fund was the sale of BAE Systems which failed the ethical screen, but the purchase of Sanofi, a healthcare company in its stead. 2018 saw the launch of a larger than average pool of new ethical funds, but with that came much conjecture, as deeper analysis of these funds showed only a gentle nod towards active ethical screening and an overreliance on basic ESG factors. In contrast, the Schroder fund has put into practice the results of its analysis alongside stock picking expertise.

Tech stocks revaluations - we have been anticipating this for a while and it has taken a long time to come to fruition, but we do believe that we are finally seeing the decline of those growth stocks, such as the FAANGs (Facebook, Apple, Amazon, Netflix and Google), who have seen rapidly rising share prices on the back of virtually no capital expenditure. That is not to say that the FAANGs are now doomed, but the revaluation seen in these stocks was well signposted and perhaps well overdue. A revaluation does not necessarily mean a bear market, it simply means a reversion to more realistic valuations.

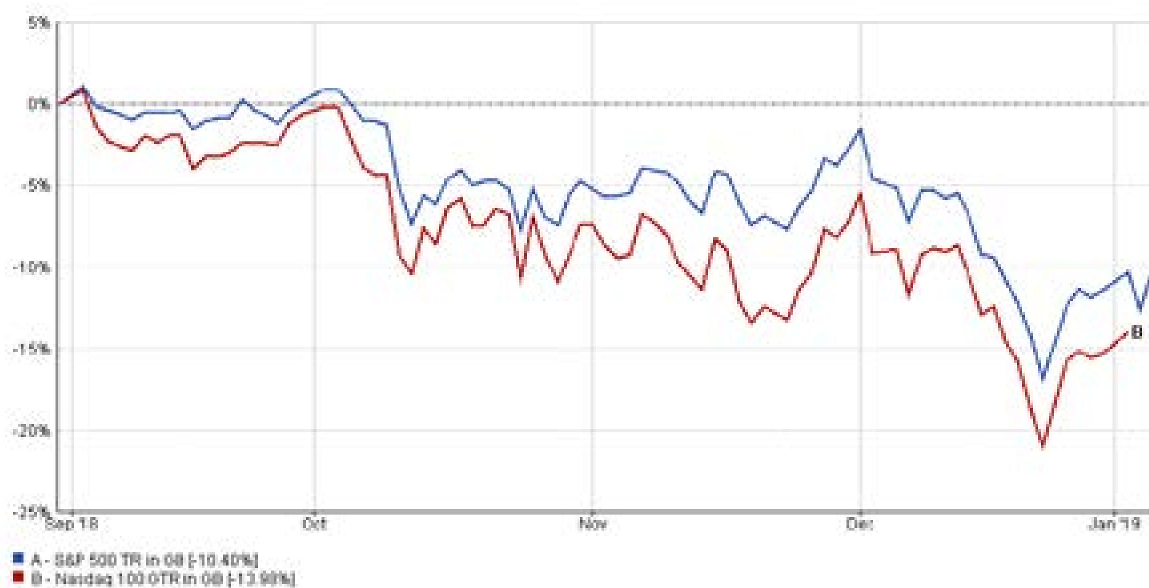
The performance of the Nasdaq 100 and the S&P 500 since the 1st September 2018 to date has seen both markets fall by 13.98% and 10.40% respectively, as can be seen in the chart below.

The S&P 500 is not out of kilter with wider markets, but both indices demonstrate how the US is not immune from a global slowdown.

We have reduced our exposure to the US. We know a recession is coming at some point, but we do not anticipate it coming in 2019. However, over the next couple of years, the signs are there to indicate a recession should hit US markets. The US is one of the hardest markets to comment on at the moment.

