MARKET PERSPECTIVES

APRIL 2019

THE LAST QUARTER...

- Global stock markets experience their strongest quarter in six years, led by the US, which has its best January for 32 years.
- The UK unemployment rate falls to 3.9% – the lowest since 1975; inflation falls below the Bank of England's target.
- Bond yields decline: 10 trillion dollars' worth of global debt trades at a negative yield. The 10 year gilt yield falls below 1%.
- Greece issues a 10-year bond yielding 3.7% (compared with 37% in 2012).
- Chinese economic growth, at 6.6%, slows to its lowest rate since 1990.
- The Argentinian peso hits an all-time low.

"Well, they talk we shall have no more Parliaments, God bless us!"

Ben Jonson, *The Staple of News*
1625

WAVERTON

INVESTMENT MANAGEMENT

OUTLOOK FOR INTEREST RATES

Both corporate and government bond yields have fallen...

In the dark days of December last year government bond yields were collapsing along with equity prices as investors became increasingly fearful that the US Federal Reserve was 'behind the curve' (i.e. tightening monetary policy when it should be loosening) and likely to precipitate a recession. Consistent with this narrative was the fact that corporate bond spreads were widening as investors demanded a higher risk premium for lending to companies in a deteriorating economic climate. Rolling on three months, we find that share prices have staged a remarkable recovery and corporate bond spreads have narrowed – both indicating that December's recessionary alarm is behind us. However, what few could have predicted is the continued fall in government bonds yields: normally one would expect recovering equities and corporate credit to be accompanied by rising government bond yields as safe haven demand wanes and inflation becomes a more worrisome risk than recession. Towards the end of March long dated government bond yields fell enough to result in an inverted yield curve in the US. An inverted yield curve normally indicates that investors expect overnight rates to fall significantly over an extended period of time and by implication is regarded as a sign that economic growth is deteriorating. A number of commentators have on the back of this warned that recession is around the corner. Negative Eurozone yields along the maturity spectrum is another ominous sign.

...and the yield curve has inverted.

It is true that 10 year / 3 month inverted yield curve has been a precursor to the last seven recessions in the US (although it is worth mentioning that the lead-time from inversion to economic recession ranges from six to seventeen months – during which time the stock market often performs quite well). But it has not been such a reliable indicator outside the US, and in any case might there be explanations for the appearance of inversion other than an economic slowdown?

Long rates are exceptionally low,...

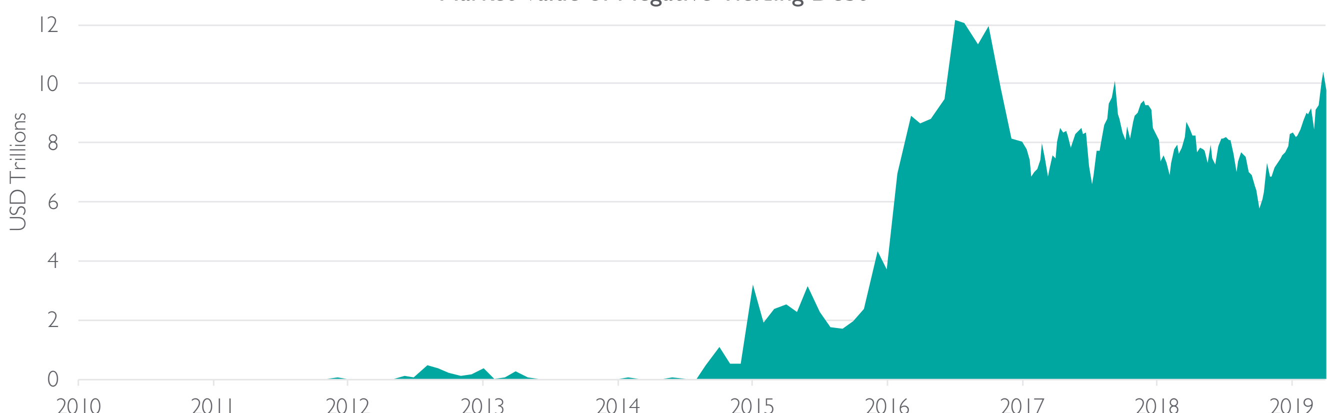
Usually, an inverted yield curve comes about because short rates go up markedly as central banks fight inflation during an economic boom. Interest rates then peak at a level significantly above the long term sustainable rate (e.g. at 13% in 1974, 20% in the early 1980s and over 5% in 2007). This time, however, overnight rates in the US are 2.5%, which is well below past peaks and beneath the natural long-term level of interest rates. Whilst the European Central Bank may well be 'behind the curve', in the US the Federal Reserve has shown itself to be flexible and willing quickly to increase liquidity should the economic need arise – such that markets are now expecting a rate cut later this year. Therefore the primary driver of inversion on this occasion has been the fall in long rates to exceptionally low levels rather than the rise in short rates to unusually high levels. Central banks set the level of short rates but markets generally dictate long rates, so it is there that we find the explanation for the inversion this time.

