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INVESTMENT MANAGEMENT & STOCKBROKING

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The Year Ahead

After six straight calendar years of positive returns across the world's major developed stock markets, 2018 marked the first fall. The US fared better than most, with the S&P-500 index down 'only' 6.2%, supported by strong gains in technology earlier in the year. This compares to the UK and Japan off around 12.5%, better than most European indices with the German DAX 18.3% lower. Emerging markets generally held up well in the final quarter and some Asian markets finished in positive territory. There was little succour to be found for bond investors as their winning run also came to an end. UK government bonds (gilts) rallied sharply in December, arguably due to their safe haven status, but only recovering losses suffered earlier in the year. Corporate bonds were generally weak too as US interest rates moved higher and investors rotated into newer issues with higher yields.

Elsewhere, unexpectedly high production levels sent the price of crude oil down by over 40% from October's peak at $76 a barrel. Gold bounced in the last few weeks but not quite enough to finish in positive territory. In fact there were very few hiding places for investors in 2018 and according to M&G, 90% of all asset classes fell in value. The few areas in the black included cash, direct property and emerging market bonds.

Whilst trade wars, Brexit and European politics in general didn't help investor sentiment, we would argue that the main source of the weakness across the financial markets in the second half of 2018 stemmed from the US tightening monetary policy, i.e. higher interest rates and the end of quantitative easing (QE). In the aftermath of the Financial Crisis, the Federal Reserve slashed interest rates to near zero and started buying vast quantities of government bonds and related fixed-income securities in an attempt to stimulate economic growth. One of the side-effects of the resultant low rates is the forcing of many investors out of low-yielding assets such as savings accounts (often with negative inflation-adjusted returns) into riskier equities and other higher-yielding asset classes. Why get locked into a 2 year Post Office savings bond offering 1.0% per annum when inflation is running nearer 2% when you could own Vodafone bonds yielding 6% *and* have the prospect of seeing capital growth? This search for yield extended into equities and countless other asset classes, inflating prices of emerging market property, vintage wines and classic cars, to name but a few.

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Despite huge doubts at certain points along the way, the consensus seems to be that the policy ultimately worked, the evidence finally coming through in 2017 when, for the very first time since 2009, we saw synchronised global GDP growth across all 45 OECD countries. Although the growth rate wasn't especially high, unemployment rates were improving as were real disposable incomes. Conditions were such that the policy could be reversed. QE is now over in the US and interest rates have risen nine times to the current level of 2.50%. The Bank of England and European Central bank have also ended QE, though both are some way behind in terms of raising rates.

So why are markets all of a sudden so erratic? We believe that the recent turmoil and volatility across all of the financial markets lies in the resetting of future interest rate expectations, led by the US. This time last year a consensus was forming that Trump-induced tax breaks would provide a stimulus sufficient to spur the US and the global economy ahead well through 2020 and that any thoughts of a natural economic slowdown, or worse, a recession, would be pushed out by several years. That was based on solid fundamental evidence and there is still good reason to hold this view. However, the introduction of a new Fed governor in February (Jerome Powell) has muddied the waters. It is taking time for markets to become accustomed to his communication style and there is a body of thought that he is raising rates too fast and on the verge of a policy mistake. Add into the mix Donald Trump and comments that the Fed is "the only problem our economy has" and all of a sudden US Inc's reputation for being well-managed becomes tarnished. A demonstrably independent and prudent central bank is one of the most important factors for stability in the financial markets.

Should we have seen this coming? We certainly felt that bonds were going to find it difficult to appreciate markedly in an environment of rising interest rates and the ending of QE. If the biggest buyer in town stops buying, the laws of supply and demand suggest this will not be good for prices. However the story is somewhat different for equities. Even with interest rates approaching 3% this is still well below historic norms. With the FTSE-100 yielding nearly 5% the relative attraction is still material. Also, it is not as if we have seen a huge economic boom in recent years, the trajectory of recovery has been extremely shallow. Furthermore, the bull market that began in 2009, though the longest in history, is far from being the most profitable.

