MARKET PERSPECTIVES

JANUARY 2019

THE LAST QUARTER...

- Equities fall back sharply, led by Japan and the US. The Dow Jones Industrial Average experiences its worst December since 1931 and 2018 ends up being the worst year for stocks since 2008.
- The NASDAQ index enters official 'bear market' territory – closing on Christmas Eve down 23% from its August high. The S&P 500 briefly touches (intra-day) minus 20% from its September high.
- Asia and Emerging Markets outperform developed markets.
- Microsoft overtakes Apple and Amazon to regain its position as the largest company in the world after a gap of 15 years.
- Gold and long-dated government bonds are safe havens.
- 30-year yields in the US rise to 3.5% in November and then fall back to 3.0% at the year-end.
- Meanwhile, the US Federal Reserve (Fed) puts short rates up to 2.5%.
- The oil price collapses 37%; Qatar leaves OPEC.
- Bitcoin closes 2018 at $3,674 – down 74% on the year.

"Stay away from Bitcoin. It's a mirage, basically"

Warren Buffet, CEO of Berkshire Hathaway
February 2014

WAVERTON

INVESTMENT MANAGEMENT

OUTLOOK FOR INTEREST RATES

Yield curve is close to inversion…

Government bond yields experienced a notable change in direction during the quarter. Having continued on the same upward trend which they had followed throughout the summer on the back of booming economic growth and rising inflation, by the end of the quarter they had fallen back well below where they had started. Meanwhile, short rates in the US continued to march upwards – such that by the end of the quarter the closely monitored US yield curve approached the point of inversion, whereby overnight interest rates are higher than long bond yields. An inverted yield curve is problematic for banks because it erodes their interest margin and generally leads to risk aversion in the system. Accordingly, it has historically been considered an important pre-recessionary indicator.

…and credit markets are nervous.

Another headwind has been the increase in corporate yield spreads over the equivalent government bond yield as investors have demanded greater compensation for additional credit risk. The consequent impediment to companies raising finance has often been another precursor to economic slowdown and can indicate a higher default rate in the future. A third worrying sign in the fixed interest arena has been the performance of emerging market bonds and other weaker credits like Italy (where the spread over the equivalent German yield has widened significantly as Italy's place in the Eurozone becomes more precarious). The consequence of all this has been that only long-dated government bonds in core territories (e.g. US, UK, Germany and Japan) have done well of late. This is not only relevant to fixed interest investors: equity managers look very closely at these signals because an economic recession is likely to be extremely bad for the earnings that ultimately underpin valuations.

However, the Fed has room for manoeuvre…

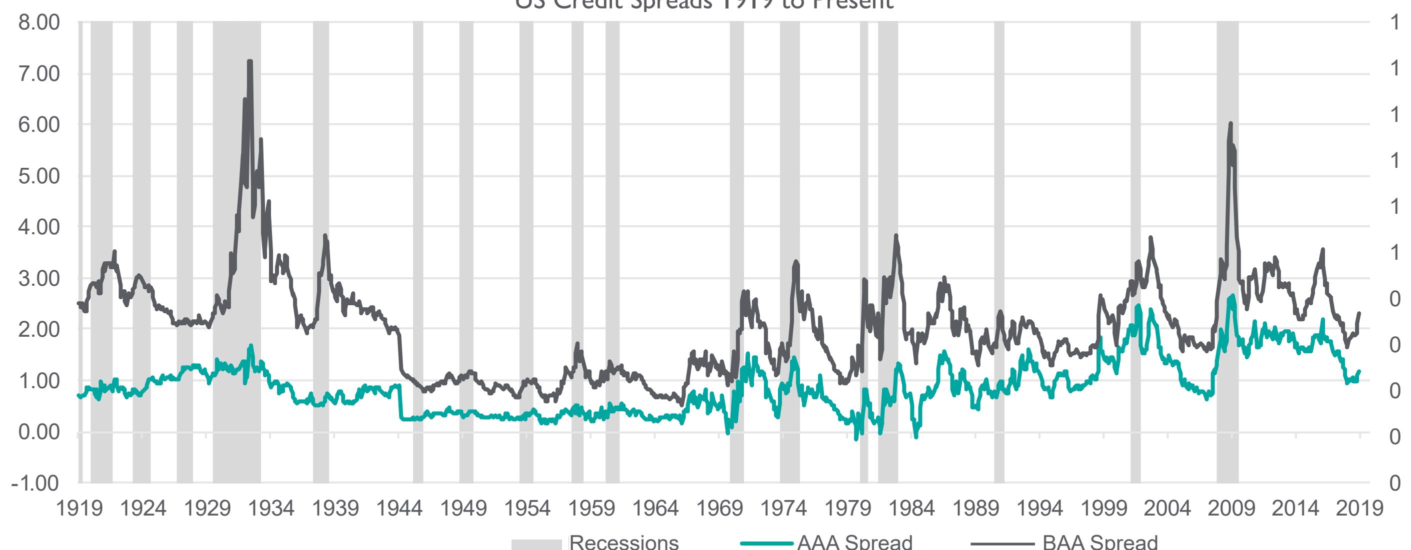
As far as the yield curve is concerned, it has not actually inverted, and has in fact been steepening in recent weeks as market expectations for Fed rate rises have diminished: whereas Jerome Powell, Chairman of the US Federal Reserve, spooked markets in December by saying that he would advocate continuing to put rates up by at least a couple of notches in 2019, the bond markets are now telling us that it is very unlikely that we will even see one rate rise. The financial community is effectively agreeing with President Trump in saying that further rate rises would constitute a policy mistake. That is not to say it won't happen, but the Fed does at least have the flexibility to relax its monetary policy, especially as inflation in the US appears to be under control and is unlikely to present any potential problem at a time when the economy is slowing, the currency is strong and the oil is price weak.

