Investec
Wealth & Investment

Market Commentary

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Overview

The role of this publication is to comment on market-related developments that have occurred during the past few months, while also peering as much as a year into the future. In January I allow myself a slightly longer historical perspective to account for the turn of the calendar to a new year. This year, though, it's a new decade, and although it will be my fifth different decade working in the City, it is the first new one since I assumed authorship of this commentary. Therefore it feels worthy of some reflection.

Although there is no shortage of things to worry about today, it's sometimes easy to forget that at the beginning of 2010 the world was only tentatively beginning to recover from the financial crisis, and that the Eurozone crisis had not yet even begun. It's hardly an exaggeration to say that both of those crises were existential threats to the whole financial system. It was very hard to find anyone with a great degree of optimism about the economic future, let alone raging bulls of equities. Indeed, for most of the past decade the majority of investors have been "waiting for the other shoe to drop". And yet here we are celebrating – if mutely – the longest equity bull market in history.

If there is any single group of people who can take credit for what has happened – and we will come to the criticism later – it is the world's central bankers. They have pushed down interest rates to levels that only people dismissed as crackpots might have forecast, while consistently providing liquidity when required. Yes, the European Central Bank (ECB) was very slow to join this party, and yes, the Federal Reserve (Fed) was a bit too heavy on the brakes in 2018, but in the end they always did what was required to stabilise markets. Of course, there is much debate as to whether or not they should have in fact allowed much deeper retrenchment to take place, but to a great degree their hands were tied by what has been described as the "financialisation" of markets and economies with the enormous debts that have been created. As we begin 2020, it remains very hard to see interest rates being allowed to rise anywhere close to the levels that prevailed prior to the financial crisis, a factor that will continue to pose challenges to investors seeking safe sources of income.

Another key progenitor of the bull market has been the Technology sector. Apple, Amazon and Microsoft have (if we discount Saudi Aramco for now) battled for the title of the world's largest company by market capitalisation, and the Tech sector has propelled much of the gains of the US equity market. Duller, but worthy, "growth compounders" (think Unilever or Diageo in the UK, for example) have also benefitted from the valuation boost provided by lower bond yields and the attraction of their steady, growing dividends. However, it is hard to see valuations being pushed a lot higher – and almost certainly not replicating the re-rating witnessed in the last decade. Capital gains are likely to be driven more by earnings and dividend growth over the next ten years.

It always pays to remind ourselves of the compounding effects of income in any investment strategy. The ten-year data for equity markets makes the point eloquently. The FTSE All-Share Index has returned 52% in capital terms, but 118% with the reinvestment of dividends. We are of the opinion that, given muted nominal growth prospects and markets that have already re-rated substantially, the next decade will see dividends playing an even greater role in total returns.

Two other subjects are worthy of comment. First is the political shift that has taken place. Whether it has been influenced by inequality, globalisation, lack of growth or fading memories of the past (and all can claim some degree of attribution), we have seen increased polarisation and a rebellion against the consensus-based institutions that have served the world so well (if not always perfectly) for several decades. Donald Trump, Brexit, and the Five Star Movement in Italy are all examples, as are the trade disputes between the US and any number of countries. Second, and allied to this, is the explosion of social and other on-line media and the echo chambers that they can create. Although volatility in financial markets has been extraordinarily subdued (thanks, again, to those central bankers), it often spikes owing to news that emanates from, and is amplified by, social media outlets. Often these episodes have been exacerbated by tight liquidity conditions in financial markets, and it's at such moments that investors have had to be careful not to over-react. Indeed, they have often created good trading opportunities. It appears inevitable that we will experience more such episodes in the future, and we will endeavour to treat each on its merits.