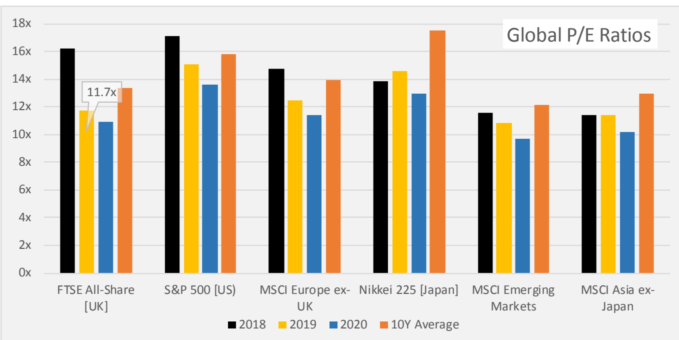
At the point of writing it seems as though interest rate expectations are being reset once again. Rather than two rises in 2019 as per Fed guidance, the odds (as read through bond market prices) are suggesting that there will be no further moves. If this is in response to a rapidly deteriorating economy then, intuitively, this isn't helpful for share prices. However, putting rates on hold could allow the economy to heat back up, and that is helpful.

The last few years have clearly ended up surprising most analysts and pundits. At the end of 2016 following the unexpected arrival of Trump and the consequences of Brexit, the outlook for 2017 was gloomy at best. However, many of the fears didn't materialise and it proved to be a great year for economic growth and the financial markets. By the end of that year, prospects heading into 2018 were improving with GDP growth exceeding expectations. However as we entered the final quarter these hopes were increasingly coming into question, leading to a very disappointing outcome for nearly every investor. Maybe the point to be made here is that a positive outlook does not guarantee positive returns. Second-guessing the market is ultimately a futile task as illustrated by this excellent article entitled *29 Reasons Not To Invest In the Stock Market* from Schroders. Below we lay down our thoughts on each major asset class.

Global Equities

Taking a top down view across the main global equity markets, valuations certainly do not reflect high expectations. The chart below shows the price earnings (P/E) ratios of the major global indices along with their 10 year average. Looking at the FTSE All-Share, we see that based on current forecasts, the 2019 P/E ratio is at 11.7x, as shown by the yellow vertical bar. This represents a sizeable discount to the US on 15.1x, but maybe the most important message from this chart is that current valuations are quite comfortably below their comparable 10 year average as shown by the orange bar. This time last year the story was quite different with many markets trading above their average – the S&P-500 was trading well over 18x.

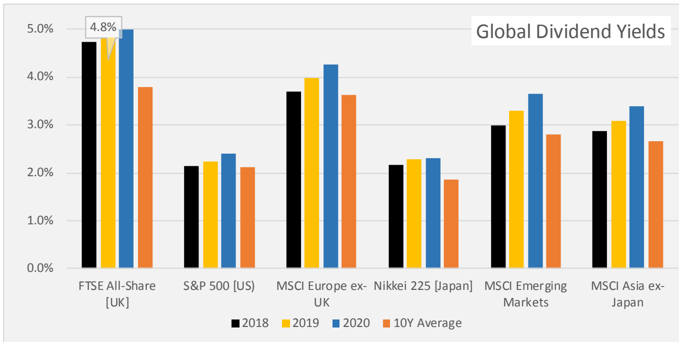
In other words, since P/E ratios are currently quite low relative to history, this makes them cheap. If you believe in reversion to the mean theory, then the ratio should revert back to the average and for this to happen, share prices (the P in the equation) need to move higher. If the FTSE-All Share gets back to its average, that's a 14% return; for Japan it is over 20%*.



Source: Bloomberg, Albert E Sharp

**** The chart also shows the 2018 and 2020 ratios – what this shows is that since prices 'P' are static at the year end 2018 level, for the ration to be falling the 'E', earnings, must be rising. Looking closer the chart therefore reveals that earnings are expected to rise quite sharply for the UK in 2019 unlike Asia or the emerging markets; Japan is looking at slightly lower aggregate earnings, with an improvement in 2010. Valuations could get cheaper first though, of course.***

Dividend yield analysis brings us to the same conclusion. The chart below shows that the dividend yield for the UK is expected to be 4.8% in 2019 (yellow bar), compared to the 10 year average of 3.8% (orange bar). For the FTSE All Share to revert back to the mean, the index would need to rise by over 26%.



Source: Bloomberg, Albert E Sharp

UK Equities

The gap between the UK and the rest of the world is largely due to the higher weightings that mature industries in the index hold. Companies such as BP, HSBC and GlaxoSmith-Kline are hardly racy growth stories and because they are unlikely to dramatically grow their business in the way that Google or Apple might, they reward investors with higher dividends. The gap could well have been exacerbated by Brexit and the resulting lack of investor appetite. Regardless, with these dividends looking secure we are inclined to conclude that the UK market is very attractive, with the caveat that it may take some time to come through.

