August 2019
Portfolio Review

At the time of writing, the UK political situation, and Brexit in particular, is changing daily and as such, the review of August will look at global issues first on the basis that any comment will undoubtedly have changed by the end of this article!

Mid-August saw the markets launch what some considered "distress signals" as we saw an inversion of the yield curve in the UK and the US. This is the difference in yield between 2-year bonds and 10-year bonds and indicates lower interest expectations in the future than in the short term. When this turns negative (inverted), it has typically been a reliable indicator of forthcoming recession, making some investors and the financial commentators naturally alarmed and President Trump for one, calling for further stimulus in the form of restarting Quantitative Easing (QE). However, there is a strong probability that years of extraordinary monetary easing have undermined the predictive quality of the yield curve. Given that the global economy has been slowing for some time now, this news will be unwelcome, but not necessarily a shock to many investors and, in the absence of external shocks, the sluggish growth is likely to continue without deteriorating fully towards economic contraction.

However, there is still a probability of external shocks and one that is much higher than usual, centred round a range of global political risks. Be this a disorderly Brexit, escalating Trump trade wars, Populist infighting in Italy, or various pressure points around China, these risks have the potential to push a fragile global economy from slow growth into recession. Hence capital markets are far more focused than usual on politics, given they could well determine the continuation or end of the current, already very 'long-in-the-tooth', economic expansion cycle that began 10 years ago.

Looking at the US, White House officials talked up the strength of the US economy following the recent market sell-off, although President Trump is still urging the US Federal Reserve (Fed) to cut interest rates by 1% and as mentioned, re-start QE! In addition, he said he is considering a temporary payroll tax cut to help boost the US economy. The IMF also called for governments to use fiscal measures to support the global economy. With government bond yields at record lows this would appear an opportunity to raise money and invest in new infrastructure or clean energy projects.

The US/China trade dispute continued to 'see-saw' with a gradual escalation in tension but ended with a faint glimmer of hope. Initially, President Trump commented that he was 'not ready to make a deal with China'. However, the US did confirm a further 90-day component supply reprieve for Huawei but did criticise China over Hong Kong and warned that Huawei was not the only Chinese company that posed a risk to national security. With no tangible progress on trade talks, China then announced some further stimulus measures to support its economy. China has also threatened imposing sanctions on US firms involved in a potential $8bn defence deal with Taiwan. China then imposed 10% tariffs of $75bn of US goods. President Trump fired off a series of tweets saying 'we don't need China and, frankly, would be better off without them' while ordering US companies to start

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looking for alternatives to manufacturing in China. However, over the weekend, at the G7 meeting, President Trump said that the US and China will 'very shortly' resume trade talks.

In Europe, the resignation of Italy's PM sent a shockwave across European markets with the Italian banking sector particularly hard hit. But instead of ending in an election, there seems to be a coalition of previously unlikely partners. The powerhouse of Germany saw its GDP shrink in Q2 amid the global slowdown and challenges for its automotive sector in meeting tougher new regulatory standards. Economic growth in the UK and continental Europe has been subdued and then weakened to very low levels as the impact of China's economic slowdown and the knock-on effect of tariffs imposed by the US take effect. In response, German government sources have claimed that the government is drawing up plans to bolster consumer demand and prevent a rise in unemployment – with a stimulus package similar to the one they unveiled 10 years ago, in the wake of recession.

All of this adds to an emerging trend, as seen also in the US, the UK, China and Italy, of a number of the world's largest economies considering fiscal stimuli, a change from the past 10 years which have been dominated by the balanced budget doctrine.

And so to the UK. Since entering No. 10, Boris Johnson's political strategy on Brexit has been to take a hard-line stance with the EU. At the very least, the Prime Minister (PM) appears to have hoped that by threatening 'no deal' — and circumventing parliament — the EU will renegotiate the backstop on the Irish border. But parliament has not been circumvented and we await the outcome of when an election will be called. Leaving parliament to one side however, UK investors may be experiencing a sense of déjà vu with the run up to the Brexit referendum back in May/June of 2016. We are told about all the things that could happen in a worst-case scenario, but experience has shown that even in such a worst case, real outcomes tend to be far less extreme than those predicted. As such, we continue to view the no-deal Brexit scenario as a political tool to find a more palatable solution to the Irish border problem, ultimately one caused by the EU's insistence on sequencing. To this end, it is looking a much higher probability of a further postponement followed by a general election.

As the aftermath of the Brexit referendum showed, it is £-Sterling which bears the brunt of any near-term economic outlook adjustment through rapid devaluation. This tends to increase the value of capital market holdings of the international element of diversified investment portfolios whose fortunes are far more determined by the global rather than the UK economy. Whilst in balance, if we experience the more likely outcome of somewhat smoother divorce proceedings, then there is considerable upside in £-Sterling's external value and in non-globally exposed UK stock markets.

Portfolios

Over the month of August, the portfolios reflected the market concerns and yield curve inversion with, as expected, the leading return coming from the more cautious growth portfolio risk level 3. This held steady with a gross return of 0.13% whilst at the higher risk end, risk level 10, the portfolio dropped -2.14%.

In the cautious portfolios, the greater exposure to the Vanguard UK Inflation Linked Gilt Index fund provided good positive performance at +4.45% gross of fees whilst H2O MultiReturns, Architas Diversified Real Assets and Troy Trojan funds generated positive figures of +0.95%, +0.84% and +0.5% respectively.

Against the major market indices, overall portfolio performance was steady and provided reasonable protection for investors as equity markets dropped. The FTSE100 dropped -4.06%, the Euro STOXX -2.6%, Emerging Markets -3.96% and the S&P 500 -1%.

The Income portfolio suffered most over the month falling -2.4% as higher yielding UK equity funds bore the brunt of concerns over the current BREXIT uncertainty, volatility in Sterling and the move towards security. Again this is totally consistent with the final comments above, that the UK (non-global) market stocks are increasingly seen as currently undervalued.