CIO BLOG

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Drawn, not Quartered

Most investors had a poor last quarter of 2018. The major stock markets all fell with losses in local currency of 17.8% for the TSE index in Japan, 14.0% for the S&P 500 in the US, 13.8% for the Dax in Germany and 11.6% for the Chinese Shanghai Composite; losses for the UK's FTSE 100 were only slightly less painful, at 10.4%. In December alone, the US market tumbled by 9%, its worst December return since 1931 during the Great Depression era, when it dropped 18%. A few markets did rise, but, apart from Brazil – where markets have welcomed political change – positive returns have been concentrated in small and relatively insignificant Frontier markets.

Government bonds offered some protection during the last three months of 2018: 10-year UK Gilts and 10-year US Treasuries returned 1.9% and 2.6%, respectively. Other fixed income asset classes were less rewarding, with investment grade credit producing zero total returns in US Dollars and Sterling, while Euro investment grade credit returned -0.6%. High Yield bond returns of -4.6% in US Dollars further reflected investors aversion to risk during the final quarter of 2018.

Gold – while volatile – produced a positive return of 7.7% in US Dollar terms, but this was an exception with most commodities suffering, particularly oil. Other alternatives were weak too: a leading Global Real Estate ETF dropped 7%, and the HFRX index of hedge funds fell 6%, both in US Dollar terms.

There is no single cause for all of the above. We would point to the following as being of influence:

- **Higher interest rates and the prospect of further rate rises in the United States.** The US Federal Reserve remains poised to continue its monetary tightening via the twin actions of higher interest rates and balance sheet reduction. This lessens the predictable liquidity which has underpinned global stocks for many years. Meanwhile, the European Central Bank confirmed that net purchases of government bonds under their asset purchase programme would stop in December.
- **The US-China trade dispute intensified, adding further downside impact to decelerating global economic growth.** Statements by both sides suggest that a deal is likely in the relatively near future. Markets, however, remain unnerved by the signs of an economic slowdown in China, partly attributed to the impact of the trade dispute, though domestic Chinese policies play a part in the slowdown as well.
- **Brexit, and other European issues**, such as rows over the Italian budget, unrest in France, a change in leadership in Germany, and the growing rift between some eastern European countries and the European Commission all cast a pall over the future direction of the continent.
- **Doubts about the sustainability of the spectacular growth of US technology sector champions, and general corporate health.** Whether the surge in US profits can last when the effect of the Trump tax cut runs out remains a point of loud debate, as well as if falls in unemployment will eventually lead to higher wages at the expense of profits.

Most of these factors are fears for the future as much as actual bad news. There is therefore room for positive surprises such as the Federal Reserve deciding interest rates do not need to rise in the way they hinted at in December, or material progress in the US-China trade dispute. It is also worth noting that equity and credit markets have become significantly cheaper than they were three months ago, a fact at odds with a reasonably robust global macroeconomic backdrop – despite a deceleration, a recession is far from imminent – and strong corporate earnings coupled with low rates of defaults.

Indeed, much of what we have witnessed in the fourth quarter is relatively normal: equities are a volatile asset class, and almost every year sees 10%+ sell-offs. But over the long-run, equity returns are very compelling, especially when compared to other asset classes. Volatility, and sometimes sharp falls, are the price paid for those favourable long-term results.

In real-time, it is impossible to know if this current sell-off in equities is just “noise” – a typical correction – or if it is a precursor to bear market and more losses ahead. We rely on a dispassionate process to guide us, taking into account the **current economic regime**, along with **valuations**, **momentum** and **sentiment** indicators.

At present, the **global macroeconomic environment remains supportive of risk assets and corporate profits**. Moreover, **equity valuations are fair**: the often cited price-to-earnings ratio for US equities is 14.8x (next 12 months), cheaper than 17.1x at this time last year; other regions remain cheaper still. Furthermore, the asset class remains far more attractive than most other alternatives. **Sentiment, which is widely negative, suggests the bulk of the selling may already have occurred**. **Momentum, however, is clearly in a downtrend, which is cautionary**. We continue to monitor market conditions closely.

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