...so we continue to be wary of bond markets.

The big buyers of long dated bonds in recent years have not been active multi-asset investors like Waverton. Rather they have been insurance companies, pension funds, commercial banks and indeed central banks themselves (deficit countries engaging in quantitative easing and surplus countries like China finding a home for their foreign currency reserves). We have mentioned many times before that we believe the long end of the bond market is distorted by forced buying from institutions which are required to hold enormous quantities of long dated government bonds regardless of their price. We reiterate that remains the case, and make the additional comment that some more marginal buying by, for example, commercial banks hedging their mortgage books, periodically adds fuel to the fire.

The yield curve is by no means an infallible augury.

The period during which the yield curve inversion 'worked' as a harbinger of recession, namely the late 1960s until the last recession, was an era during which bonds systematically yielded more than equities. That yield ratio flipped in 2008, thus reverting to the state of affairs which existed pre-1958: global equities in aggregate now yield 80% more than global bonds (although in the US, equities do once again yield a bit less than bonds). This will be the first occasion for many decades when we have seen yield curve inversion at a time when bond yields were not materially higher than the dividend yield on equities and therefore we cannot assume that the rule which applied between 1970 and 2008 should continue to apply now. Between 1935 and 1960 there were six recessions which were not preceded by an inverted yield curve whereas, in the 1920s, yield curve inversion occurred in the depths of recessions and turned out to be the precursor to economic recovery.



Note: BNYDMVU Index
Source: Bloomberg Finance LP

OUTLOOK FOR EQUITIES

Equities have moved in the opposite direction to earnings estimates...

Whilst equity markets are by no means discounting economic recession, they have certainly already priced in a considerable degree of earnings downgrades. At the beginning of this year the aggregate forecast earnings growth for 2019 was +9.5%; now it is +6.7% – and yet share prices have gone up 9% in the interim. Equity markets have been prepared to look through these downgrades because they started the year inexpensively; moreover, whilst the economic data that we have seen over the last three months has been weak, it has not suggested that a recession is imminent and, for the moment, forward-looking markets are seeing enough to reassure them, including the evident pliability of central banks.

...and the economic growth outlook is mixed.

One area of concern is Europe, where the German 10-year bond yield is now below the Japanese equivalent. German manufacturing is in recession, as is the Italian economy as a whole. A 'no deal' Brexit could tip the entire continent into a downturn. In America, the housing market is tailing off and the effect of Donald Trump's tax cuts is waning, so there are signs of a slowdown taking place in the world's largest economy. However, as we said in the last edition of *Market Perspectives*, we believe the US economy is still fundamentally strong with manufacturing, consumer confidence and employment indicators looking healthy. Moreover, there are parts of the world that have improved over the last three months: China is regularly touted as the 'next shoe to drop', but the Chinese stock market is up nearly 25% over the last quarter on the back of improved industrial production and hopes that the trade dispute with the US will be resolved. Elsewhere in Asia, political risk is dissipating, currencies are appreciating and an accommodative US Federal Reserve is encouraging investors back into the region. Emerging markets bucked the wider trend over the last quarter in that they saw in aggregate material earnings upgrades.

