Cave's Quarterly

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Stockbroking & Investments Since 1906

Edition 12, Q4 2018 Round Up

2018 – 'Annus horribilis' for investment markets

Whereas 2017 was synonymous with synchronised global growth, low volatility and generally healthy investment returns, 2018 was quite different, as 95% of asset classes made negative returns and equity markets endured their worst year in a decade. Volatility made a triumphant return in October as rising interest rates, spiking US treasury yields, slowing economic growth and geopolitical tensions all sent shivers through markets, leading investors to shun risk assets.

The twists and turns of Brexit

Through almost all UK news outlets, we are unfortunately still being subjected to every twist and turn of the Brexit negotiations. Prime Minister May and her European counterparts reached an agreement in November, however the likelihood of passing her much-opposed deal through UK parliament is looking doubtful, despite having fought off a confidence vote within her own party membership in early December. Her withdrawal agreement effectively hands back border controls to the UK, though opponents of the deal say it will keep the UK too closely tied to EU rules and minimise the benefits of trade deals struck with other countries. The three most probable pathways emerging from here are as follows; parliament accepting Mrs May's deal (likely result = soft Brexit and stock market positive), returning to the electorate and holding a second referendum with a vote on May's deal (likely result = no Brexit and stock market positive), or rejecting the deal and exiting Europe with 'no deal' in place (likely result = hard Brexit, stock market and economic uncertainty).

MPC cuts UK growth forecast

While Brexit uncertainties persist, UK equities remain unloved (or even 'uninvestable' according to UBS) as they are not conducive to rational economic analysis; the possibility of a general election, and thus a hard left Corbyn-led government, also remains a real threat.

As a result, UK equity valuations have fallen, and the stock market currently trades on a price multiple of 11 times one-year forward earnings, down from 14.5 times at the start of 2018. The FTSE All-Share yields 4.3%, a level only previously breached during the 2007-08 financial crisis.

In December the Bank of England's Monetary Policy Committee (MPC) cut its UK growth forecast and voted unanimously to keep interest rates at 0.75%. After raising rates in August, the central bank has since been reluctant to push rates higher while uncertainty remains over Brexit, however it is thought we could see a sharp increase in rates on a 'smooth' and 'orderly' Brexit outcome.

Italy feud ends

Despite weaker-than-expected data in the European economy, the ECB intended to stop expanding its €2.6tn bond-buying programme by the end of 2018. Mario Draghi acknowledged that inflation continued to be 'muted', though emphasised that there are indications the economy will strengthen. The fiscal position in Italy has been one of the biggest concerns in Europe, as the European Commission rejected their budget plan and warned that government's plans to increase borrowing broke EU rules and would drive up costs for businesses and the state. However, the long-running feud ended in December as Rome and Brussels reached an agreement which saw Italy promise to a narrower deficit through delaying some spending measures. Whilst not an ideal solution, it "corrects the situation of serious non-compliance with the stability and growth pact" according to EU commission vice-president, Valdis Dombrovskis. Italian debt rallied on the news, as borrowing costs on the benchmark 10-year bond fell to 2.76%.

US economy shows few signs of imminent downturn

The 15% tumble in the S&P500 has wiped $4.5tn off the value of American equities since September, as fears of the US economy overheating, the Federal Reserve raising rates too quickly, Trump trade uncertainty and the threat of government 'shutdown' saw investors fleeing to 'safe haven' assets amid fears of an economic downturn on the horizon.

However, looking at the wider picture, there are few signs that a downturn is imminent. Business and consumer confidence remain high, business surveys point to expanding output, US wage growth rose 3.3% year on year in October, and the monthly average of initial jobless claims fell to the lowest level since 1969. Should the US economy continue to tick along, the Federal Reserve is expected to continue raising interest rates at a pace of 25bps per quarter (as it has throughout 2018), much to Trump's dismay as he pressures Chairman Powell and the FOMC to adopt a more dovish, accommodative rate path.