Our favourite funds include SDL UK Buffettology and Henderson Smaller Companies. Although 2018 was hardly a vintage for either, both are up 26% over the last two years, which compares to the FTSE All Share's 3.5%, illustrating the value of active management.

US Equities

Despite the daily bombardment of shocking Trump headlines we find it difficult to form a negative view on US equities. It is not just the size, it is the pro-business mindset, structurally lower tax rates and globally dominant position that many of the companies hold that places the region at the centre of the investment universe. To be positive on the US generally, requires being positive on technology, given the high weighing of the likes of Microsoft, Google and Apple across the various large-cap indices. The combined market capitalisation of on these four alone is almost £2.5 trillion, compared to all of the top 100 companies in the UK worth £1.8 trillion. In our view, valuations still look attractive with sales and profits expected to grow by 20% this year amongst them. Maybe the added attraction is the scope for merger activity that didn't quite materialise last year on the scale some expected. For this reason we think that it is worth getting direct exposure and the Allianz Technology Investment Trust is the favoured fund.

As Q4 results come out over the next few weeks, we expect to see that earnings for the S&P-500 index will have grown by almost 28% in 2018. This huge number is largely the result of tax cuts and so without this stimulus, 2019 should be much lower. Goldman Sachs forecasts something closer to 6% but warns that this could prove closer to 3% if economic growth fades.

They make a fair point and we agree that one should be selective, which is why we favour the value-driven Dodge & Cox US Stock Fund, along with small cap exposure in Artemis US Smaller Companies. This is one of the few regions where we feel a tracking stock complements large-cap exposure because of the attractive of the composition on the index and the paucity of managers who can consistently beat the benchmark.

Europe ex-UK

In the past we have happily held a zero position in Europe on the view that (a) the region was increasingly being badly governed, (b) nearly every country was beset with political risk, (c) the ECB was making the wrong decisions and (d) the odds of the EU and euro to imploding were becoming shorter. As a result we had an overweight position in Asia and the US and for the most part it paid off handsomely. However we shifted our position when the valuation gap become so pronounced, it became difficult to ignore. All of the risks continue to exist and we cannot ignore them, but we do see pockets of value.

There is a general point across all of the regions that is maybe more pronounced in Europe, in that it is still possible to make money in a market that is going sideways or down if you do your homework. It is all very well being negative on a region, but you might find a vehicle that works. That is the case here, although it is probably fair to say that our overall position is underweight. So very selectively we highlight the Artemis European Opportunities Fund, with an excellent track record of stock picking and strict valuation discipline. The other is European Assets Trust an investment trust currently languishing at a near 10% discount to net asset value. With exposure to smaller companies with a value bias, an area that has been horribly out of favour for much of the last 18 months, the fund has lagged its benchmark. Nevertheless, we expect this to reverse and illustrates why fund selection shouldn't be driven by what has performed well recently. Now with a yield close to 6% we believe that with patience, the upside could be significant and well ahead of the wider market. Consequently, a tracker in Europe is off the agenda.

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Japan

After moving in a trading range for much of 2018, the final quarter was brutal for stocks in the region as investors worried about slower global growth, a factor critical to corporate profitability. The prospect of a new VAT regime in 2019 also spooked investors who cannot forget the disastrous implementation in 2014 which nearly triggered a recession. Nevertheless, the long-term story for Japan continues to offer appeal as Shinzo Abe continues with reforms, supported by a stable government. Chinese tourism, up fourfold in the last five years, is helping and the consumer is in good health with a tight labour market pushing wage growth and discretionary spending. Corporate governance continues to improve and the culture of paying out dividends is catching on. The sell-off looks overdone and as discussed above, we see healthy upside potential.

This is one of the regions where we think a tracker makes sense, taking the view that the mega-cap stocks should benefit most from the long-term policy of weakening the yen. A perfect bedfellow is the small cap focused Legg Mason Japan Equity Fund, which despite having a nasty 20% drawdown in the last few months is still up 130% over the last five years. As we discuss further below, currency is a particular issue here, with the scope for large swings. Holding yen last year was an 8% boost to returns, but it could easily reverse.

