Market Commentary

Quarterly update January 2019

iguard ... a new way of thinking

Economic & Market Overview

- Equity markets suffered their worst quarter since the European debt crisis in 2011 and, on an annual basis, the worst calendar year since the Global Financial Crisis of 2008/09.
- The US Federal Reserve continued to raise interest rates, citing robust growth and low unemployment in the US, though investors feared a policy error, sparking a sell-off across markets.
- The oil price fell over 40% in less than three months, with Brent crude down to $50 per barrel.

Equity markets suffered their worst quarter since the European debt crisis of 2011 and, when combined with the previous quarters in the year, led to the worst calendar year performance since the Global Financial Crisis of 2008/09. Slowing global growth, falling oil prices, a row over the Italian budget, continued uncertainty over Brexit and disappointing earnings results from bellwether companies all took their toll on investor confidence. Against the backdrop of US interest rates seemingly rising on autopilot, this led to a sharp increase in volatility and falling asset prices. At the beginning of the period, portfolio diversification provided little comfort, as even US Treasuries found themselves in the eye of the storm. Assets that had demonstrated stellar performance earlier in the year now found themselves at the sharp end of the sell-off, with US equities and technology stocks hit particularly badly, whilst Emerging Markets (EMs) proved to be a relative outperformer, although still suffered losses. As the quarter wore on, diversification reasserted itself as investors, increasingly intent on second guessing the next recession, turned to traditional 'safe haven' assets, leading to a rally in government bonds and gold. Despite soothing words from the Chair of the US Federal Reserve (Fed), reiterating that interest rate rises were data dependent, the volatility continued, extinguishing any hopes for a year-end 'Santa rally'.

Signs that the US was not immune from its own trade war with China came in the form of patchy earnings results from US industrial bellwether companies, including Caterpillar and 3M. Third quarter US GDP came in at an annualised rate of 3.5%, robust but noticeably slower than the 4.2% recorded in the previous quarter. Furthermore, softer economic data emanating out of Europe and China reinforced the message of a global slowdown. The Brent crude oil price, having peaked for the year at just over $86 at the beginning of October, went rapidly into reverse, with the weakness blamed on the softening growth outlook and the US shale industry increasingly overcoming logistical bottlenecks, with greater than expected volumes of oil being transported from the wellhead to the refiners.

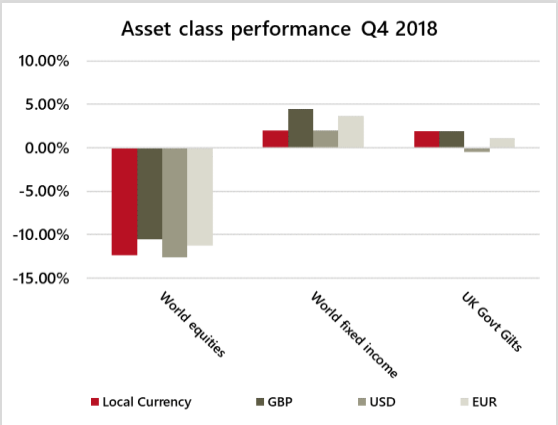
Political uncertainty continued to be a hinderance, with the Republican Party losing control of Congress in the US mid-term elections, a stand-off between the Italian government and the European Commission over Italy's proposed budget, and almost any outcome seeming possible at the end of the UK's Brexit process, from hard to soft Brexit, to General Election or even second referendum. At least EMs were able to provide some clarity, as Jair Bolsonaro of the Social Liberal Party, considered to be the market-friendly choice, won the Brazilian Presidential Election.

