ALBERT E SHARP

INVESTMENT MANAGEMENT & STOCKBROKING

Market Commentary

October 2019

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MONTHLY COMMENTARY

OCTOBER 2019

Despite a decline in some regional stock markets in the third quarter, 2019 is proving to be a good year for most investors. In the US, the S&P-500 index edged up another 1.7% in the last three months, and is now up more than 20% year to date, including dividends. However, after taking into account another fall in value of the pound against the dollar, this translates to a total return of 25% for UK investors. The UK itself has fared well by historic standards yet the FTSE All Share return of almost 15%, after a flat Q3, puts the index towards the lower end of the leaderboard in 2019. Continental Europe isn't far behind the US, suggesting that Brexit is maybe not the most important factor driving share price returns, despite the negative headlines. Emerging markets has been the notable lagging category, although it has been a very mixed bag. China started the year well, and is still up over 16%, but it lost ground last quarter as the protests in Hong Kong worsened and trade war fears weighed. After gaining another 4% in the last three months, Brazil is up over 19% as political unrest appears to ease and for similar reasons Greece is up almost 45%.

Bond prices have generally continued to firm into the second half, with one of the highest returns coming from 10-year Italian government debt; now ahead by 16%, year to date, the issue yields just 0.8% per annum. This is due to the complete shift in expectations regarding the path of interest rates in Europe (and the US for that matter) as policy makers seek to ease monetary conditions in order to avert a region-wide recession. However, 0.8% is still much more than French, German and Swiss government bonds that carry a negative yield. In fact $17 trillion worth of government debt securities around the world now effectively provide a guaranteed loss for the holder if held to maturity.

Elsewhere, gold was off 5% in the month, but ahead by 12% for the year as investors seek perceived safety. Despite the rally it is still some 17% off its peak seven years ago. The oil price has eased in the second half of the year and is now almost 20% below its recent high in April, notwithstanding renewed Middle East tensions. Add Brexit uncertainty, Trump impeachment, Chinese DF-41 intercontinental ballistic nuclear missiles, climate change, even measles into the mix, it sometimes seems as though there is no good news out there at all.

It is therefore easy to overlook the fact that the US is enjoying the longest period of economic expansion in modern history. In the third quarter of 2019, it notched up 122 months of continuous growth, beating the previous record that started in 1991. Ironically, it is human nature to use this positive news to reply with "well, in that case, it can't last much longer". This line of thought seems intuitive, but is not supported by any empirical evidence.

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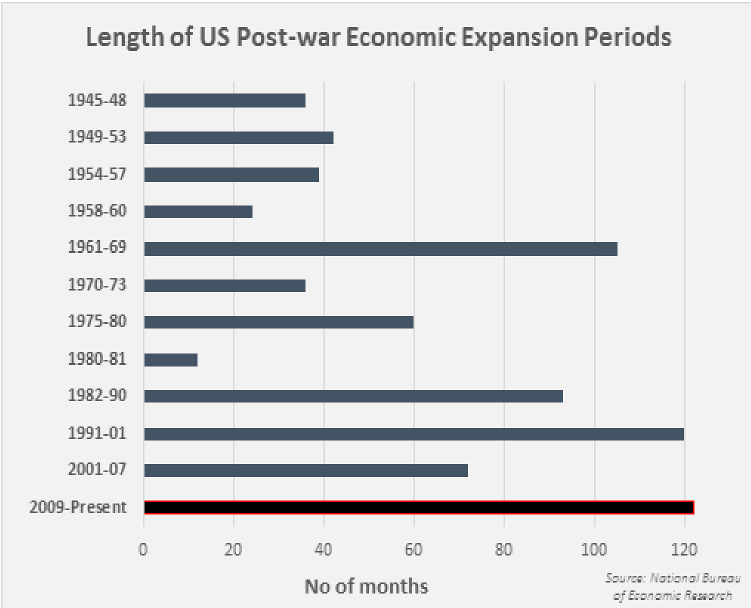
Back in early 2016, economic indicators were showing signs of a slowdown and many commentators predicted a recession simply because they thought it was "about time". This prompted Glenn D. Rudebusch, an economist and senior policy advisor at the Federal Reserve Bank of San Francisco to ask the question, "Do economic recoveries die of old age?" The findings suggested that there may have been something in this pre-war, but certainly not post-war. The reason largely comes down to a greater recent level of government intervention compared to the laissez-faire approach of the past. An increased propensity to shift interest rates, to actively pump money into the economy when needed has certainly helped to smooth the cycle. Interestingly, there seemed to be converse evidence that as recessions aged, the probability of them ending grew. Rudebusch concluded that "expansions, like Peter Pan, endure but never seem to grow old".



