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INVESTMENT VIEWS

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EQUITIES	:	No “Santa rally” this time as US stocks slump into a bear market
BONDS	:	Government bond yields tumble as risk aversion spikes
CURRENCIES	:	The dollar remains well bid despite slowing US growth
COMMODITIES	:	Oil’s collapse continues, but the gold price gathers strength

Will the Federal Reserve maintain its tightening plans for long enough to tip the US economy into recession? This is a question for investors as we head into 2019. Last year was one to forget with equity bear markets (or price falls of at least 20%) now well underway in Asia and Europe and cracks finally starting to show in corporate bond markets. A turbulent December saw US equities head much lower too with the S&P slumping 20% from its September peak.

What happens next will be heavily influenced by how the US economy fares in the coming months. Over the past century the average bear market has lasted roughly 1½ years with a capital loss (or drawdown) of 44%. The outcome has been contingent on whether or not the US economy contracts for at least 2 consecutive quarters; the most common definition of recession. If it does, the average peak-to-trough loss in US equities has been just shy of 50%. In the 2 bear markets without a major economic downturn (1962 and 1987), the average drawdown was “only” 31%.

Whilst the odds seem to favour further US market weakness, pockets of value are appearing elsewhere if an American recession can be avoided. As we noted last month, a number of emerging market assets are already flashing up as cheap on our valuation screens.

As regards the US, it is hard to dispute that it is now participating in the broader global slowdown that began in late 2017. A recession is long overdue but, at face value, the odds of a sharp contraction over the next 12 months still seem relatively low. As recently as the second quarter, GDP was expanding at an above-trend 4.2% annualised pace and the Atlanta Fed Nowcast suggests the fourth quarter will deliver respectable, annualised growth of 2.7%. Unemployment, at 3.7%, remains at a 49-year low.

Furthermore, a number of forward-looking recession indicators suggest there is no immediate cause for alarm. At 54.1, the ISM manufacturing (activity) index remains in expansionary territory and infers a negligible chance of recession, although it looks set to head lower as the recent 40%+ oil price collapse (itself a sign that US and global growth is slowing sharply) filters through. Investment in the booming shale industry has been a key driver of US manufacturing activity in recent years; activity and production levels will ease unless oil rebounds soon.

Similarly, flagship measures of consumer and business sentiment remain at elevated levels. The Conference Board consumer confidence and NFIB small business optimism indices have both been on a relentless march higher since Trump's election; it would be unusual to see the economy suffer with these measures close to multi-year highs.

However, with the positive effects of the late 2017 fiscal splurge now fading, some private sector fragilities are being exposed. Even though aggregate household spending is growing at a healthy 4% annualised rate, individuals have relied heavily on credit to fund this. Higher interest costs are starting to bite with a greater share of income being diverted to service and repay debts. This is particularly true of the vital auto and housing markets that rely upon debt-financed purchases; struggles in these "big ticket" sectors have typically been a precursor to a US recession, given their role as the foundation of the consumption food-chain.

Annual US vehicle sales have stagnated around 17.5 million since late 2015 as Fed tightening raises the cost of servicing U$1.2 trillion of auto loans. We note that nearly 25% of these are classed as "subprime," where the borrower has a tarnished credit record. The housing market is also acting as a drag on broader economic growth. Mortgage activity and property sales tumbled last year in response to rising rates; absent a Fed U-turn and a meaningful fall in mortgage costs, this trend looks set to persist.

With rates rising, business investment slowing sharply and the US/China trade war still to be resolved, we expect recession risks to build over the coming months. This, in turn, suggests markets have further to fall. A significant policy response could arrest both the economic and market declines, but this seems unlikely. With the mid-term elections birthing Congressional gridlock, an imminent fiscal stimulus is improbable; why would the Democrats support another round of Trump tax cuts and government spending with the next Presidential election less than 2 years away? An economic slowdown, especially one that morphs into recession, would likely limit the Donald to a single-term in office.

So all eyes are on the Fed and perhaps the most reliable recession predictor of them all; the US yield curve. An inverted curve, whereby short-term rates exceed those at the long-end, has preceded every recession since WW2. Last month's fall in the 5-year treasury yield below the 2 and 3-year equivalents is thus noteworthy. The bond market suggests that the Fed has tightened too much and that it will have to cut short rates to avert/address economic troubles. For now, the more influential 10-year/2-year spread remains marginally positive at 0.15%; it offered a 1.25% premium in early 2017. But with US economic data set to deteriorate further, this reliable recession gauge looks set to invert sometime soon.