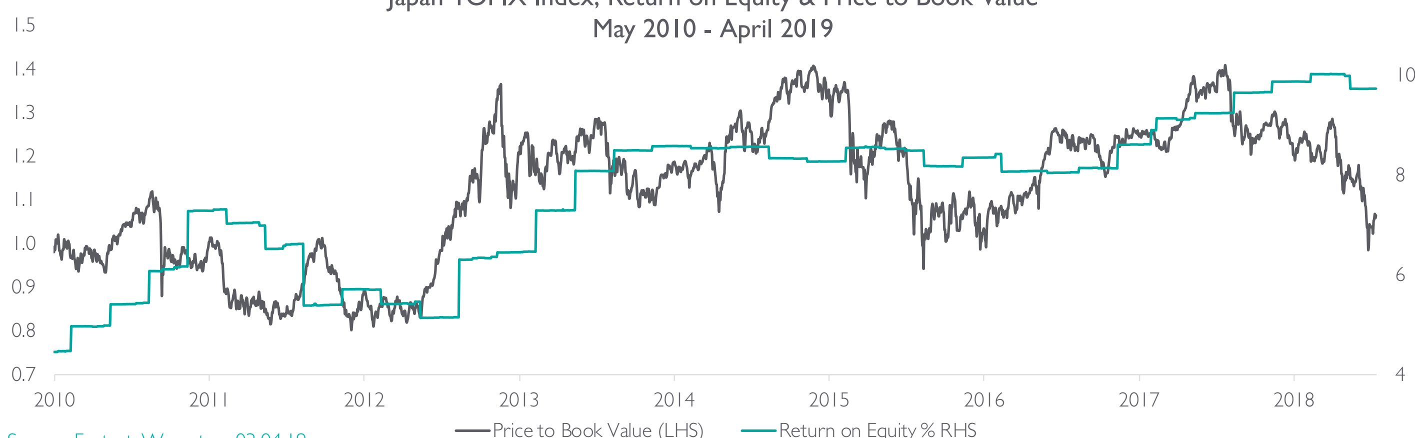
Japan looks interesting.

The Japanese stock market has been underperforming the MSCI World index recently – perhaps because it is traditionally quite cyclical and therefore more vulnerable to adverse sentiment surrounding an economic slowdown. However, on a 'bottom-up' basis, we are finding more company ideas in Japan and our analysts are increasingly positive about the willingness of Japanese management to be more shareholder-friendly than they have been in the past. We note that the Return on Equity (ROE) of Japanese companies has improved from less than 5% in 2010 to nearly 10% today, but the price / book valuation of the stock market has not changed to reflect this. The accession of the new emperor on May 1st, the Rugby World Cup in September this year and the Tokyo Olympics next year may be the catalysts that are needed to highlight the opportunities that are available there.

Ultimately, investors should entrust their capital to the private sector in preference to the public sector.

Given the earnings downgrades and price appreciation that we have seen over the last quarter, stock markets no longer look as cheap as they did. The key consideration for 2019 will be the rate of earnings growth: if this can be maintained at a modest single digit growth rate and combined with a degree of confidence that 2020 will also be benign, shares are likely to make further progress. Aside from the obvious political risks, the chief threat to this is rising interest rates. At present interest rates are proving to be a tailwind in spite of the inversion of the yield curve. On prior occasions when an inverted yield curve heralded a recession government bonds presented a legitimate safe haven given their valuation relative to other asset classes. At current prices, however, it is very difficult to make the case for government paper as being a safe haven on anything other than a short-term basis because yields are so extraordinarily low – to the point of being negative in many instances. Active investors should not succumb to what is, through regulation and central bank manipulation, a government-sponsored programme to try to force the private sector to lend money to politicians with no or even a negative return by way of compensation. Whilst hard left socialist governments and emerging markets typically default by directly reneging on their debts (e.g. Argentina) or by devaluing their currencies (e.g. Zimbabwe), liberal democracies, it seems, have discovered and now fully embrace slow default through financial repression. In all those variants of default, it is primarily domestic investors and the 'man in the street' who pay the price for believing too much in their politicians. This can be avoided by diversifying globally and entrusting one's capital to the private sector rather than to policy makers in overly indebted nations. The choice is between accepting that there will be some ups and downs in the business cycle, many of which can be ameliorated by active asset allocation and / or diversification, or succumbing to slow but inevitable impoverishment through financial repression.