...and credit spreads are not at critical levels.

Looking at credit markets, spreads are not as wide as they were in the 2011 Eurozone crisis or the growth scare of early 2016 – on neither of which occasion was there an ensuing recession. Unless credit markets worsen significantly from here we would regard the present correction as a rational re-pricing of credit risk following a period in which it was too easy for doubtful credits to secure financing. In terms of emerging market and peripheral Eurozone spreads, we think this is primarily a reflection of political risk (e.g. in Italy) or specific risk (e.g. countries dependant on the oil price like Russia) rather than general global economic risk. Although political and economic risk go hand in hand (particularly in Europe, where a break-up of the euro would be extremely damaging to the economy in the short term), it is interesting to note that equities in Asia and Emerging Markets have held up relatively well in recent months, which would be surprising if an economic recession was in the offing.

Bonds are more attractive than they were.

In conclusion, and notwithstanding the recent strong performance of long-dated government bonds (US treasuries are represented in multi-asset portfolios) we remain happy to be underweight fixed-interest overall. Government bond yields are not attractive: the UK 10-year gilt yield is 1.3%, Germany just 0.2% and Japan is fractionally negative. Some corporate bonds are looking good value at these levels, but liquidity is an ongoing issue and only by doing the necessary work on the credit can one be comfortable investing.



Source: Federal Reserve Bank of St Louis, Moody's, Waverton

OUTLOOK FOR EQUITIES

Lower share prices coupled with strong earnings...

Equity markets have had a terrible quarter. An initial decline in October was construed as profit-taking following a strong summer and a degree of trepidation regarding the interest rate rises which were known to be in the pipeline. However, the third quarter earnings season was healthy, so equities stabilised in November. In December the sell-off gathered pace as equities took fright at the signals coming from the bond market which we have described on the previous page. The ongoing US / China trade war and a budget shut down in Washington added to the sense of despair.

...have resulted in a significant de-rating.

The strong earnings that we have seen in 2018 combined with the indices' price falls have served to de-rate equities significantly: the historic price / earnings ratio has fallen back to 15.6 x, which is about 25% below the twenty-year average. Clearly, investors are positioning themselves for a fall in profits – either from a decline in corporate profitability (which is currently at a historically high level) and / or a generalised economic recession. At present, the analyst community's earnings estimates indicate an expected 9.5% earnings growth in 2019, a figure which we have felt for some time is too high. If we see similar downgrades to expectations in 2019 as we have typically seen over the course of prior years, we would expect an outturn of c. 6.5% earnings growth in 2019. That would be consistent with 2.5% inflation, 2.5% real GDP growth and a small amount of operational gearing – i.e. an economic slowdown from 2018's level of 3.7% and lower than economists' consensus forecast of 3.5% in 2019, little change in inflation or interest rates, and no change in corporate profitability. If this were to be the outcome, it would mean that equities at current levels are indeed as cheap as the historic price / earnings ratio suggests: only if we see an earnings decline in 2019 would we conclude that equities are potentially expensive at these levels.

A decline in earnings looks unlikely in the short term.