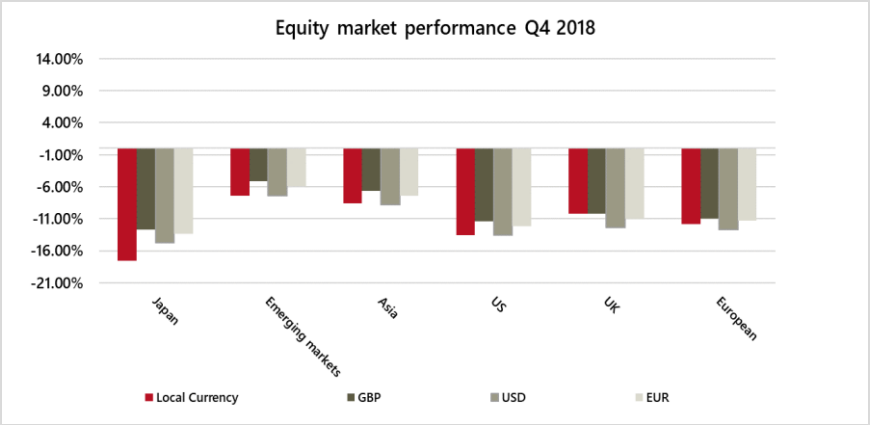
Despite the shakier footings, the Fed continued to raise interest rates, citing robust growth and low unemployment in the US. As the 10-year US Treasury yield hit 3.23%, markets cracked as investors feared a policy error on behalf of the Fed: volatility spiked and assets across the board sold off, with US dollar cash the only refuge. Technology stocks, outperformers for most of the year, fell sharply. Prices were not helped by concerns that Apple may have reached its 'peak iPhone' moment, as the company announced that it would cease reporting unit sales of its devices as figures began to disappoint. For a brief period, Microsoft reclaimed the title of the world's most valuable company, two decades since it last held the position.

Quarterly growth contracted in Germany, with the weakness being put down to the introduction of new emissions tests causing severe delays to new cars being certified, in turn leading to a collapse in production volumes. Other data was more positive, with Q3 lending data in Europe published in Q4 continuing to point towards strong demand for loans, whilst GDP growth in France picked up and Spain's growth remained unchanged at a healthy rate of 0.6% for the quarter.

December brought no respite to the sell-off, as US equities led markets lower, coming close to a bear market, defined as a 20% fall from peak to trough. The Brent crude oil price capitulated, touching as low as $50, a fall of over 40% in less than three months. Never one to miss a tweet, President Trump promptly blamed the equity market rout on the Fed Chair, Jerome Powell. In this case, he may have had a point.

Market Data





Source: Lipper

Market Commentary

Quarterly update January 2019

iguard ... a new way of thinking

Sector Review

Fixed Interest: Major government bonds, including 10-year US Treasuries and German Bunds, rallied over the quarter, reflecting the demand for 'safe haven' assets amid sharp falls in equity markets and continued macro uncertainty. In the periphery, Italian government bonds enjoyed their highest monthly return in December since July 2015, despite the country's credit rating being downgraded in October to Baa3, the lowest investment grade rating. The improvement in performance came after the Italian government agreed to reduce its planned budget deficit from 2.4% to 2.0% following pressure from the European Commission. Elsewhere, Emerging Market (EM) debt, which struggled midway through 2018, started to recoup its losses as EM currencies started to recover. Over the quarter, deterioration of risk sentiment led to broad-based underperformance across investment grade credit sectors relative to government bonds. High yield bonds were also weaker, led down by the energy sector, notably in the US.

Property: Demand for UK commercial property slowed in the quarter, with transaction volumes declining from £6.4bn in September to £4.0bn in October and £3.1bn in November. Despite the slowdown, total transactions for the year still broke through £50bn for the sixth year in a row. London offices remained in high demand and accounted for two of the three largest deals in November. Foreign investors continued to dominate the market, with overseas capital accounting for 70% of all transactions by volume. However, having seen the strongest investor interest in 2018 due to the popularity of distribution space for e-commerce, the industrial sector finally slowed in the last quarter, as volumes in the sector fell to £304m in November, down from £744m in October.

