Winter 2019

market outlook.

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The UK Economy

In the UK, consumer confidence remained at its lowest level since 2013 in January and growth in consumer borrowing fell to its slowest since 2014 in December. Over the past few years, disposable income has been squeezed by higher inflation and fiscal austerity. However, with unemployment at a forty year low and employment at a record high, the tight labour market is feeding through into wage growth which reached 3.5% in October, its strongest since 2008.

Thanks to lower oil prices and Sterling's weakness since the referendum working its way out, CPI inflation fell from 3% at the start of 2018 to 2.1% in December. However, despite rising real income, with Brexit still on the horizon, rather than spend, households are continuing to favour rebuilding their finances.

The Bank of England is widely expected to maintain interest rates at 0.75% in February, however, the accompanying Inflation Report should provide some insight to their outlook, although, the future direction for interest rates will remain heavily dependent on the Brexit outcome.

The vote on the current EU withdrawal bill took place in January after being cancelled in December and, unsurprisingly, politicians voted against it. The main issue of contention remains the border with Northern Ireland, which saw many of the Prime Minister's own party voting against her. With 432 votes against versus 202 in favour, it was a record Commons defeat and Jeremy Corbyn seized the opportunity to call a no confidence vote in the government which was predictably defeated the following day.

Ahead of the vote on the Withdrawal Bill, parliament passed a motion forcing Theresa May to reveal her next steps sooner rather than later. The revelation which has been dubbed 'Plan B' was more of a restatement of Plan A with some reassurance that the issues with the Irish border can be resolved.

May appears to have convinced politicians she should have the chance to renegotiate with Europe, after she won six out of seven tabled amendments to Plan B, which also saw a bigger than expected emergence of rebel Labour MPs. While she lost one vote disapproving a no-deal Brexit, MPs failed to implement anything preventing one. MPs did back an amendment removing the contentious Irish backstop from the Withdrawal Bill and so Theresa May must now return to Europe to renegotiate.

While on the face of it, it looks like 'mission impossible' as Donald Tusk, the president of the European Council, immediately said the deal isn't open to more negotiation (although interestingly, he also said the EU would consider a Brexit extension despite the fact that MPs also voted to reject a delay), the vote does bolster Theresa May's hand: either the EU agrees to talk about the backstop in order to avoid a no-deal Brexit (and a no-deal Brexit would be damaging for the EU and especially so for the Irish economy), or MPs are forced to fall into line and back her original Brexit Plan rather than risk a no-deal exit. More details on the progress of Plan B are expected by mid-February, although, with time running out, an extension to the March deadline is looking increasingly likely.

The Japanese Economy

Japanese markets, whilst positive year to date, have had a slower start to the year than other markets in sterling terms. Little has happened politically or economically over the past quarter, with Prime Minister Shinzo Abe arguably keeping mass policy change quashed in order to dodge the U.S. 'trade' firing line. That being said, at the domestic level there have been some economic announcements that are relatively poignant, particularly surrounding inflation (the key to Japan's historic economic stagnancy). Once again, Bank of Japan Governor, Haruhiko Kuroda, announced a lowering of inflation expectation, this time from 1.4% to 0.9%. This is relatively meaningful, as subsequent inflation targets have been lowered also, and with Quantitative Easing (QE - printing of money via bond purchasing) still in full flow, there remains a concern that with the current lack of domestic level stimulus, if QE was withdrawn, the economy would struggle to be self-sustaining in fending off deflation. In addition, and as I have mentioned in previous quarters, despite the 'job to applicant ratio' levels supporting a wage inflationary environment, it is yet to be seen. So, whilst compression in crude oil prices was cited as the reason for lacklustre inflation expectations; with GDP data weakening, there is little by way of economic data to suggest that current stimulus levels will aid in making the Japanese economy self -sufficient over the short to medium term.

Parking the above factors aside, there are still some really attractive opportunities in Japan. You will recall from the last Market Outlook, I mentioned that due to regulation changes, there are rafts of under-researched companies in the small and mid-cap space. The lack of research of these names cause a compression in valuation and masses of opportunity, something that was prevalent in the market throughout 2018. In addition to which, February 2019 will see the formal activation of the free trade pact between Japan and Europe, the largest free trade deal of its kind. This agreement will go some way to alleviate the pressures from potential trade frictions with the U.S. in addition to generating opportunities for a number of smaller/medium sized companies to reduce overheads. And, whilst this could introduce a more competitive environment in many sectors, any downward price pressures will likely be beneficial to the consumer… something that will be key ahead of the planned October 2019 sales tax hike (from 8% to 10%), especially as we have seen consumer confidence data drop throughout 2018. So, whilst Japan does have its macroeconomic challenges to overcome, there are areas of real opportunity from a 'bottom up' stock picking perspective!