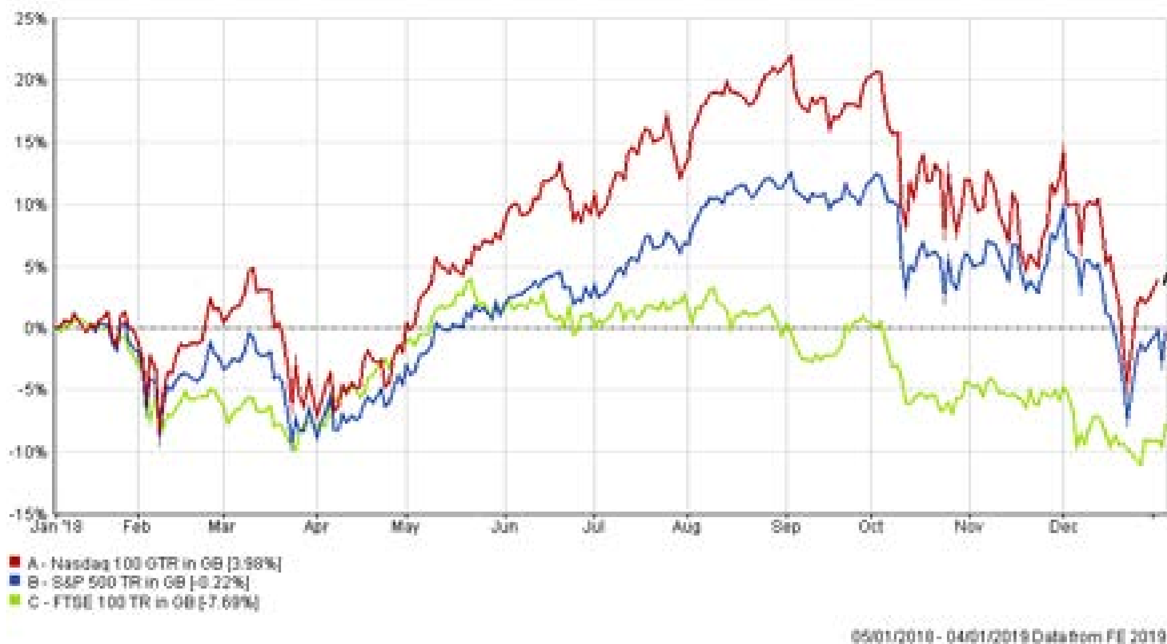
This is not really due to stock issues, since most corporates remain in rude health, but it is due to the uncertainty caused by the Trump administration. There are indicators coming through that Trump's plans to boost domestic markets, such as the auto industry, are actually having the reverse effect. If his core supporters fail to benefit from his election whilst his foreign policy and personal finances are pored over, the result may be greater uncertainty in the US than the UK. The overleaf chart demonstrates the point that relative to the US, the UK's decline started much earlier, which suggests there is more certainty and opportunity in the UK than the US, where further falls from record highs could conceivably be quite marked.

US Stock Markets have fallen in value



31/08/2018 - 04/01/2019 Data from FE 2019

The UK stock market has fallen further



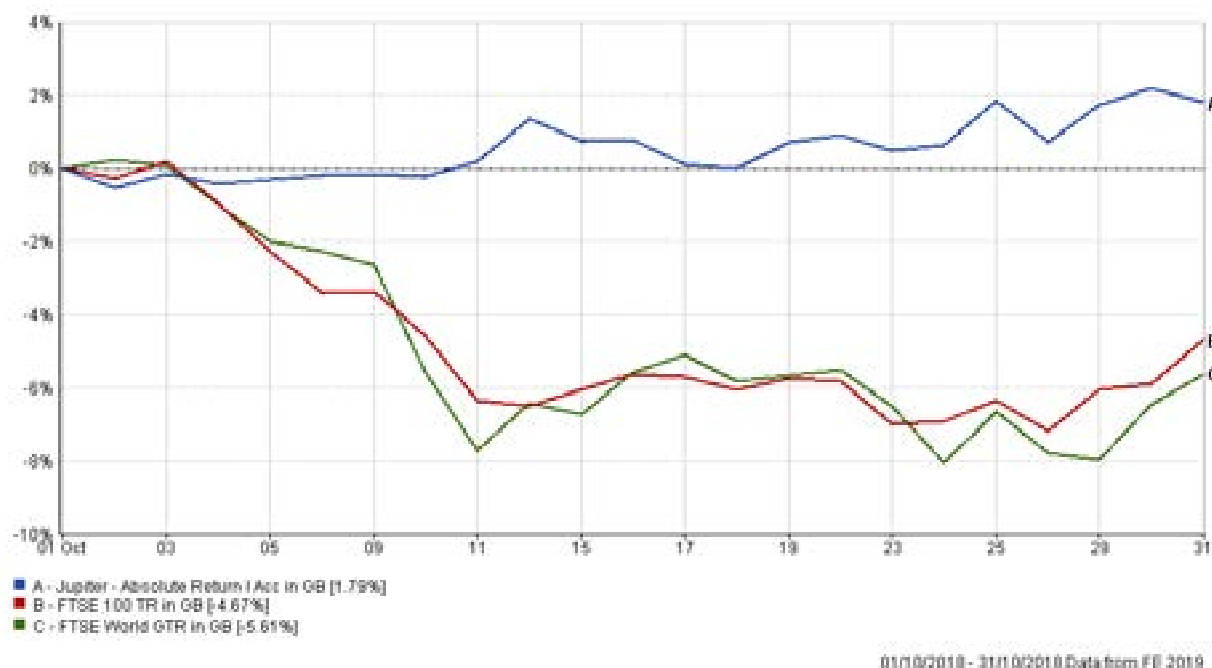
On a similar theme of risk and reward, we have sold out of Europe. Broader European stock markets face continued challenges in 2019. That is not to say that they may not rebound, but when weighing up the potential risks versus reward for the region against others, we currently see too many headwinds in Europe. The Italian budget has just been passed, but six years ago, how many of us would have anticipated Greece rejecting the first Italian budget as an inadequate attempt at austerity. There is increasingly less stability in Germany as Merkel's role domestically reduces and Macron's position in France is hardly watertight with populist uprisings and about turns in policies.