As the recession narrative builds, markets will struggle; the prospect of the authorities re-introducing pro-growth policies will also build. As such, the Fed's tightening cycle is probably nearing its end with base rates set to rise a couple of times this year at most. Indeed, as the vast accumulated debts crowd out activity, an eventual return to rate cuts, and possibly even QE, is on the cards. History suggests that markets will remain vulnerable before any pivot back to easy money policies as they will still be pricing in the probability (or reality) of recession. However, any convincing commitment to more stimulus, either from the Fed or the US Government, will trigger a reappraisal of our cautious asset allocation. Having favoured protection over growth in 2018, we hope and expect to be adding back to risk during 2019, even if markets and the concurrent commentary remain unsettled.

IN OTHER NEWS…

As an investment team, we all use Twitter to follow real time news and to harvest a wider field of views. It also throws up the weird and wonderful. One analyst recently asked her followers “tell me your fav weird fact”. A few of the tweet replies are shared below.

"Ham actor" originally referred to the smell of pork fat that poorer actors used to remove makeup, instead of using expensive cold cream.

George Washington died in 1799. The first dinosaur fossil was discovered in 1824. George Washington never knew dinosaurs existed. The word dinosaur comes from “dinosauria” meaning “terrible lizard”.

C. S. Lewis, John F. Kennedy and Aldous Huxley all died on the same day.

Early race cars always had both a driver and a "riding mechanic" who would look around to monitor where the other cars were. Ray Harroun won the first Indy 500 in 1911 by driving alone thanks to his innovation, the rear-view mirror.

Mammoths existed when the Egyptian Pyramids were being built. If an Egyptian pharaoh had travelled to Wrangel Island near Siberia he could have seen Pygmy Woolly Mammoths.

EQUITIES

Global equity markets lost 8% in dollar terms last month, as measured by the MSCI World index. US markets were amongst the hardest hit as their excessive valuations finally succumbed to gravity; by mid-December the S&P 500 index had fallen exactly 20% from its late September peak. Financial liquidity conditions tightened further with the US Federal Reserve pressing ahead with another interest rate hike and credit spreads continued to widen.

In the US, the S&P 500 index lost 9% over the month, whilst the small cap Russell 2000 index tumbled 12%. Energy stocks were the worst performing sector as the oil price continued to slide. A flattening yield curve hit financial stocks, reducing the profitability of lending to an economy that is now slowing, and technology names continued to de-rate from previously euphoric valuations. The arrest of the Huawei CFO, Meng Wanzhou, in Canada, over allegations that she contravened US banking sanctions against Iran, also negatively impacted tech sector sentiment. Ms Meng is the daughter of Huawei founder and much-respected Chinese industrialist Ren Zhengfei. Huawei is at the centre of a global race to install 5G telecoms infrastructure and is, therefore, high on the US list of cyber-security concerns.

The UK was one of the better performers in an otherwise torrid month for markets. The FTSE All Share fell 4% as Brexit again dominated the headlines. Parliament dealt a heavy blow to the Tories when it voted to hold the government in contempt for failing to publish its full Brexit legal advice. Mrs May was then forced to call off a parliamentary vote on her exit deal as she sought further assurances from her European counterparts on the thorny issue of the Irish border. The Prime Minister did manage to survive a vote of no confidence (called by rebel Tory backbenchers) by a vote of 200 to 117, but only after she promised not to stand for re-election.

Mrs May has imposed her own deadline of 21st January for her deal to be voted on by Parliament. Opposition leader, Jeremy Corbyn, has so far refused to call a vote of no confidence in the Government, but has proffered a gimmicky vote of no confidence in Mrs May; even the staunchly pro-Brexit ERG (European Research Group) dismissed his threat as meaningless. With the Brexit deadline day of 29th March now less than three months away the Government has stepped up contingency plans by asking supermarkets and pharmaceuticals to stockpile food and medicine, whilst putting 3,500 troops on stand-by. UK markets look set to remain jittery until Parliament comes up with a clear way forward.

In other developed markets, the MSCI Europe-ex UK index dropped by 6%, whilst the Japanese Topix index lost 10%. Bank and industrial stocks were weak in both markets. Falling yields hit bank stocks, whilst softer economic data hurt industrial companies. Auto sales, which are typically a barometer of broader activity, have been especially weak. Nissan said it would issue a recall for 150,000 vehicles in Japan, shortly after the dramatic arrest of its ex-Chairman Carlos Ghosn at Tokyo's Haneda airport. Mr Ghosn was also chairman and chief executive of Renault. Both Japanese and European stocks also faced the headwind of a stronger currency last month.

The broad MSCI Emerging Markets index lost just 3%, less than half of the falls in developed market stocks. Within the EM complex, Asian markets fell by a little over 3%, whilst Latin American markets fell by less than 2%. Brazilian assets proved resilient ahead of the 1st January inauguration of President Jair Bolsonaro. The right wing politician has promised to clamp down on an out-of-control murder rate and free the country from socialism, corruption and political correctness; it is little wonder that Donald Trump is a fan. But he has also promised to adhere to orthodox economic policies which could bear significant fruit as the Brazilian economy emerges from its recent depression.