AAP



Source: Factset, Waverton, 03.04.19

TOTAL RETURN INDICES TO 31st MARCH 2019

STERLING ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx £ Gilts Index	3.5%	5.7%	3.8%	3.9%
Bloomberg Barclays Global Aggregate Bond Index	-0.1%	3.5%	3.8%	7.2%
MSCI United Kingdom All Cap Index	9.7%	-2.0%	-2.7%	6.3%
MSCI United Kingdom Index	9.4%	-1.2%	-1.7%	7.6%
MSCI AC World Index	9.6%	-2.1%	3.4%	10.5%
MSCI AC World (ex UK) Index	9.7%	-2.1%	3.7%	10.6%
MSCI AC World (ex US) Index	7.8%	-2.3%	-0.3%	3.1%
S&P Composite Index	11.1%	-1.6%	7.3%	17.9%
MSCI Europe (ex UK) Index	8.0%	-3.9%	-1.0%	2.2%
MSCI Japan	4.3%	-8.4%	-3.9%	-0.8%
MSCI AC Asia Pacific ex Japan Index	8.9%	1.6%	1.4%	3.9%
MSCI Emerging Markets	7.4%	1.8%	1.9%	-0.3%
Waverton Growth Index	7.9%	-0.6%	3.4%	8.6%
Waverton Growth UK Bias Index	7.9%	-0.6%	2.0%	7.8%
Waverton Balanced Index	6.9%	0.2%	3.3%	7.5%
Waverton Balanced UK Bias Index	6.9%	0.3%	2.2%	6.8%
Waverton Cautious Index	5.8%	1.1%	3.3%	6.4%
Waverton Defensive Index	4.7%	1.3%	2.9%	5.2%
Return on Cash £ (1 month deposit rate)	0.2%	0.4%	0.5%	0.7%
Inflation - UK CPI	-0.3%	0.2%	1.0%	1.7%
Gold Price (£994.38)	-1.2%	8.8%	4.9%	5.4%
£ vs US$	2.3%	-0.1%	-1.3%	-7.1%
£ vs Euro	4.2%	3.4%	2.6%	1.7%
£ vs Yen	3.2%	-2.6%	-1.4%	-3.3%

US DOLLAR ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx $ Treasuries Index	2.1%	4.9%	4.1%	4.3%
Bloomberg Barclays Global Aggregate Bond Index	2.2%	3.4%	2.5%	-0.4%
MSCI United Kingdom All Cap Index	12.2%	-2.1%	-4.0%	-1.3%
MSCI United Kingdom Index	11.9%	-1.3%	-2.9%	-0.1%
MSCI AC World Index	12.2%	-2.1%	2.1%	2.6%
MSCI AC World (ex UK) Index	12.2%	-2.2%	2.4%	2.8%
MSCI AC World (ex US) Index	10.3%	-2.3%	-1.6%	-4.2%
S&P Composite Index	13.6%	-1.7%	5.9%	9.5%
MSCI Europe (ex UK) Index	10.5%	-4.0%	-2.3%	-5.1%
MSCI Japan	6.7%	-8.5%	-5.2%	-7.8%
MSCI AC Asia Pacific ex Japan Index	11.5%	1.6%	0.1%	-3.5%
MSCI Emerging Markets	9.9%	1.7%	0.6%	-7.4%
Waverton Growth Index	9.7%	-0.7%	2.6%	3.0%
Waverton Balanced Index	8.2%	0.2%	2.9%	3.3%
Waverton Cautious Index	6.8%	1.1%	3.2%	3.4%
Waverton Defensive Index	5.4%	1.4%	3.1%	3.4%
Return on Cash $ (1 month deposit rate)	0.6%	1.2%	1.8%	2.3%
Inflation - US CPI	0.2%	0.4%	0.8%	1.5%
Gold Price ($1295.72)	1.1%	8.7%	3.6%	-2.1%
US$ vs £	-2.3%	0.1%	1.3%	7.7%
US$ vs Euro	1.8%	3.4%	4.0%	9.5%
US$ vs Yen	0.9%	-2.6%	-0.1%	4.1%

* 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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