Market Review

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NW BROWN
WEALTH MANAGEMENT

Can markets improve after a difficult 2018?

2018 was a difficult year for investors, with both bonds and equities delivering negative capital returns. The last quarter was particularly painful for global equity markets, which have been driven down since early October on account of growing concerns over US-China trade frictions, the ramifications of rising interest rates around the world and the possibility of a global economic slowdown. Other political risks such as a disorderly Brexit are also weighing on sentiment and, by the end of the year, the FTSE 100 index was down approximately 15% from its 2018 peak in May.

Looking forward, we cannot rule out further weakness in the short term. However, it does seem that 2019 has a good chance of being kinder to investors. Fears of a global recession are hopefully overblown, poor sentiment leaves plenty of room for positive surprises and valuations are now attractive. We expand on these points in the conclusion but would first like to update readers on some of the key issues facing the market.

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Will US-China trade wars escalate further?

One of the key drivers of the recent market weakness has been the escalating trade tensions between the US and China. The context here is that President Trump has been a long-held critic of China’s trade practices and is particularly keen to cut America’s huge trade deficit with China in an attempt to repatriate jobs. His preferred tactic for bringing China to the negotiating table has been to apply gradually escalating trade tariffs. However, with China equally intent on playing hard ball, this has so far simply resulted in the two nations trading tit-for-tat tariffs and aggression. As things stand, negotiations have yet to yield any meaningful outcomes and President Trump is seemingly ready to ratchet up the pressure again with a further round of tariffs.

The concern investors have is that an escalating trade war between the two largest economies in the world will start to cause meaningful damage to global growth prospects. The outcome is unpredictable, and there is certainly a danger that tensions may escalate further. However, reputable estimates suggest that a full-blown escalation would knock around 1% off global GDP. This is certainly not good, but equally not enough to cause a recession on its own given that the global economy is projected to grow by around 3.5% in 2019 (modestly down from nearly 4% in 2018). Moreover, as the negative implications of tariffs become clearer, the chances of a deal being struck will surely increase.

Will the Federal Reserve cause a recession by tightening too quickly?

Alongside trade, the other major driver of the recent market weakness is the fear that leading central banks may inadvertently cause the next recession by tightening monetary policy too quickly through a mixture of interest rate hikes and the gradual reversal of quantitative easing (QE). For their part, central banks are keen to return to more “normal” monetary policy following the extreme measures taken in the aftermath of the Global Financial Crisis. In particular, the US central bank (the Federal Reserve) is leading the way, having begun the process of reversing QE and raised interest rates four times in 2018 alone. However, its latest decision to raise rates in December (by 0.25% to a target range of 2.25-2.5%) has rattled the market. Given that US GDP growth is set to moderate from 3% in 2018 to 2.3% in 2019 (in large part because President Trump’s 2018 fiscal stimulus is set to fade), investors were hoping for a pause in the tightening process. In the event, Federal Reserve chairman Jerome Powell did indicate that there are likely to be just two rate rises in 2019 (instead of three as previously expected), but still hinted at further rate rises in both 2020 and 2021.

This "hawkish" policy has also attracted public rebuke from President Trump, who is keen to sustain GDP growth in the US above 3% - something that will be hard to achieve under the pressure of further interest rate rises. In this case, investors seem to agree with Mr Trump that the Federal Reserve is tightening too quickly. On the other hand, those who defend Mr Powell argue that further interest rate hikes are justified by a tight labour market and an economy that is still set to grow at a healthy pace despite a slowdown.

In summary, Mr Powell is well aware of the dangers of tightening monetary policy too quickly and, just one year into his new role, will not want to be blamed for causing the next US recession. It therefore seems unlikely that he will tighten too quickly. In any case, having already raised rates significantly, he has plenty of scope to moderate or even reverse the tightening process if the US economy slows more than expected. However, the irony is that Mr Trump's public hectoring may make it more difficult for the Federal Reserve to do this in the event it is required. For central bankers, the credibility of independence is everything and Mr Powell will not want to be seen to be following White House instructions.

What about European political disruption?

Closer to home, political disruption across Europe is a further concern for investors. Brexit difficulties continue, Angela Merkel's leadership has been rejected in various German regions, President Macron of France has been derailed by the "gilets jaunes" protests and Italy has been at loggerheads with the EU over its desire to increase government spending. These political fragilities need monitoring and could well limit the European Central Bank's ability to lift interest rates at all.

As for Brexit, MPs are now set to vote on the UK's Brexit deal in the week beginning 14 January. The vote was due to be held before Christmas, but was ultimately postponed after Theresa May admitted she was set to lose. With the political situation evolving on a daily basis, it is difficult to predict whether Parliament will reluctantly pass Theresa May's deal, table a second referendum, or allow a 'hard' exit with no deal as we head towards the 29 March 2019 deadline. From a portfolio perspective, we continue to be alive to the opportunity that this uncertainty presents whilst running well diversified portfolios that are not overly reliant on the UK economy.

Conclusion

2018 was tough for investors, although it does seem that 2019 has a good chance of delivering a better outcome for three key reasons:

1. **Fears of a global recession are hopefully overblown.** Whilst the pace of its growth looks set to slow, the global economy should nonetheless continue to grow in 2019 against a supportive backdrop of low inflation. This continued expansion should in turn underpin corporate earnings growth and support the performance of equities.

2. **The bar for positive surprises is now set relatively low.** Expectations heading into 2018 were broadly upbeat, resulting in a situation where most surprises were negative. In contrast, macro expectations and asset prices have adjusted sharply downwards for 2019, lowering the bar for positive surprises that could lift asset prices.

3. **Attractive valuations.** Global equity markets are more reasonably valued, particularly outside of the US market, with many companies offering high dividend yields. Markets still need to adjust to a rising interest rate environment but this process is well underway.

It is natural to feel uneasy during periods of market volatility. However, it is important to remember that market sentiment is cyclical and will eventually recover – pessimism inevitably gives way to optimism and vice versa. We do not know whether the market will suffer more weakness in the short term – this is impossible to predict – but we remain convinced that global growth will continue in the long term and that equities will therefore continue to deliver attractive long term performance relative to inflation and other asset classes.

In the meantime, we would highlight that a prominent exposure to risk assets such as equities is vital for meeting long term goals that require growth. On the downside, holding these assets does mean having to live with volatility in the short term. It is tempting to think that it is possible to "time the markets" – but the vast majority of investors who think they can do this end up getting it wrong, mistiming market swings and racking up unnecessary trading expenses in the process. In our experience it is far better to set a sensible long term asset allocation that can be stuck to. Essentially, clients need enough equity exposure to deliver attractive returns and protect them against inflation, but not so much that they are put under financial duress during downturns. The key to equity investment remains the ability to be calm and stay invested during times of stress. We find this is far more effective than attempting to second-guess markets.