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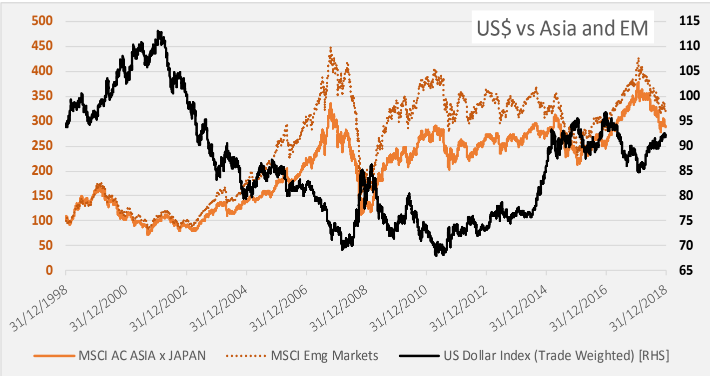
Asia ex-Japan

This is an area where currencies matter too and as the chart shows there seems to be a clear link between a stronger dollar (black line, right hand scale [RHS]) and the performance of the Asian index (thick orange line). The reason for this and emerging markets in general (orange dotted line) is that many governments in this category have high dollar-denominated debts and in order to meet repayments, they need to find more of their own currency to convert, which can suddenly become a huge drain on resources if the dollar goes up in value. This environment has been in place for the last 12 months and appears to have held back equities, but further dollar appreciation looks limited as US interest rates moderate.



Source: Bloomberg, Albert E Sharp

Of course there is more to it than that and the recent weakening of the Chinese economic data and how authorities respond is highly relevant as is the Trump tariff dispute. The end of this saga doesn't feel as though it is likely to end anytime soon and that is unhelpful, but making generalised comments risks overlooking the countless exciting opportunities that exist across this huge and varied region. There are several funds that we like here, including Schroder Asia Pacific, Fidelity Asian Values and Scottish Oriental Smaller Companies, the latter two of which were some of the few equity funds globally that delivered positive returns in 2018.

Emerging Markets

As we saw above, dollar strength is an issue here too, but the dynamics are quite different depending upon the country-specific conditions. The fortunes of Russia and Brazil are both somewhat reliant upon the oil price, but the political forces, the composition of the workforce and the corporate cultures are strikingly different. So generalisation is difficult although we cannot ignore the fact that the valuation discount that EM now trades on is at similar levels to the financial crisis, which is difficult to justify.

We also note that investors should be very careful when selecting emerging markets funds if they also have an Asia fund, due to the possibility of overlap. The chances of seeing the likes of Samsung, Taiwan Semiconductor and Tencent appear in both are high, which is why we are particularly drawn to the Guinness Emerging Markets Income fund which only invests in companies with an established track record of delivering dividend growth, an approach that is quite different to its peer group. Again, with such a large universe of opportunities, this could be an area where the broad market is weak, but some funds do well and the recently-launched Mobius Investment Trust could be one of them.

UK Property

The open-end direct bricks and mortar funds such as Aviva Property enjoyed being amongst the few categories showing a gain last year and we believe that there is a more to come in 2019, again with most of the return coming from income rather than capital appreciation. The spectre of the Brexit result still hangs over this sub asset class but we think that nervous sellers have probably been shaken out by now, reducing the chance of another lock down.

Again, it is very difficult to generalise on this broad area, but we are always watching the investment trusts where NAV discounts can present great opportunities. Upside for UK residential property looks limited and our attention is drawn towards vehicles in the commercial and specialist sectors.

Fixed Income

Nearly every category of bond lost money last year with UK government issues (gilts) up less than 1 and bunds up 3.3%, the year-end beneficiaries of a rush to safe-haven assets. Given what proved to be a very steep rise in US interest rates, with the 10 year treasury yield jumping from 2.4% to 3.3%, this outcome is unsurprising. However with the yield back down to 2.7% expectations have clearly moderated in recent weeks and many bond prices have recovered. Even if rates do go up in the US, the angle is not likely to be anything as acute as 2018 in which case conditions for positive returns now look far better. That said, the ending of QE means that with the Fed and ECB not buying bonds in the open market, simple rules of demand and supply suggest that prices will at best lose support. For this reason we find it very difficult to make a positive case for gilts and European government bonds.