So why is it so compelling to think that a recession is always just around the corner? The answer lies in negativity bias, a human condition that emerges from a part of the brain called the amygdala. Its function is to detect danger and it helped keep our cave-dwelling ancestors alive. These two almond-shaped regions in the medial temporal lobe in combination are often referred to as the brain's alarm bell. Analysis of neurological activity from this area shows that when confronted with nasty images, as opposed to happy ones, far more electrical charges are emitted. It is possible to live with faulty or missing amygdalae and those with such a condition have demonstrated a rare indifference to snakes, spiders and even to being held up at gunpoint. From these extremes, its pervasiveness in human behaviour is subtle and not always immediately obvious. Our interest in the subject stems from why it is that humans frequently tend to panic easily and over-estimate financial risks.

Moreover, if we can recognise over-reactions, then can we benefit from an investment perspective? The answer is yes. Fund manager Nick Train realised this over twenty years ago and has taught himself to physically resist negativity, in other words, how to be bullish. He says, "People who are pessimistic and cynical, I observe, don't do particularly well in this industry." We would strongly agree with this remark and optimism is a key factor that we look out for in selecting a fund manager. Incidentally, Citywire magazine ranks Train number one in his group of 201 peers.

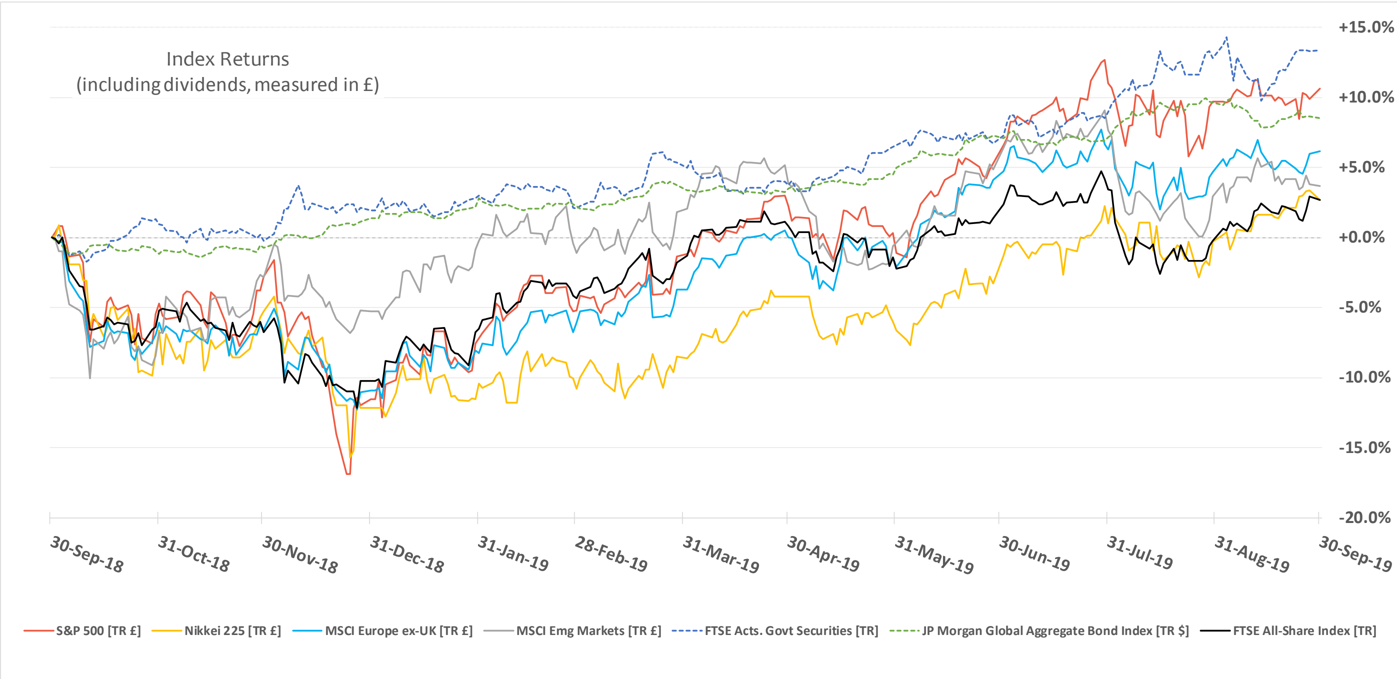
The conclusion here is quite profound, encapsulated by the antics of Alex Honnold. The 34 year old American rock climber, subject of the film Free Solo, has successfully performed some of the most audacious climbs in history, including scaling the 3,000-foot sheer granite face of El Capitan in the Yosemite Valley- without ropes. It is simply terrifying to even watch and incomprehensible that anyone would attempt such a feat. Very clearly, Alex Honnold's brain is wired differently to most human beings. So in 2016, it was with great excitement in the world of neuroscience that he agreed to have his brain scanned and the betting was that he had no amygdalae. They were wrong, he did, but there seemed to be no activity whatsoever. Was he damaged? Did he have a condition?