To round off this section, we must also comment on the last twelve months. Despite, for example, Brexit, Trump, trade wars, riots in Hong Kong, concerns about liquidity and the hardy perennial of tensions in the Middle East, investors have enjoyed a year of terrific gains in an environment of extraordinarily low volatility. Certainly some of the strength in equities stems from the low starting point following the sell-off during the final quarter of 2018. Looked at over a two-year rolling period, the gains are less impressive, but that serves to remind us of the natural ebbs and flows of markets and the benefits of staying the course. As we start 2020, we see the potential for further equity market gains, although not of the same magnitude as in 2019. A key determinant of the outcome will be the health of the US economy, and we continue to believe that it will avoid a downturn in the coming twelve months, at least.

Key Influences

The actions of central banks, which, as explained earlier, have been critical to the fortunes of investors over the last decade, will continue to dominate. The most recent round of messaging suggests that, in aggregate, they are in no hurry to tighten policy. Growth is subdued by historical standards, as is inflation. There is even growing talk of letting inflation "run hot" for a while to balance the previous undershoot of the preferred 2% target. Both the Fed and the ECB are expected to air further thoughts on the subject in 2020. Although this does not provide a fool-proof failsafe mechanism for markets, it should limit the potential for lasting major setbacks. Having said that, the decision by Sweden's central bank to raise interest rates back to zero (who would have predicted such a phrase ten years ago?!) suggests that we are close to the limits of traditional monetary policy without creating damaging side-effects elsewhere in the system.

The other main actors will be politicians… again. In the UK, much will hang on the post-Brexit transition period and the negotiations with the EU covering our future trade relationship. In the US, we have already been reminded early in the year of the uncertainty of foreign policy with the killing of Iranian military leader Qassem Soleimani. It is prudent to assume disruptive retaliation, although very difficult to predict exactly what. Suffice to say that it will keep markets on edge, but also dampen the risk of euphoric excess. The US presidential election will be the major set piece of 2020. First, though, it will be instructive to see how far to the left the Democratic Party is willing to swing in its choice of candidate. An Elizabeth Warren or Bernie Sanders ticket would be poorly received by investors.

Markets – UK

Equity markets breathed a huge sigh of relief following the Conservative Party's election victory in December. Not only was the threat of an extremely left wing Labour government averted, but there was also the promise that the Brexit logjam would finally be broken. Small and mid-cap companies found special favour thanks to the promise of increased investment in the economy by the government. UK equities have been consistently avoided by international investors since the Brexit referendum, but there is clear evidence that this group has been encouraged to return. This follows the lead of several corporate buyers, who had already been tempted by attractive valuations. The

FTSE All-Share Index continues to sport one of the highest dividend yields (4.5%) amongst major markets, and this income looks especially attractive relative to a 10-year government bond yield of 0.77%. However, given that such a large chunk of the yield (>15%) is generated by Oil companies, there is some caution as to how quickly the market's aggregate payout can grow.

US

US equities begin the new decade trading at all-time highs, which is testament, in particular, to the growth achieved by its Technology sector, which now accounts for around a quarter of the market capitalisation. One of the features of the last decade has been the paucity of new companies listing on the stock market as more managements elect to remain in private ownership. There has been no shortage of capital available through this channel, obviating the need to raise funds in the public markets. However, the disappointing debuts of companies such as Uber, alongside the failure of WeWork to list at all, suggest that some of the frothier private valuations might be under pressure. The big prospective Initial Public Offering for 2020 is Airbnb, a name familiar to many. The appetite for shares and the valuation achieved will be an important indicator of how investors view the prospects of such innovative and disruptive new businesses.

Europe

Europe is a frustratingly general tag for a diverse group of economies that have a wide range of individual strengths and weaknesses. Germany, as the largest member, tends to set the tone, and it experienced a year to forget in 2019, narrowly avoiding falling into a technical recession. However, that cannot disguise a recession in its manufacturing sector. The slowdown in world trade hit its exports, while the secular shift away from higher carbon-emitting vehicles caught its automotive industry unprepared. The good news is that year-on-year weakness is beginning to bottom out. Europe's perennial problem child, Italy, also appears to be on a more stable political footing for now, which is encouraging. Spain and France have fared relatively well owing to a greater domestic focus, although President Macron is struggling to push through major pension reforms. All in all there are reasonable grounds to expect Europe as a whole to perform better in 2020, especially if President Trump can resist escalating trade tensions ahead of the US election.