Where we do continue to hold European exposure is via the BMO Property Growth & Income fund, where 51% of the fund is invested in European Property Equities, of which 38% is in Germany and 15% in Sweden. Whilst e-commerce has taken hold in the UK, in Europe it has grown at a much slower rate. For example, 20% of non-food sales are online in the UK, but are only 2% in Italy. Similar statistics apply in the food space, where culturally the French patisserie is much more a part of daily life than in the UK. European shopping centres remain attractive, with lower occupancy to turnover ratios and cheaper rental space. In the UK, the fund owns a Supermarket Income REIT which was the only European stock to not fall in the October/November decline. The REIT owns the likes of Sainsburys and Tescos, where there is inherent asset value in the land and despite declining footfall in stores, there are opportunities in the move to providing more home deliveries and installing solar panels on the vast roof spaces available, thus meeting green energy requirements and increasing capital appreciation.

Brexit could be a threat to UK Commercial Property, particularly in London where foreign buyers have bought so much of the inventory and landmark buildings in recent years. Our UK property exposure is typically focused on the rest of the UK, in smaller developments. That is not to say the funds may be immune from a hard Brexit or recession, but the tenants are much more domestically focused and are on long-term tenancy agreements. Most property managers still see value in the UK market, unlike in 2007 and so we have diverted some of our equity exposure into property, via the BMO UK Property fund, L&G UK Property and Kames Property Income funds predominantly. We have held the L&G fund at various times in the past, as it maintains a healthy liquidity buffer and the Kames fund is similar to the BMO fund in terms of the properties it seeks to own.

We have increased our fixed income holdings and reintroduced some absolute return funds to our strategies. We have not owned the latter for a while, having grown disillusioned with their performance during the very times they are meant to produce positive returns, but we monitored global market performance closely over October 2018 and if our base case is that we are set to experience greater periods of market volatility, we have sought to include those funds which proved themselves capable of producing a non-correlated return during October. This should signify an ability to do so in the future should market conditions repeat. One such fund is the Jupiter Absolute Return fund. For a long time, the fund has had a good thesis, but very little to practically promote it. 2018 saw a turnaround in that, with a positive return in October 2018 and importantly, zero correlation to broader equity markets. The graph opposite shows how that plays out in reality. Whilst we take larger positions in the UK for example where we see real value, we offset that with larger positions in funds which are there to provide resilience should markets remain volatile. This may dampen our performance in a raging bull market, but we feel this is a sensible approach to take for investors in the face of global uncertainty.

Jupiter absolute return fund provides resilience



We have increased our Japan weighting. Like the UK, Japan has already experienced a devaluation in its stock market. We have included the First State Japan Focus and Schroder Tokyo funds to portfolios. Whilst the market has de-rated, profit outlooks have improved, female participation in the workforce has been a major positive for Japan and foreign worker participation rates have also improved. For a long time, Japanese resurgence was all about the success or otherwise of Prime Minister Shinzo Abe's policies, however, corporates are now standing on their own two feet, they understand the need for investor participation by returning dividends to investors and reinvesting in the business, so whilst Japan remains sensitive to global events, Japanese corporates are in as good shape as they have been historically.

We have increased exposure to Asia and China, whilst reducing exposure to the emerging markets. We have sold out of our Latin America, Emerging Europe and Emerging Market funds. Newly elected President Bolsonaro in Brazil is currently prompting a further rise in the Bovespa, but we are uncertain about his policies longer-term and have decided to take the profits from the fund rather than hang on. The Emerging Markets are most under pressure if we do see a decline in the US. The impact of the Dollar will be felt most strongly in these markets and so again on a risk reward basis, we have sold out of these areas, believing that Asia and China offer greater prospects.