US equities: It was an extremely volatile quarter, with a broad market sell-off triggered in October by investor fears that the US Federal Reserve (Fed) may adopt a more aggressive stance in raising interest rates. In addition, the continued trade war with China and concerns over the outlook for technology companies weighed on US equities. High profile technology stocks struggled particularly, most notably Apple, over fears that earnings growth may slow. The decline accelerated in December when, after reports in October suggested that he was looking to fire Fed chairman Jerome Powell, President Trump made matters worse when he blamed the Fed for the equity market rout.

UK equities: UK equities fell sharply over the period amidst rising concerns of a global economic slowdown. UK domestic sectors performed poorly, whilst sterling came under further pressure as worries about the possibility of a 'No Deal' exit from the EU intensified. Having published her draft EU Withdrawal Agreement, Prime Minister Theresa May was forced to delay Parliament's vote on the deal after it became clear that it would not be passed. This delay increased political uncertainty further from an already elevated level and saw the pound fall to a 20-month low versus the US dollar. However, her survival of the subsequent no-confidence vote within her own party allowed it recover some of its losses.

European equities: In a difficult period for European equities, only the telecoms and utilities sectors posted positive returns. Softer macroeconomic data in Europe put pressure on equities as the Purchasing Managers Index for business activity slowed to its weakest level in four years amid continued global trade tensions and slowing demand from China. Political disruption dented business confidence, with the anti-government "gilets jaunes" protests in France forcing President Macron to introduce fuel duty cuts and other stimulus measures to ease the tensions. Elsewhere, the Italian populist coalition government agreed to delay some of its budget spending, resulting in a forecast deficit of 2.0% compared to an initial 2.4%.

Japanese equities: Much like the rest of global markets, Japanese equities ended the quarter markedly lower, reflecting the deterioration in global sentiment. More economically sensitive sectors of the market fared the worst, such as mining, securities and machinery, which fell sharply on concerns over global growth. In addition, strength in the yen, a currency viewed as a safe haven asset, reduced the value of overseas earnings to exporters. On the economic front, preliminary readings suggested that Japan's economy contracted at an annualised rate of 1.2% in the third quarter, not helped by a succession of natural disasters that disrupted manufacturing and export activity. There was little in terms of corporate news, though Nissan dominated the headlines after its chairman Carlos Ghosn was arrested and subsequently removed from his position after allegations of financial misconduct.

Asian equities: Asian equity markets recorded a negative return but outperformed the wider global equity index. As well as ongoing trade tensions between the US and China, deteriorating economic figures in China were one of the major causes of concern for global investors. China's economy recorded its weakest quarterly growth since 2009, whilst industrial production and retail sales also slowed more than expected. Chinese policymakers responded by cutting banks' reserve ratio requirements to encourage lending. Technology heavyweights performed the worst, including Taiwan Semiconductor and Samsung Electronics, which posted disappointing corporate results.

Emerging Market equities: Emerging equities were not immune to the global sell-off, but losses were smaller than those registered in Developed Markets. Asian EMs performed less well, dragged lower by growing evidence of a slowdown in China's economy. However, in Latin America, the Brazilian market posted strong gains as equities and the currency reacted favourably to the Bolsonaro Presidential election victory, with investors anticipating pro-market reforms. Finally, a sharp fall in oil prices produced mixed fortunes, acting as a headwind for energy producers, notably Russia, whilst net oil importers, such as Indonesia, the Philippines and India, benefitted, with these markets rising over the quarter.

Market Commentary

Quarterly update January 2019

iguard ... a new way of thinking

Performance Review

Positive contributors to performance were:

- Fund selection in High Yield.
- Fund selection in UK equities
- Overweight position in cash.
- Underweight position in High Yield.
- Underweight position in UK equities.
- Underweight positions in Asian equities.

Negative contributors to performance were:

- Fund selection in Absolute Return.
- Fund selection in Corporate Bonds.
- Fund selection in US equities.
- Fund selection in European equities.
- Fund selection in Asian equities.
- Fund selection in Japanese equities.
- Overweight position in Global equities.
- Overweight position in Japanese equities.
- Underweight position in Government Bonds.

For our lower risk models, the portfolios delivered returns of -1.1% to -4.1% over the quarter.

