December 2018 Portfolio Review

We look back at a year full of challenges for investors as trade wars came into effect and Europe endured a mini Italian debt crisis, while parts of the emerging markets were hit by tighter dollar liquidity and political risk. When markets are trending up, things don't feel risky. But when prices start falling, the risks seem a lot clearer. So, in the lead up to Christmas Eve (2018) the US market had retrenched approximately 14% from the start of the month, continuing a downward trend from October on the back of concerns around a global slowdown. By the end of the year it had regained somewhat to end 7.8% down.

Initial confidence, especially in the US, has petered out. Slowing economic growth amid tightening central bank liquidity caused market sell-offs, starting in emerging markets and culminating in the US market's turnover in October. US investors, (especially the active retail investors) started selling ETFs, pushing up volatility and driving down risk appetite.

Crucially, this scenario has little to do with the underlying economic fundamentals, and everything to do with the workings of financial markets, particularly liquidity and Quantitative Tightening (QT).

Though not showing the same volatility as the US, the All-Share and FTSE100 ended the month down c3.5%. December was an uncomfortable ride for equities, with the only respite coming from Gilts. With a short period to run to the 29th March and the concerns around global growth, we are not surprised to see volatility continuing and the decisions we took in the Summer have provided support for portfolios in a testing time.

Risk assets always come with a risk premium attached – the amount you get paid for tolerating a certain level of risk. Due to the disappointing 2018 we've had, risk premia have gone up, which in large part explains why equities have fallen so much. It's this that has changed as much as any significant change in the global economy's outlook.

Of course, financial markets aren't in a vacuum. Falling stocks and (particularly) widening credit spreads aren't just an expression of an economy. Asset price movements have an impact on the real economy, and if things get really bad, it could cause more of a slowdown than expected.

Bankruptcies will be important to watch early next year. The weak spots are especially among the retailers both in the UK and the US. However, outside of this, corporate cashflows are doing okay. Without default contagion, we would not expect dour markets to have too large an impact. The global economy should remain on a reasonable growth path, markets should stabilise, and risk appetite rebuild.

But while there's potential for a relative policy easing in the world's developed economies, the same isn't true in China. In a recent speech, President Xi Jinping gave no hint of any fiscal moves from the government, and there's even been whispers from the politburo about shifting the economic targets so as not to reverse the deleveraging process. The stimulus measures they've already enacted have been

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and will be effective, but those hoping Chinese demand can bail out the global economy again will be disappointed.

Another factor that could help is the apparent end of dollar strength. The strength of the US dollar, and its effect on emerging markets in particular, has been one of the main concerns over this year. Recently it's looked like this trend will change – particularly with the Fed's change of tone. If the dollar does indeed weaken next year, that could well help sentiment and bring back some risk appetite – at least among investment managers.

The last word is about the UK and Brexit. As we approach the "deadline" without a clear move towards a decision, each day that passes heightens a sense of crisis. We're trying not to get caught up in that emotion. Globally, equity market valuations have improved, but they're clearly cheap in the UK.

Portfolios

2018 effectively turned the performance from sectors in 2017 upside down, with the worst performers in that year providing some element of calm whilst the stellar performers gave up almost half their previous year returns.

The resultant performance was negative for all portfolios, however, all acted as expected. The lower risk portfolios protected on the downside with a gross return of approximately -c1.3% whilst the highest risk portfolio, 'Growth R10,' with significantly higher US and emerging market exposure capped the decline at -c4.8%. All other portfolios fell in order between these bands. Against the FTSE 100 which a lot of investors look at as a comparison, this was down about 8.2% over the year.

To keep things in context, a similar period occurred between May 2015 and February 2016 but talk of a possible looming no deal Brexit didn't monopolise headlines at the time and so went relatively unnoticed.

Again, showing the benefits of diversification, the H2O Multi-Returns fund generated high positive returns, flying in the face of trends. Why? As a diversifier in portfolios, the fund looks away from just investing in standard equity type holdings and focuses on currencies and exchange rate variations. Relative to sterling, the strengthening of major currencies throughout December, especially in the case of the Yen, presented an alternative opportunity for positive returns.

Indeed, the Natixis fund was the lead performer in 2018 generating a gross return of c10.5% for the year.

In a turbulent year, worst performance came from the most speculative arenas as you may expect. Emerging Markets and India specific funds were down by c15%. However, these feature more prevalently in the higher risk portfolios and contrary to the suggestions of many asset allocation models, our portfolios have reduced weightings in these areas given our concerns some time ago.

As always, please contact us or speak directly with your planner if you have any questions.