What could cause an overall earnings decline from here? A sudden decline in profitability worldwide without an economic recession is unlikely unless either interest rates or taxes rise very significantly and quickly; neither of those are on the horizon, so the more realistic risk is a recession. We agree that the runes emanating from the bond markets are a cause for concern, but none of them are flashing unambiguously red at this stage – and the indicators which we look at in the real economy are mostly looking pretty healthy. For example, high corporate profitability is usually a good sign for near-term economic growth, as is a low oil price. Equally, business & consumer confidence and world trade are all suggesting that there is no immediate prospect of recession, even though the rate of economic growth may slow somewhat.

The US economy is fundamentally strong.

The primary engine of world economic growth, the US, is showing few signs of distress and looks to be in good shape, even if it may slow down from last year's heady level; moreover, any sign of weakness there will surely be met with some positive policy action by the Fed. The more significant risks probably lie in the Eurozone (where, even if the currency bloc does hold together, it will come at a high economic price and at the expense of any enduring confidence in the banking system) and in China (which is seeing a marked slowdown and where certain sectors of the economy are vulnerable to a credit crisis). The Eurozone is a risk that will not go away any time soon, but there is no particular reason to believe it will trigger a crisis this year: it is probably something which will come unstuck in the next recession, wherever that starts, rather than be a cause of recession itself. As far as China is concerned, a profit warning from bellwether Apple in early January has frayed nerves, but it is quite possible that this is more of an Apple-specific problem than a big red light for the region as a whole.

Equities are already pricing in a lot of risks.

In conclusion, we believe that the present market malaise is more akin to the growth scare of early 2016 than it is to the great bear markets of the past. The banking system is well capitalised, the corporate world is well financed and continues to generate returns on capital well above the corporate cost of capital, and the global economy does not look as though it is going into reverse any time soon. That said, the economic cycle is already extended and there are plenty of risks out there – but equities are already priced for that and we are confident that sustainable global businesses with strong balance sheets will win through in time.

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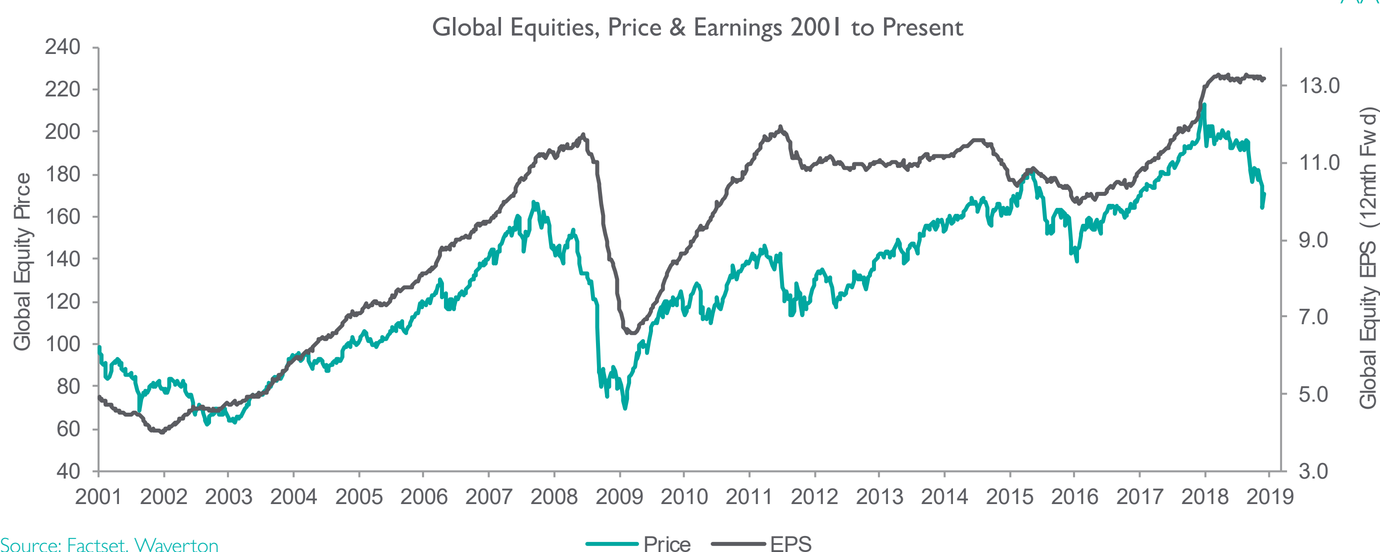