Both the Republicans and Democrats emerged from the US midterms with grounds for optimism, as the former tightened its grip on the Senate whilst the latter won the House of Representatives. Generally speaking, history tells us that the economy and equity markets tend to perform well in times of political gridlock in Washington, as the balances and checks are in place to reduce the potential for serious political shock. However, as Trump's tax stimulus begins to fade and the Federal Reserve gradually pulls the monetary punch bowl away, it may be different this time. In gaining the House, the Democrats also now have it within their power to investigate criminal allegations against the Trump administration, which is likely to bring about greater instability, particularly should they seek to impeach him.

Talks between Trump and Xi Jinping at the G20 in Argentina were hoped to result in a cooling of trade tensions and eventually lead to a tentative truce. However, the US's detention of Meng Wanzhou, one of China's best-known executives and Huawei's CFO, was a move which only increased tensions with Beijing. The US and its western allies have long had concerns about China's reputation for theft of intellectual property and digital espionage, however taking a more robust stance via the arrest of a Chinese businesswoman is unlikely to affect Beijing's current behaviour and appears more of a trade negotiating chip.

With the US tariffs on Chinese imports set to increase early in the New Year, any signs of escalation/de-escalation will unquestionably have implications for financial markets.

For global investors, there are immediate worries both in the US and China. In the US, just how much higher tariffs will raise costs in the US and subdue corporate investment could have serious effects, as corporates have already begun to cite higher tariffs as reasons for lower expected profits. In China, economic growth and any subsequent ramifications for emerging market assets are main concerns, although it seems increasingly apparent that China plans to respond by supporting domestic growth with both augmented monetary and fiscal stimulus. Infrastructure investment in China has increased and the reserve ratio has been cut, dramatically reducing SHIBOR (Shanghai Interbank Offer Rate), which should bring stability through the tariff turmoil in the medium-term, though could leave short-term indicators under pressure.

US/China Trade War

The odds of an amicable conclusion to the US/China trade war have got slimmer as the year has gone on. At the centre of the issue, both nations are vying to become the dominant global player in tech. The 'America First' program continues to be politically popular in the US, however falling equity prices and slowing corporate investment may prompt a reconsideration from the current administration.

Pressure on Japan

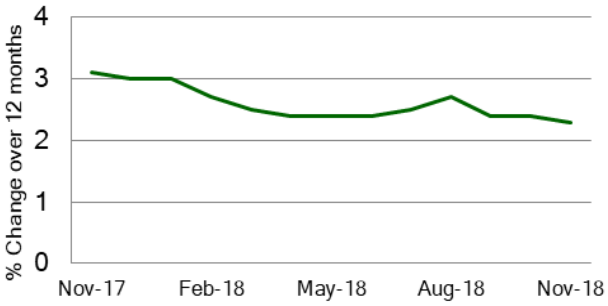
Inflationary pressures lay dormant in Japan as, despite higher food and utilities prices, weak consumer price growth persisted. Japanese equity markets were amongst the worst hit (the Topix index ended the year 16% lower) as Yen strength, triggered by nervy investors fleeing to the 'safe haven' currency, put pressure on Japanese stocks.

Elevated market risk

As we enter 2019, risks in markets seem to be elevated. With this at the forefront of our minds, we remain focussed on generating returns from appropriately balanced portfolios built to withstand a multitude of different investment scenarios. Despite often being uncomfortable, volatility does create opportunities for investors and can be a key driver of investment outperformance over the long term. Though conditions in the next quarter may be 'bumpy', we approach it with cautious optimism.

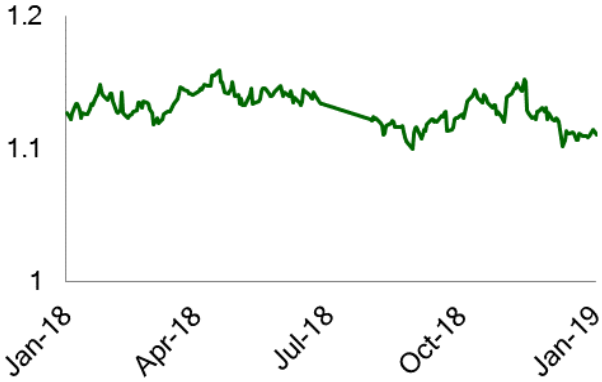
A year in numbers

UK Consumer Prices Index (CPI)



FTSE 100 Index

GBP/EUR Exchange Rate



GBP/USD Exchange Rate

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