Japan

Japan's rulers have a frustrating habit of undermining incipient recoveries. First the government increased VAT by 2% in October, which will constrain consumer demand despite some other fiscal concessions. Then it lowered the threshold at which foreign investors must seek permission to invest in Japanese companies from 10% to 1%. This potentially restrains the sort of activist investors who have succeeded in influencing corporate governance for the better in Japan, even if the rule is mainly intended to hinder China's technological and economic progress. We make no secret of our view that Japan is the home to some of the best value equities in the world as well being a country at the forefront of innovation, much of which is necessitated by a shrinking and ageing population. But extracting that value is often a lot harder than one feels it should be.

Emerging Markets

The slowdown in global trade has been a major factor in the lacklustre relative performance of EM equities over the last year. Another reason has been the persistent strength of the dollar, which has made servicing and refinancing dollar-denominated debt more expensive. More positively towards the end of the year the dollar showed some signs of losing momentum, while the "phase one" China/US trade deal promises to alleviate the trade malaise. Add to that further supportive measures being taken by China's government, including a further reduction in the Reserve Requirement Ratio for banks on New Year's Day, and the outlook is a lot brighter at the start of 2020.

Fixed Income

Government bonds continue to offer very little to investors by way of income, which leaves their role in balanced portfolios very much as "insurance assets". Even then, there is a feeling that there is a limit to how low, or even negative, bond yields can go, making the risk/reward balance somewhat asymmetric, meaning that investors could potentially lose more money than they could ever make from a change in sentiment. Another option for investors is take more duration risk – that is to buy bonds with much more distant maturities than the global average of eight-and-a-half years. Holders of Austria's 100-year bond made out like bandits when yields plummeted in the summer of 2019, but also gave a lot back when yields rose again. Longer maturities also mean higher volatility, which is not for everyone.

One sub-sector that we find relatively attractive is the Additional Tier 1 capital of European Banks, also known as Contingent Convertible or "Coco" bonds. The yields are more generous, and conversion into equity would probably only take place in the event of another financial crisis, which we do not believe is on the cards.

The biggest threat to the government bond market remains inflation, and despite the odd scare there remains little sign of it breaking higher thanks to the strong disinflationary forces of technology and demographics. But we remain on high alert for any shifts in the trend.

UK Gilts have delivered a total return of -3.9% over the last three months and 6.9% over the last year. Index-Linked Gilts returned -8.6% and 5.8% over the same respective periods. Emerging Market sovereign bonds produced a total return of -5.7% in sterling over the three months to end December (9.5% over 12m). Global High Yield bonds delivered -4.4% (8.7% over 12m).

Conclusion and Outlook

It feels as though in these commentaries we spend much time – perhaps the majority – writing about the risks to investors, for which we do not apologise: people really don't like to lose money, and we strive to minimise losses as much as to maximise gains. Many of the key themes have not changed much for the last six years, as I discovered on re-reading my previous year-end commentaries. The ebb and flow of monetary policy has been a thread that runs through the whole narrative, both in terms of interest rates and the dynamics of central bank balance sheets. (Geo)politics has become increasingly influential. Neither of these factors looks set to diminish.

This uncertainty has meant that it has been more difficult to add value through tactical asset allocation, and for much of the last three years we have remained close to neutral in terms of our appetite for portfolio risk relative to the benchmark. Luckily, we have other strings to our bow in the form of stock and fund selection, and continue to evolve our process to create even more success in these disciplines. This will increasingly include a focus on three letters that are becoming highly prominent in the investment world: E.S.G, which stand for Environmental, Social and Governance, subjects with which clients and portfolio managers are becoming more and more engaged. We will provide more details about how we apply these screens to our portfolios as the year progresses.

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