Source: Factset, Waverton

TOTAL RETURN INDICES TO 31st DECEMBER 2018

STERLING ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx £ Gilts Index	2.1%	0.2%	0.4%	0.6%
Citigroup World Govt Bond Index	4.2%	3.8%	6.6%	5.3%
MSCI United Kingdom All Cap Index	-10.6%	-11.3%	-3.1%	-9.8%
MSCI United Kingdom Index	-9.7%	-10.1%	-1.6%	-8.8%
MSCI AC World Index	-10.7%	-5.7%	0.7%	-3.8%
MSCI AC World (ex UK) Index	-10.7%	-5.4%	0.9%	-3.5%
MSCI AC World (ex US) Index	-9.3%	-7.6%	-4.4%	-8.9%
S&P Composite Index	-11.5%	-3.4%	6.1%	1.6%
MSCI Europe (ex UK) Index	-11.0%	-8.3%	-5.4%	-9.9%
MSCI Japan	-12.2%	-7.8%	-4.8%	-7.5%
MSCI AC Asia Pacific ex Japan Index	-6.7%	-6.9%	-4.6%	-8.6%
MSCI Emerging Markets	-5.3%	-5.1%	-7.2%	-9.3%
Waverton Growth Index	-7.9%	-4.2%	0.7%	-2.7%
Waverton Growth UK Bias Index	-7.9%	-5.5%	-0.1%	-4.0%
Waverton Balanced Index	-6.2%	-3.3%	0.6%	-2.2%
Waverton Balanced UK Bias Index	-6.2%	-4.3%	0.0%	-3.2%
Waverton Cautious Index	-4.5%	-2.4%	0.5%	-1.7%
Waverton Defensive Index	-3.2%	-1.7%	0.5%	-1.1%
Return on Cash £ (1 month deposit rate)	0.1%	0.3%	0.4%	0.6%
Inflation - UK CPI	0.4%	1.1%	1.9%	2.0%
Gold Price (£1009.16)	11.3%	6.2%	7.2%	5.0%
£ vs US$	-2.3%	-3.5%	-9.2%	-5.9%
£ vs Euro	-0.8%	-1.5%	-2.3%	-1.1%
£ vs Yen	-5.7%	-4.4%	-6.3%	-8.3%

US DOLLAR ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx $ Treasuries Index	2.7%	1.9%	2.1%	0.8%
Citigroup World Govt Bond Index	1.8%	0.1%	-3.3%	-0.8%
MSCI United Kingdom All Cap Index	-12.7%	-14.4%	-12.0%	-15.1%
MSCI United Kingdom Index	-11.8%	-13.2%	-10.7%	-14.2%
MSCI AC World Index	-12.8%	-9.0%	-8.5%	-9.4%
MSCI AC World (ex UK) Index	-12.8%	-8.8%	-8.4%	-9.1%
MSCI AC World (ex US) Index	-11.5%	-10.8%	-13.2%	-14.2%
S&P Composite Index	-13.5%	-6.9%	-3.7%	-4.4%
MSCI Europe (ex UK) Index	-13.1%	-11.5%	-14.1%	-15.1%
MSCI Japan	-14.2%	-11.1%	-13.6%	-12.9%
MSCI AC Asia Pacific ex Japan Index	-8.9%	-10.2%	-13.4%	-13.9%
MSCI Emerging Markets	-7.5%	-8.5%	-15.8%	-14.6%
Waverton Growth Index	-9.4%	-6.5%	-6.1%	-6.9%
Waverton Balanced Index	-7.4%	-4.9%	-4.6%	-5.4%
Waverton Cautious Index	-5.3%	-3.4%	-3.1%	-4.0%
Waverton Defensive Index	-3.7%	-2.2%	-1.9%	-2.6%
Return on Cash $ (1 month deposit rate)	0.6%	1.1%	1.6%	2.1%
Inflation - US CPI	0.4%	0.8%	1.4%	2.0%
Gold Price ($1281.65)	8.3%	2.5%	-3.2%	-1.1%
US$ vs £	2.4%	3.7%	10.1%	6.2%
US$ vs Euro	1.6%	2.1%	7.6%	5.0%
US$ vs Yen	-3.4%	-0.9%	3.2%	-2.6%

* All MSCI benchmarks are net of tax

Source: Factset,Thomson Reuters DataStream

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WAVERTON INVESTMENT MANAGEMENT LIMITED 16 BABMAES STREET LONDON SW1Y 6AH 020 7484 7484 WAVERTON.CO.UK

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