The biggest detractors to returns were an overweight to equities and an underweight to Government Bonds. This positioning had served the portfolio well over the longer term but, with global equity markets declining on persistent concerns over global trade and slowing economic growth and investors looking for safe haven assets, what had been a tailwind quickly became a headwind. Fund selection can sometimes offset unhelpful tactical positioning, but this was not the case this time around as Absolute Return funds struggled to navigate through the prevailing volatility and Corporate Bonds had a disappointing quarter as a deterioration of risk sentiment led to the broad-based underperformance across investment grade credit sectors.

In the medium and higher risk models, returns were also negative for the period ranging from -5.3% to -10.6%.

Exposure to equities was the biggest detractor to returns as global equities posted sharp declines in Q4, again on fears over slowing global trade and economic growth. An underweight position in UK equities was beneficial but was more than offset by disappointing fund selection elsewhere, as assets that had performed strongly earlier in the year sold off significantly. However, one bright spot was within High Yield, where an allocation to Emerging Market Debt outperformed markedly.

Portfolio changes

Tactical Asset Allocation

- Overweight to neutral position in Absolute Return.
- Overweight to neutral position in US equities.
- Reduced overweight position in cash.
- Reduced underweight to UK equities.
- Underweight to neutral position in Asian equities.

Market Commentary

Quarterly update January 2019

iguard ... a new way of thinking

Outlook

Against a background of slowing global growth, continued trade tensions between the US and China, steadily increasing US interest rates and the withdrawal of Quantitative Easing (QE) by the Fed, equity markets have re-rated sharply lower, as investors have increasingly tried to second guess the timing of end of the current economic cycle (already the second longest on record). One of the principle concerns has been the potential for a policy error by the Fed, with their desire to raise rates ahead of the next downturn becoming the very cause of the next recession if they move too aggressively. Such concerns come from the fact that, historically, the Fed's decisions have been largely driven by events within the US, but with China being the second largest economy in the world and the EU being the world's largest trading bloc, a more global outlook is required. In addition, despite unemployment running at rock bottom levels, inflation has yet to become a problem, with the Fed's preferred measure of inflation having fallen below target in recent months. Therefore, whilst relatively subdued growth in bank credit provides no obvious inflationary pressure either, the reason that investors fear rates overshooting is clear.

Despite these concerns, we believe that the increase in US interest rates should be seen in the context of the removal of emergency levels of rates following the 2008/09 financial crash rather than tightening per se. They should peak at a far lower level due to inflationary pressures remaining under control and growth subdued relative to previous recoveries, enabling the US economic cycle to continue. However, this requires the Fed to remain "data dependent". There are early signs that US dollar strength is beginning to roll over, which we would expect in the context of a lower peak in interest rates. This will have the effect of easing liquidity in markets and boost Emerging Markets in particular, especially those countries running a current account deficit and reliant on overseas funding.

Fourth quarter GDP figures released in the coming weeks may very well be poor, especially year on year, but equity valuations have become materially cheaper, pricing in a significant deterioration in the global economy. We have used lower market levels to close out the underweight positions to equities that we had in the higher risk portfolios but have only moved to a broadly neutral and diversified allocation to equities despite the value on offer. In spite of our core case, we acknowledge the potential for a policy mistake by the Fed and would prefer to see confirmation of their data dependency through actions and not just words before we would feel that a more bullish position is justified. Of course, US interest rates are not the only risk for investors to consider, and a re-escalation of the US/China trade war would not be helpful for market sentiment. In addition, the European Central Bank's plan to wind down their QE programme has the potential to unsettle markets. Therefore, despite believing that this economic cycle can continue, our focus remains on adding ballast to the portfolios for further periods of volatility. We are increasingly conscious that, if interest rates do peak at a lower than usual level, this may have to be at prices that we would not have considered attractive in previous market cycles. However, the alternative is to be overly exposed to further market falls and, as long as the price paid is not excessively high, it will still be beneficial to hold 'safe haven' assets when the cycle does end.

Important Information