The Emerging Markets & Asia Economy

It would be great to say that the close of 2018 was anything more than a story of sentiment driven by US/ China trade frictions and indeed assumed US Fed hawkishness, but unfortunately this is the majority of what drove markets. Despite this short term 'doom and gloom', these factors being the primary drivers can been seen as an immense positive, as we have seen so far in 2019.

2018 saw the Emerging and Asian region somewhat artificially supressed, primarily by US protectionism, and indeed the perceived hawkishness of US Federal Reserve (Fed) policy. Whilst it was difficult for the broader market to 'see the wood for the trees' in the downturn, it has created an incredibly attractive opportunity in Asian and EM markets. As, whilst trade worries were and are still apparent, the EM and Asian stock markets and local currencies have priced in a lot of the downside of a potentially negative outcome, despite negotiations yet to conclude (March 2019) and despite tensions thawing somewhat! With this in mind, when one looks towards 2019 and a resolution to the trade dispute between China and the US, whether it is positive or not, there is potential upside in markets throughout the year. Also, in amidst of all of the trade noise, it is easy to forget that China is still growing at 6.4%; a number that dwarfs US, UK and European data which is immense for a country with a population of over 1.3 billion. In addition, whilst we have seen the manufacturing output decline in China, Chinese Premier Xi Jinping's 5 year plan to shrink the manufacturing base and grow the domestic consumer and services sector has been a resounding success, seeing service sector data materially exceed expectations. With that in mind, and with valuations compressed to extremely low levels, any form of certainty surrounding trade between China and the US, when coupled with the market's new found clarity surrounding the Fed's accommodative nature, the year ahead holds an incredible platform from which Asian and EM markets can launch themselves.

Asian and Emerging markets have some of the most attractive opportunities and valuations globally, but one must be mindful that it will be region specific. So, we have seen new leadership sworn in over the past couple of months in both Brazil and Mexico, with the new President of the former being openly racist, sexist and pro-military rule and the latter appearing relatively lax on policy to date. With this in mind, the fragility of Latin American markets is apparent. However, there are immense opportunities elsewhere. We mentioned the valuations and supporting macroeconomic data in Chinese markets, and when coupled with the recent policy action by the Chinese government by way of fiscal stimulus (Cash injections, bond issuance), it appears a great opportunity. In addition to this, the PBOC (Peoples Bank of China) have cut the Capital Reserve Requirement (amount of capital a bank is forced to hold back) in successive months in order to stimulate lending and thus consumption.

Alongside China, there is also the prevailing story in India, and with the short term pain of large scale change somewhat behind them (demonetisation, Goods and Services Tax, identification system, etc.), and with the inevitability of domestic level stimulus ahead of an election later this year, domestic corporates further down the market cap spectrum stand to benefit. With all of the above in mind, when accounting for political stability, policy action and valuations, 2019 is giving every opportunity for Asian and EM markets to realise some of their potential.

The US Economy

There is no getting away from it, the past quarter has been rife with volatility in US markets… but what has actually happened, and what is relevant? We have seen an arguably healthy reversion in US markets at the close of 2018; driven by not only trade uncertainties, but also by a December statement by head of the Fed, Jerome Powell, that eluded to both the addressing of the balance sheet and the rate rise cycle as being on a predetermined path, and it was partially this that threw broader equity markets into disarray. However, this faded into insignificance following Powell's further elaboration in January that stated that both the rate cycle and the balance sheet policy would remain accommodative, seeing the market rally as the world's largest economy's central bank remained heavily accommodative and data dependent. This was emphasised at the end of January when Powell stated that the case for raising interest rates had weakened as inflation would need to pick up further.

In terms of trade tensions with China, well, not that much has happened. Towards the end of the year we saw US President Donald Trump agree a trade ceasefire with Chinese Premier Xi Jinping, which has seen Chinese Global automotive import tariffs drop from 45% to 15%, and China resume purchases of agriculture products from the US (such as Soybeans). Whilst there is still some dispute over intellectual property rights in China, the tensions between the two superpowers have thawed ahead of the March 2019 trade negotiation deadlines. In addition to all of this, Donald Trump has forced a partial government shut down over a disagreement with Congress over the budget… as Trump wanted an extra 100% increase over the proposed amount in order to fund the fabled 'Mexican Wall'! So, whilst there are some factors that remain unclear, the reality is that the US government shutdown is somewhat irrelevant to markets and trade tensions have largely been priced in allowing for more attractive valuations globally. This leaves the only real driver being Fed policy in the months/ year ahead.