The conclusion was not that he was physically abnormal, just that he could somehow control what he observed and deal with it in a way that very few individuals were capable of, although Honnold himself could not easily explain how it happened. What was observable was that his process was consistent and the preparation was meticulous to the point where he knew every single move, well before any ascent. Further, each climb acted as an extra layer of armour and it was accumulated experience that ultimately led to his outstanding achievements. As JB MacKinnon wrote "There was nothing to process; there was only who he had become. "This is not scary," he said to himself, "because this is what I do."

The relevance of all this is that there are distinct parallels in Honnold's behavioural traits that we look for in a fund manager. Factors include a verifiable commitment to detailed planning and the compounding effect of learning from experience. This provides courage to follow an untrodden path, away from the herd. Like Honnold, the really successful managers do something different and regard their craft as a vocation, a calling – not just a job. It is no coincidence that Warren Buffet is going strong at 89 as is his business partner, Charlie Munger, at 95. Terry Smith is a relative youngster at 66 and shows absolutely no sign of stopping. Hideo Shiozumi, the Japanese fund manager at Legg Mason is 76 and at a recent lunch commented that he has no intention of retiring anytime soon. Knowing how to spot potential in a money manager is a skill and a craft in itself and much can be learned from observing the characteristics of high-performing human beings outside the industry.

Going back to the subject of economic expansion, we cannot answer the question of how much further there is to go, but we can say that its length should be no guide to the proximity of its demise. Australia has enjoyed a near 28-year run of GDP growth and there is no reason why the US or any other country for that matter cannot do the same. The pertinent extension of the question is what does this mean for share prices?

Firstly, there is little evidence to link stock market returns directly to economic growth. Whilst a sudden, unexpected slump would not be good for the stock market, it would not be the slump in of itself that caused a sell-off but the change in expectations. Human emotion is the driver, not interest rates, unemployment or productivity numbers. As Sir John Templeton said many years ago, "Bull markets are born on pessimism, grow on scepticism, mature on optimism, and die on euphoria." In that case, we may have a lot further to go because euphoria seems in very short supply, especially if measured by the gold price. Or maybe John Templeton wasn't aware of TINA, because with bond prices offering yields close to or below zero, you could argue There Is No Alternative.



Index	Region/Asset Class	30 Sep 2019	1 Month Change	1 Year Change	2 Year Change
UK 100	UK	7,408.2	+2.8%	-1.4%	+0.5%
UK Mid Cap	UK	541.9	+3.5%	-2.9%	-2.3%
UK Small Cap	UK	5,467.6	+1.7%	-6.1%	-4.3%
Dow Jones Ind Avg	USA	26,916.8	+1.9%	+1.7%	+20.1%
S&P 500 Index	USA	2,976.7	+1.7%	+2.2%	+18.2%
NASDAQ Comp.	USA	7,999.3	+0.5%	-0.6%	+23.1%
Nikkei 225	Japan	21,755.8	+5.1%	-9.8%	+6.9%
Euro Stoxx 50	Europe	3,569.5	+4.2%	+5.0%	-0.7%
CAC 40 Index	France	5,677.8	+3.6%	+3.4%	+6.5%
DAX Index	Germany	12,428.1	+4.1%	+1.5%	-3.1%
Milan Index	Italy	22,107.7	+3.7%	+6.7%	-2.6%
MSCI Emg Mkts (£)	Emg Mkts	571.8	+0.7%	+3.7%	+5.8%
IBOVESPA Index	Brazil	104,745.3	+3.6%	+32.0%	+41.0%
IMOEX Index	Russia	2,747.2	+0.3%	+11.0%	+32.3%
S&P BSE SENSEX	India	38,667.3	+3.6%	+6.7%	+23.6%
Shanghai SE Comp.	China	2,905.2	+0.7%	+3.0%	-13.3%
Hang Seng	Hong Kong	26,092.3	+1.4%	-6.1%	-5.3%
UK All Property	UK Property	132.8	-0.3%	-1.0%	+3.4%
UK Conv Gilts	UK Gilts	4,014.9	+0.5%	+13.4%	+14.1%
UK Index linked Gilts	UK IL Gilts	5,691.4	-0.3%	+18.4%	+20.0%
JPM Glob Agg. Bond ($)	Global Bonds	604.1	-1.0%	+8.5%	+7.1%
iBoxx Non-Gilt	UK Corp Bonds	368.9	+0.1%	+10.2%	+10.3%
WTI Crude ($/barrel)	Oil	54.1	-1.9%	-26.2%	+4.6%
LMEX	Base Metals	2,774.3	+0.6%	-7.4%	-11.2%
Gold Spot ($/oz)	Commodities	1,472.38	-3.2%	+23.5%	+15.0%
S&P Agri & Livestock	Agriculture	663.82	+6.0%	-5.7%	-12.6%
£1 = US$	Currencies	1.23	+1.1%	-5.7%	-8.3%
£1 = €	Currencies	1.13	+1.9%	+0.4%	-0.6%
£1 = Yen	Currencies	132.81	+2.7%	-10.4%	-11.9%