BONDS

The Federal Reserve has raised the range for target interest rates by 0.25% to 2.25-2.5%, as it had previously indicated. Fed Chair Powell said that markets should expect two further increases in 2019, rather than the three it had initially signalled. The bond market argues for a more dovish reality with futures prices suggesting only one more hike this year. Mr Powell also said the Fed's path of reducing its balance sheet would remain on "auto pilot", despite reducing its forecasts for growth next year (from 2.5% to 2.3%). This provided little comfort for jumpy equity markets. The yield on the 10-year Treasury dropped from 3% at the start of the month to finish at 2.7%. As noted in the lead article, parts of the US yield curve inverted during December, with the five-year bond trading at a lower yield than its two-year counterpart; a warning sign that recession risks are building.

Investors bid up prices for the safety of government bonds, but credit markets struggled last month. US investment grade spreads rose from 1.7% to 1.9% (CSI BBB index) as investors demanded a higher premium for lending to corporations. Lower grade "junk" spreads widened from 4.2% to 5.2%, the highest level since 2016, and based on the Markit iBoxx High Yield index US junk bond investors lost 4% in the fourth quarter.

Given the widespread risk aversion, nearly all global government bond markets received a bid last month, leading to lower yields and higher prices. The yield on 10-year UK gilts fell from 1.4% to 1.3% during December. The Bank of England left its benchmark rate unchanged at 0.75% as it warned of intensifying Brexit uncertainty, but UK economic data was far from bleak. UK retail sales rose by more than expected in November as shoppers defied the gloom to take advantage of Black Friday deals. Household goods stores fared especially well with sales up by more than 5% on the prior month. The proportion of online sales exceeded 20% for the first time ever, according to the ONS.

In Europe, the Swedish central bank raised interest rates for the first time since 2011, from -0.5% to -0.25%. It became the fifth central bank in the developed world to do so. The Riksbank's action is interesting as it was one of the first central banks to experiment with negative interest rates in early 2015. Rates have been kept below zero ever since. It is questionable how much further the bank can raise rates given the backdrop of cooling inflation, lower growth and one of the most indebted private sectors in the world, with household debt measured at 180% of disposable income and the bulk of this comprised of variable loans (source: PIMCO). Elsewhere in Europe, Mario Draghi called an end to its €2.6tn QE programme, following four years of monthly bond purchases, but the ECB downgraded its Eurozone growth forecasts to 1.7% for the next two years and warned that the balance of risks is moving to the downside. It, therefore, seems unlikely that the ECB will replicate the Fed's rate rises and balance sheet contraction any time soon.

In Asia, Urjit Patel resigned as Governor of the Reserve Bank of India (RBI) following a spat with the ruling BJP party. The RBI had refused political pressure to start cutting rates to help boost economic growth in the run up to national elections in April or May this year. Rates were left unchanged at 6.5% last month, but the collapsing oil price will cool renewed inflationary pressures and could result in a looser policy despite the Bank's fraught relationship with the Government.

CURRENCIES

The trade-weighted US dollar fell by 1% this month as a less aggressive Federal Reserve, and the resulting fall in US Treasury yields, tempered the demand for the greenback. The currency finished the year with a 12 month gain of 4%. With government bond yields falling across the board, US rates are still much higher than those in the UK, Europe and Japan. This dynamic could provide continued support to the dollar in 2019 despite the marked slowdown in US growth. Indeed, the euro's weakness was a major driver of the dollar's strength in 2018 with mounting economic and political pressures causing the single currency to fall by almost 5%.

Despite last month's Brexit chaos the pound finished little changed around U$1.28, but had fallen as low as U$1.25 intra-month. Brexit newsflow will likely determine the movement of both the euro and sterling versus the dollar in 2019. A soft Brexit deal that lifts economic uncertainty could see both currencies rally, whilst a no-deal, hard Brexit could see both currencies take a further leg lower. Regardless, as we noted last month, the pound looks cheap on a longer-term perspective.

The Mexican Peso was one of the best performing currencies last month. It rallied 4% against the dollar after new left-wing President Obrador promised to oversee a budget surplus. The currency had previously weakened after the new Government scrapped the building of a U$13bn airport, as promised during his election campaign, and put on hold new auctions of oilfields in the Gulf of Mexico. The new budget perhaps indicates a less aggressive left-leaning government than many market participants feared.