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In such a broad category, we prefer to entrust the day-to-day management of our fixed income exposure to managers with a broad remit and the ability to move up and down investment grades and maturity spectra. Liquidity is a growing problem that needs to be handled carefully, further supporting the case for active management. We are increasingly warming to the Royal London team and single out their Global Opportunities and Short Duration Credit funds as particular favourites. There are several others that we rate including the Baillie Gifford Strategic Bond fund and Artemis Strategic Bond fund. Diversification is the watchword in this area.

Absolute Return

In June of this year we reassessed our approach to absolute return and concluded that we could no longer support multi-asset teams executing a series of complex strategies. We were finding it increasingly difficult to understand, let alone measure what was at stake and the investment case was moving into the realms of 'trust us'. The performance was not necessarily so bad, but we identified other vehicles that we could understand far better. There is always an element of trust given away when buying a fund and this should be in exchange for hard evidence.

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Our approach now is to focus on vehicles with a narrower focus of activity, with proven expertise and backed up by a track record. For that reason the Artemis US Absolute Return Fund is ideal, specialising purely in long/short equity. It is low risk and one of the attractions, we would argue, is that it should produce bond-like returns of old whilst not having to rely on anything other than the fund manager's skill. This is very appealing given the constraints that bond markets face. Don't expect huge returns here, something close to 4% would be a good result. For the same reasons we like Henderson UK Absolute Return and Muzinich Global Tactical Credit.

Alternatives

Given the range of different sub-asset classes here, one cannot make a sweeping statement, suffice to say that we continue to avoid buying gold, oil or any other commodity in the view that it is a game of 'buy and hope'. Infrastructure often finds itself in this asset class and we definitely see merit in the investment case. However many funds trade at rich premia to their NAV which makes us nervous. That said, open-end funds do not have this issue and the narrative fits neatly into the late-cycle investment thesis that we are increasingly moving towards.

Currencies

We believe that betting on the direction of a currency is exactly that – gambling. However in order to manage portfolio risk, FX needs to be considered and we do not take the view that it simply 'all comes out in the wash'. For a start, if some clarity on Brexit is achieved sterling could rally very sharply. In which case all other international holdings would fall in value, all else equal. Also, having gone through a period of dollar strength, flattening interest rates and more treasury issuance could temper further appreciation or even weaken it. It is not to say that we are bearish on the dollar, more that we see risks building and for that reason it is prudent to hedge some exposure. The yen also requires consideration and with structural reasons to believe that it will weaken over the long-term, we think it appropriate to hedge here too.

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In summary, we will continue to invest where we see value, to stay diversified in the knowledge that concentrated positions create risk and in a state of preparedness to move quickly if needed. Our views might change, but they will not be based upon the biased opinions of the media; we prefer reading economic data to newspaper headlines.

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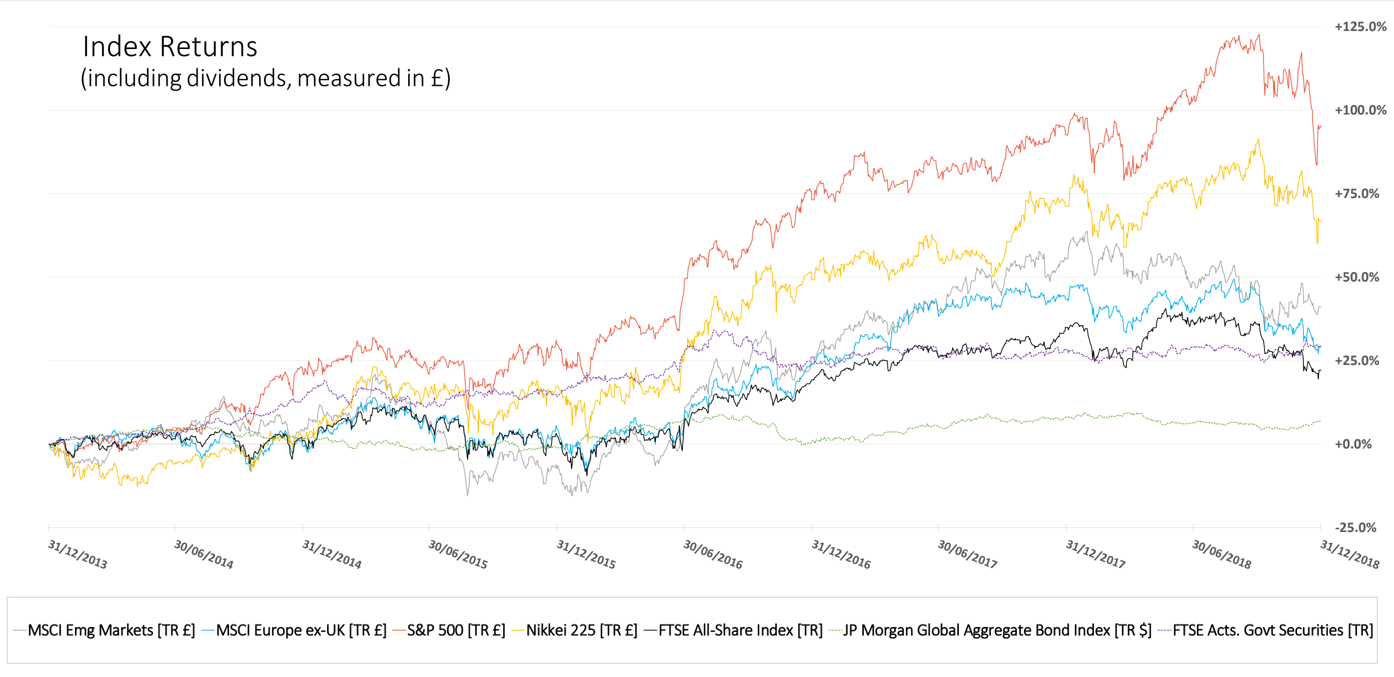