Whilst it feels as if the same drum is being constantly beaten, one of Donald Trump driven volatility, the fourth quarter pullback has injected some much needed valuation relief into the US markets. And, let's remember that throughout all of the bluster, employment data is strong, growth is robust, and the Federal Reserve is firmly data dependent and accommodative on policy. So, the weak close to 2018 has offered up a great valuation opportunity in a country that's economic data is robust… and despite headlines, a recession in the US seems unlikely any time soon! With all of this in mind, whilst US valuations do look more attractive than they did through the majority of last year, the market still looks more expensive when compared to other regional equity markets, and whilst we think the US markets will have a steady 2019, it is the country's economic stability and steady market that gives other global equity markets the platform on which to grow. We cannot forget that for a large part of 2018, broader equity markets had been beaten up somewhat irrationally; driven primarily by US protectionism, and as agreements are made and sentiment settles, we are left with a year ahead that has a strong valuation and economic platform with which to aid markets/investors… all of which seems supported by central bank accommodation!

The European Economy

With European political uncertainty arguably a 2017 issue, and European Central Bank (ECB) tepidness throughout 2018, the European backdrop has been somewhat muted over the past quarter. That being said, we did see the winding up of Quantitative Easing in its entirety in December that has seen the ECB purchase no further Government Bonds in January… and with recent retail sales data significantly beating expectation and inflation no longer teetering on the edge of negative, it could be thought that it has been a relative success. Attractive valuations in many European corporates across the market cap spectrum were further compressed towards the end of 2018 by a pullback in US markets; and unjustifiably so, given the European markets negative correlation with that of the US throughout the majority of 2018. With that in mind, opportunities in quality businesses seem rife in the right areas for longer term investors. So, whilst a January statement from the ECB president, Mario Draghi, cited there were many risks to the downside (suggesting the potential for a reduced growth outlook, further pushing out rate rise expectations), this had a buoying effect for investors and indeed bond and equity markets. The statement from Draghi, whilst relatively negative from a data perspective, boosted optimism over expectation for a continually accommodative central bank. This saw a bounce in Italian bonds, which is positive for the country that was previously seen as a drag on the European markets up until a December agreement between the EU and Italian 5 Star Government that agreed the reduction of the targeted Italian debt to GDP for 2019, from 2.4% to 2.04%.

In addition to the above, one cannot be complacent to global trade concerns continuing to be a source of uncertainty. To put things into perspective, whilst European trading terms with the US are still a bone of contention, trade negotiations with Japan have been one of the success stories of 2018, seeing the free trade pact between the two nations come into play at the beginning of February. In addition, whilst trade talks between China and Europe are progressing slowly, the Chinese reducing automotive tariffs from 45% to 15% has primarily benefitted the European manufacturers with the majority of the top selling foreign models being German. With all of this in mind, we have seen sentiment drive the compression in European markets, primarily due to US trade uncertainty, in addition to the uncertainty surround Italian debt contagion. With EU/Italian relations heading in the right direction, trade negotiations between the US and China progressing, and ECB policy likely to remain accommodative throughout 2019, the environment, whilst not without its risks, has provided a platform for valuations to progress.

Fixed interest

Any thoughts that October 2018's apparent correlation normalisation between bonds and equities have been quashed so far this year; seeing the broader bond market follow equity markets year to date in delivering positive returns. This return of the atypical positive correlation between bonds and equities however seems justified given the more fluid comments and approach to monetary stimulus from central bankers. Following an address in December from the US Federal Reserve Chair, Jerome Powell, loosely suggesting that interest rate policy and the balance sheet was on "autopilot", we saw a fall in broader markets. However, after Powell elaborating on his statement further in January, we saw a surge in not only equities but also bond yields. In addition to the US Fed, it has become clear that the Bank of England (BoE) will remain timid in its approach to policy adjustment given the uncertainty surrounding Brexit and its implications for the UK consumer. January saw Mark Carney state that there will not be a predetermined policy path dependent on the outcome of Brexit, further emphasising the BoE's accommodative stance, and its measured position on interest rates.

Whilst spreads have widened, and debt has had a strong start to 2019, bonds' positive correlation to equities in addition to a rebound in the yield curve in 2019 so far suggests that equities are still the more attractive asset class. As, despite interest rates remaining low, they remain on an upward path, and when coupled with global fundamentals and valuations both being supportive of equities, as soon as an element of trade and political clarity returns to western markets, the bond market will offer little by way of upside. However, as we keep iterating, bonds do offer an element of downside protection, but with correlations remaining positive, and equities more geared in to political stability, corporate credit offers the stronger risk-adjusted returns in the current climate.

If you would like to discuss this or any other aspect of your portfolio, please do not hesitate to contact us on **01423 501 401**, Monday to Friday 9am-5pm, or you can email us at **info@mzltd.co.uk**.

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