So as 2018 ended, were we any the wiser?

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Smart Investment Management

As any year ends and a new one begins, it is normal to reflect on the 12 months that have passed, analysing how markets have performed and what we know now that we did not know at the start of the year to inform our positioning going forward.

In terms of the former, namely returns, the numbers are clear: 2018 was the worst year for investors since the Global Financial Crisis. Most major equity indices were down, with stock markets in the UK, Europe, Japan, Asia and Emerging Markets (EMs) showing double digits falls. Few non-equity asset classes offered positive returns to offset such falls. Fixed Interest struggled across the year, under pressure from rising interest rates in the US and concerns that Quantitative Tightening would remove buyers from the market whilst, in spite of a strong rally in Q4, even gold failed to make positive returns in exactly the kind of year for which many investors would have held it. Whilst there were few hiding places, the scale of the falls was very much that of a correction and not a crash. Furthermore, the fact that it was the worst year for a decade says as much about how good those 10 years have been for investors as it does about 2018. Nonetheless, after many years of rising markets, a return to more normal levels of volatility felt painful for investors.

Perhaps more interesting is the second part of the analysis. As would be expected, some issues are much clearer than before: the expected victory for populist parties in Italy arrived but did not immediately threaten the stability of the EU or the euro, as the coalition Government avoided provoking Brussels too much by agreeing a watered down budget (although still one that will be in deficit); North Korea appeared to want to 'come in from the cold' politically, although little actual progress has been made yet and with the US administration appearing to be focused on other issues it remains to be seen whether the former's offer to 'denuclearise' the Korean peninsula comes to pass; the conflict in Syria seemed likely to end with the Assad regime still in power (although Ukraine and Iran remained 'known unknowns' in the geopolitical risk area); and at a corporate level, Elon Musk, the CEO of Tesla, likes to live on the edge (was this actually news?), landing himself with several lawsuits (including one for defamation) and flirting with potential disbarment as a company director (he avoided disbarment at a cost of $20m but the lawsuits are still pending). However, alongside increased knowledge on these lesser issues, what is interesting is that many of the larger issues that concerned investors at the start of 2018 remain at the forefront of their thinking now and continue to drive markets.

One such issue is US interest rates. It is not unusual for investors to worry about rate rises at this stage of the cycle, with their main concern being that the central bank in question will overshoot the appropriate level and choke off growth, and such worries will typically only abate when rates peak. This time around is no exception but, whilst markets remain twitchy about the issue, we do believe that there is more clarity than a year ago, as it seems more certain that rates will indeed peak at a lower level than previous cycles. However, the same cannot be said for a number of other issues where we are very little better off than a year ago.

The US/China trade war is one example, the possibility of which had concerned investors since Donald Trump's election as US President. This time last year he was just getting started but, with the scale of his actions exceeding what most had expected, the outcome is less predictable than ever, as it is unclear whether this is indeed a trade war or whether trade is simply the first salvo in a larger battle for control of the globe. Furthermore, with Trump's tendency to shoot from the hip and make rapid policy changes (apparently spontaneously and without consulting his advisers) showing no signs of abating, it may be that this is not even known within The White House. As it was a fight of his own choosing, to a certain degree Trump can dictate the pace of his 'campaign', deciding how and when to escalate, as well as when he may choose to make concessions. That is a luxury that the UK government does not have over Brexit but, in 2018, not even the approach of a legally binding deadline was

enough to guarantee that we gained any real knowledge throughout the year. The outcome of Brexit is arguably even less certain than it was 12 months ago, with almost any outcome, from leaving without a deal to staying in the European Union (EU), now seeming possible. Therefore, investing in UK assets comes with a huge 'known unknown' and, with such heightened risk, it is no surprise that many investors have shied away from them.

In summary, whilst 2018 provided insight on some subjects, the issues of January 2019 do not feel that different to those of January 2018, and it is certainly possible that having prolonged periods of uncertainty on such major issues is proving wearing to investors, contributing to market volatility. What 2018 did provide is a reality check that may yet prove to be helpful at this stage of the cycle, possibly avoiding the euphoria on which Sir John Templeton famously said bull markets die. With asset prices at more reasonable levels and the global economy still growing, albeit it more slowly, it is possible that this cycle has further to run. However, there is no doubt that, with investors having a somewhat bearish mindset currently, downside risks have increased, as has the chance that this is in fact the beginning of the end for this economic cycle. Therefore, as we enter 2019 we remain highly diversified and focused on assets that we believe can offer more defensive characteristics in the event of a downturn, notwithstanding that no asset guarantees, as we saw with gold last year.