China is perhaps the most contentious as there is very little positive news surrounding China at the moment, and relations with the US are clearly not helping. However, history shows that valuations in China are such that now is the time to increase investment allocation. As Charlie Awdry, Henderson's China Opportunities fund manager states, domestic sentiment in China is poor and risk aversion so high that market implied discount rates (the return demanded by investors to compensate them for investing in the market) are very high. Stock picking in China will remain key and at present the managers are avoiding Chinese banking shares and so whilst we see value in the market, it is very much on a stock specific basis and focused on those sectors where valuations have retrenched, such as technology.

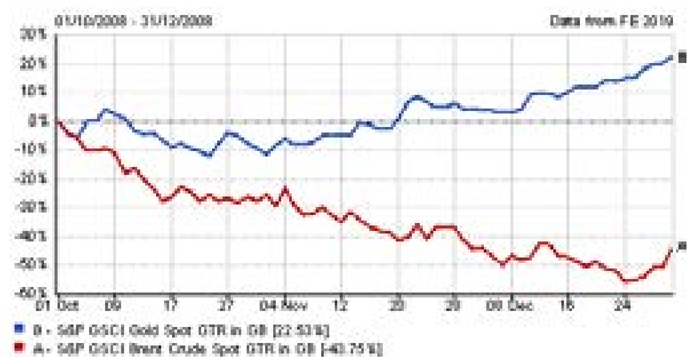
We have sold our exposure to commodities. Historically, gold and oil were seen as safe haven investments, so when market volatility occurred, those physical assets rose in value. We have simply not seen that with any great reliability over the last 10 years. The oil price fell over 40% from its high in October 2018 to a low in December 2018. This was due to factors concerning OPEC and wasn't necessarily reflected in prices at the pumps when we fill up our cars, but if we hold commodities as a buffer against volatility and inflation, then we have to take account of how the assets are actually behaving rather than how they should behave.

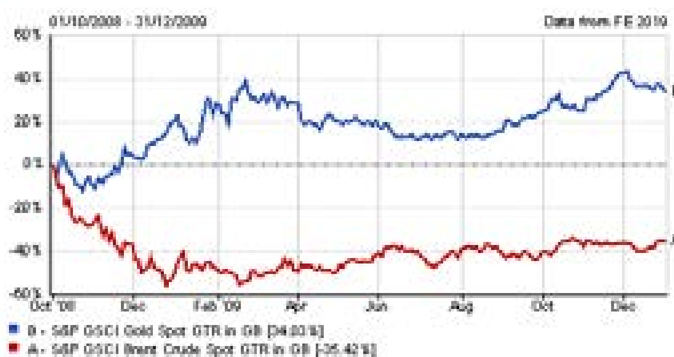
As per the charts overleaf, we recently ran a comparison on the performance of the S&P Gold Spot price versus the S&P Brent Crude Spot price over the period 1st September 2018 to 31st December 2018 versus 1st September 2008 to 31st December 2008. The pattern of returns was spookily similar. 2008 saw a more extreme range of returns, one would expect that given the nature of the Global Financial Crisis, but the pattern was the same in 2018. We then looked forward to see how the assets behaved during the next year or so. By the end of 2009, the gold price had risen a little and the oil price had recovered some of its losses, but only after a period of further volatility in the early part of 2009, which suggests a similar outlook for 2019.

We still maintain some commodity exposure via our individual funds, our value funds such as Schroder Recovery, JO Hambro UK Equity Income and even our global funds will own underlying stocks such as Anglo American, but these are held for individual valuation purposes as opposed to the asset classes per se. Whilst the evidence from 2009 implies we may see growth in both gold and oil, the global geopolitical climate is a quite different place to 2008/2009 when there was a general coming together of economies to fend off the Global Financial Crisis. 2019 sees far less cooperation and much more self-interest. We would expect to see the oil price bounce around, but would be surprised to see it recover anywhere near its post Global Financial Crisis highs and believe a safer way to access such returns is via our broader funds.

A further threat to traditional commodities is renewable energy. A recent Liontrust report stated that they expect solar and wind to become the cheapest energy sources by 2020, thus driving accelerated uptake. This would reverse current electricity generation economics and challenge traditional fossil fuel power generation. If this trend takes hold as anticipated, then traditional resource companies won't be the beneficiaries, but lower carbon technologies, as well as companies improving our aging electricity grids and power infrastructure will reap the rewards. Again, a theme we can exploit not via traditional resource funds, but via our global thematic funds.

10 Years on - Is history repeating itself?





Past performance is no guide to future returns. The value of units can go down as well as up. Please note that pension fund and life fund performance differs from unit trust/OEIC performance due to the underlying difference in the taxation treatment.

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