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Portfolio Review

October saw a return of downdraft volatility in stock markets following dips in the early part of the year. Whilst the US recovered, the UK and Europe remained flat and have now dipped back to 1st quarter levels.

All investors may feel a concern that this recent bout of stock market turbulence is a sign that good times for investors are finally coming to an end, having enjoyed a choppy but profitable uptrend for more than 9 years. Whilst this may not be the case, as we have said over the last couple of newsletters, it is reasonable to expect that investors need to brace for slightly lower investment returns and higher levels of volatility, in this late phase of the economic cycle.

This downturn is painful for investors who have only recently invested from cash but for all other investors, it is just another period of volatility which is part and parcel of healthy capital markets and the risk discomfort factor that rewards equity investors with higher long-term returns than lower risk investors. In the meantime, the fundamentals of the economy and corporate earnings have not changed direction or deteriorated in outlook since the beginning of October. It is therefore reasonable to expect that stock markets will eventually return to follow their lead – even if that is at a more realistic trajectory of expected future profit growth than had been the case in the US over much of the last 2 quarters.

Overall returns will be affected by fixed interest bond holdings which struggle to contribute positive returns when interest rates and yields rise back to more normal levels. Further, profit margins of quoted companies come under pressure due to rising wages from tightening labour markets and higher cost of capital increase the cost of business activity.

Some of this downturn is arguably a case of "a classic scenario of more sellers than buyers in the markets". It appears this insight and return to fundamentals has finally hit home with global equity investors, who – despite news of continued economic growth – have suddenly felt the urge to part company with their previously so cherished and profitable stock market investments.

The trigger point was a step-up in longer term US bond yields, when bond investors began to price in US interest rates rising to the 3% level - as the US central bank had communicated for a while but had not been believed by markets. Just as in February, the prospect of removal of the very cheap credit equity markets had thrived on for the past decade was enough to stop and reverse their September rush to ever higher valuation heights. The February correction only returned stocks globally back to their previous trajectory, after they had clearly overshot over December and January. However, they continued more or less within the boundaries of their trend channel that started in 2016 and was predicated on the assumption of continued cheap credit.

The forced deleveraging of the Chinese financial sector at the behest of the government has added to this liquidity squeeze. Not only have more nervous domestic investors cashed in their holdings, but there was additional forced selling by overseas Chinese equity investors, who need to raise cash to pay back loans they can no longer afford. To top this, the 'stock-market-fuel' of company share buybacks that pushed liquidity into markets over the summer is also currently absent, as companies are not permitted to buy their own shares during the so-called blackout period before their quarterly results announcements.

Add in to the mix views on Italy, Brexit, China or the Saudi oil price threats and an increased level of volatility is not going away anytime soon.

Portfolios

Given the market background, it is not surprising to see that higher equity portfolios fell more sharply than those more conservatively positioned. Greater exposure to overseas assets, especially in emerging markets, as with the more speculative growth portfolios led to more pronounced declines in portfolios whilst those at the less speculative end of the scale showed greater resilience supported by increased weightings in index-linked gilts.

At high-level investors may be forgiven for thinking the decline took hold across all investments, however, some good news came through from specific areas of the portfolios, helping to dampen turbulence.

Greatest support came from the Vanguard UK Inflation-Linked Gilt fund, rising 2.76% over the month. Again, the opportunist diversification of the H2O Multi-Returns fund provided a positive gross return of approximately 2%, as did one of the other 'absolute return' constituent funds, the JPM Global Macro Opportunities funds.

In recent meetings with managers from Fidelity and Columbia Threadneedle amongst others, the general consensus was that discerning, active management over stock selection was of even greater importance now. This was deemed especially the case in the US where the wind has dropped out of the momentum of the FAANG driven rally with p/e ratios riding at all-time highs.

Whilst it may be tempting, in some cases, to move down the risk profile following recent experience, the relatively flat second half to the month gave nothing away in terms of short term expectations. The portfolios have acted as we would have expected in such times.