The Australian dollar weakened by 4% in December. At 2.8% annualised, third quarter economic growth came in below estimates with construction activity and consumer spending notably weak. With the household saving rate falling to a 10-year low of 2.4%, consumers evidently lack the financial firepower to spark an economic acceleration and we suspect the "lucky country's" 27-year spell without a recession is about to be tested.

GOLD/COMMODITIES

The oil price continues to slide. US WTI oil fell by 11% during December and is now 38% below its end of September level. The European Brent contract fell by 8% and is 35% lower than three months ago. Even a production cut by the OPEC cartel, which agreed to reduce output by 1.2 million barrels per day, was not enough to shore up collapsing prices. As we have discussed in previous newsletters, the ramp up of US shale oil production has meant the oil market can cope more easily with reduced OPEC output. Rampant US production has led to higher oil reserves at the major refining bottleneck in Cushing, Oklahoma; stockpiles have nearly doubled to 41mn, from just 22mn back in August.

Gold rose by 5% last month, hitting its highest level since June. The yellow metal benefited from two key factors: dovish talk by the Fed and a "safe haven" bid as equity markets endured a rocky patch. In price terms, gold rose by $60 over the month, ending the year at $1,282/oz. It outperformed the MSCI World equities index by 20% in dollar terms over the fourth quarter and remains a core holding across mandates.

Gold mining shares fared even better with the NYSE Gold Bugs index rising by 11%. We believe that gold equities look increasingly attractive, offering a combination of cheap valuations and solid balance sheets, and we are watching price momentum closely for attractive entry points for multi-asset mandates. The most risk-tolerant growth portfolios already have a dedicated exposure.

Industrial metals were adversely affected by concerns over slowing economic growth. China's official manufacturing PMI dipped below 50, indicating contracting activity, for the first time since 2016. Copper fell by 5% and Aluminium fell by 6% last month. Iron ore proved more resilient, rising by 9% as the Chinese stockpiled ore ahead of anticipated winter production curbs. Iron ore prices were also supported by a runaway train incident on BHP's private railway line in the Pilbara region of Western Australia that hit supply levels. The 268-wagon train rode on without a driver for 92km, after it rolled away when a driver got out to inspect a faulty braking system. The runaway train was eventually de-railed by the company's remote operations centre.

POLICY SUMMARY MATRIX

The matrix set out below is a summary of our current policy stance on the various equity and bond markets which we monitor. It is not intended as anything other than a guide on where we stand and we will change the content as our views alter. Cash exposure is a residual and will tend to be high when negatives outweigh positives and vice versa.

6-12 MONTH VIEW	OVERALL	EQUITIES	BONDS	ALTERNATIVES
+	ALTERNATIVES	Asia Latin America	Inflation Linked Emerging Market	Uncorrelated Strategies, Gold
○		UK, Japanese Australian High Yield Healthcare Resources	US, Australian	
−	EQUITIES BONDS	US, European Technology	UK, European Japanese Corporate High Yield	

MARKET PERFORMANCE

All performance numbers show % changes except for bond yields which show yield changes.

	31-DEC-18	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.2754	+0.0%	-2.1%	-5.6%
CHF	1.0187	+1.7%	+0.0%	-0.7%
AUD	0.7049	-3.5%	-2.4%	-9.7%
JPY	109.69	+3.5%	+3.7%	+2.8%
EUR	1.1467	+1.3%	-1.2%	-4.5%
BOND YIELDS (10 yr)				
UK	1.28	-0.09	-0.30	+0.09
US	2.69	-0.30	-0.38	+0.28
Germany	0.24	-0.07	-0.23	-0.18
Australia	2.32	-0.27	-0.35	-0.31
Japan	-0.01	-0.09	-0.13	-0.05
EQUITIES				
US. S&P 500 (USD)	2,506.85	-9.2%	-14.0%	-6.2%
UK. FTSE 100 (GBP)	6,728.13	-3.6%	-10.4%	-12.5%
MSCI Europe ex UK (EUR)	1,165.64	-6.0%	-12.0%	-13.4%
Japan. Topix (JPY)	1,494.09	-10.4%	-17.8%	-17.8%
China. Shanghai Comp (RMB)	2,493.90	-3.6%	-11.6%	-24.6%
HK. Hang Seng (HKD)	25,845.70	-2.5%	-7.0%	-13.6%
Australia. All Ords (AUD)	5,709.40	-0.7%	-9.7%	-7.4%
MSCI Pacific ex Japan (USD)	1,225.25	-2.1%	-8.6%	-13.8%
MSCI World (USD)	1,883.90	-7.7%	-13.7%	-10.4%
MSCI World (GBP)	1,478.03	-7.7%	-11.7%	-5.0%
COMMODITIES				
Oil (WTI)	45.41	-11.1%	-37.5%	-20.9%
Gold	1,282.45	+4.9%	+7.5%	-1.6%

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