Index	Region/Asset Class	31 Dec 2018	1 Month Change	1 Year Change	2 Year Change
UK 100	UK	6,728.1	-3.6%	-12.5%	-5.8%
UK Mid Cap	UK	481.2	-4.6%	-16.0%	-7.3%
UK Small Cap	UK	5,177.2	-3.8%	-12.4%	+0.7%
Dow Jones Ind Avg	USA	23,327.5	-8.7%	-5.6%	+18.0%
S&P 500 Index	USA	2,506.9	-9.2%	-6.2%	+12.0%
NASDAQ Comp.	USA	6,635.3	-9.5%	-3.9%	+23.3%
Nikkei 225	Japan	20,014.8	-10.5%	-12.1%	+4.7%
Euro Stoxx 50	Europe	3,001.4	-5.4%	-14.3%	-8.8%
CAC 40 Index	France	4,730.7	-5.5%	-11.0%	-2.7%
DAX Index	Germany	10,559.0	-6.2%	-18.3%	-8.0%
Milan Index	Italy	18,324.0	-4.5%	-16.1%	-4.7%
MSCI Emg Mkts (£)	Emg Mkts	522.5	-2.5%	-9.3%	+13.8%
IBOVESPA Index	Brazil	87,887.3	-1.8%	+15.0%	+45.9%
IMOEX Index	Russia	2,358.5	-1.4%	+11.8%	+5.6%
S&P BSE SENSEX	India	36,068.3	-0.3%	+5.9%	+35.5%
Shanghai SE Comp.	China	2,493.9	-3.6%	-24.6%	-19.6%
Hang Seng	Hong Kong	25,845.7	-2.5%	-13.6%	+17.5%
UK All Property	UK Property	134.9	-0.1%	+5.8%	+10.9%
UK Conv Gilts	UK Gilts	3,609.6	+2.2%	+0.6%	+2.4%
UK Index linked Gilts	UK IL Gilts	4,895.4	+2.5%	-0.3%	+2.1%
JPM Glob Agg. Bond ($)	Global Bonds	562.9	+1.9%	-1.2%	+5.7%
iBoxx Non-Gilt	UK Corp Bonds	335.3	+1.0%	-1.5%	+2.7%
WTI Crude ($/barrel)	Oil	45.4	-10.8%	-24.8%	-15.5%
LMEX	Base Metals	2,801.1	-3.7%	-18.1%	+5.3%
Gold Spot ($/oz)	Commodities	1,282.45	+4.9%	-1.6%	+11.3%
S&P Agri & Livestock	Agriculture	706.42	-1.8%	-6.3%	-12.1%
£1 = US$	Currencies	1.28	+0.0%	-5.6%	+3.4%
£1 = €	Currencies	1.11	-1.3%	-1.2%	-5.2%
£1 = Yen	Currencies	139.87	-3.4%	-8.1%	-3.2%