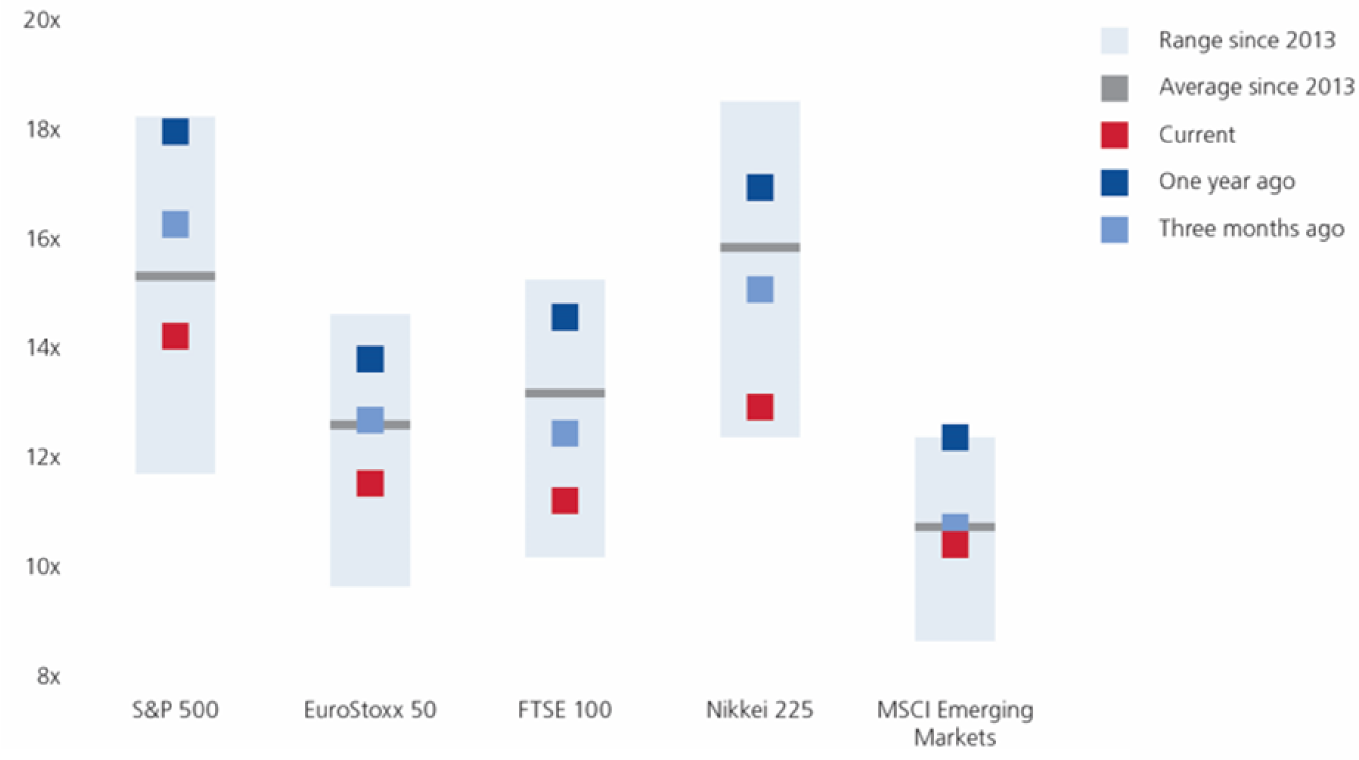
Q4 2018: Quarterly Report
December 2018

Macro summary

In contrast to 2017, this year has been a volatile year for equity markets. This was most acute over the last quarter, which produced one of the largest market falls since the financial crisis. Over the Christmas period, when markets are thin given many investors are away, we saw some of the sharpest moves in both directions. The MSCI World Equity Index fell -13.4% in the quarter and ended the year down -8.7% in dollar total return terms. While the talk here in the UK has been focussed on Brexit, broader market moves had little to do with our negotiations with the European Union (EU). The prospects for global economic growth next year were called into question as President Trump's erratic approach to trade policy, paired with a tightening of monetary conditions, raised fears of a more pronounced slowdown. Given the falls equity markets have already experienced, current valuations account for slower growth prospects and a lot of negative news appears priced in.

Figure 1: Global forward price-to-earnings ratios over a 5 year period



Source: Bloomberg, LGT Vestra

With US growth above trend and improving labour markets, the Federal Reserve (Fed) pressed ahead with its fourth rate rise of the year despite increasing criticism from the President. Markets expected a more accommodative stance ahead of the policy change, so were unimpressed with the somewhat hawkish tone from the Fed. However, with reduced growth estimates for 2019, they reduced the speed and scope of rate rises expected in the year to come. Following further falls in equity markets, the futures market has now priced out rate rises in 2019 as inflationary pressures appear to have abated much faster than previously expected. The partial US shutdown has not aided sentiment and highlighted the difficulty Trump will face, given a divided house, to implement further significant policy changes.

Chinese growth has been slowing as the government has prioritised debt reduction over stimulus. This policy is facing significant headwinds as US tariffs have brought supply chains into question and stymied expenditure plans. In December, at the G20 summit, Presidents Trump and Xi appeared to agree a way forward in trade negotiations but any improvement was short lived as there was little detail forthcoming. Matters were complicated further by the arrest of a senior Chinese executive in Canada at the request of the US. It is in the interests of both sides to agree a deal and, while we believe it is likely that they will get an agreement in the first quarter of the new year, the pathway towards one will not be without a great deal of rhetoric. The unintended consequence of Trump's trade policies may be to widen Chinese influence in other countries. If growth continues to slow, we can expect more stimulus from the Chinese government and deleveraging to be put on the backburner.

On Europe, the protests in France have questioned the future of Macron's planned economic reforms. The end of the 'Merkel era' in Germany adds uncertainty for the year ahead. On the positive side, the Italians have finally agreed a budget with the EU. Back to Brexit, a messy departure from the EU would not be good for European manufacturers. The path to Brexit remains unclear but the UK market is made up of international companies with the bulk of earnings in many cases coming from outside the country. As such, a dividend yield of nearly 5% and a price earnings ratio of below 12x is supportive for the market at these levels.

The oil price fell sharply and persistently throughout the quarter. The proposed sanctions by the US on Iran were slightly eased, with some countries allowed to continue to take Iranian oil while US production also rose. The US now produces more oil than Saudi Arabia or Russia, resulting in OPEC, while still important to the oil market, being less dominant than it has been in the past. Energy company bond issues are a large part of the high yield bond market and with the prospects of economic growth moderating, credit spreads have moved sharply wider.

With equity markets falling and concerns growing about global growth, high-grade government bonds found support, despite rising short term interest rates. In the US, the Treasury curve flattened. The Bank of England (BoE) raised rates in August but has made it clear that further rate rises would be very slow. Ten-year gilt yields, which had moved up to 1.7% in early October, fell to 1.2% in December.

While markets can be moved by comments on Twitter and shifts in sentiment, it is important to look through the noise and observe what the companies that make up the indices are actually doing. In 2018, US corporate earnings grew over 20% and free cash flow has also grown. While the US earnings growth was supported by tax cuts, sales were also up. With the market down and earnings up, valuations now appear to be pricing in a lot of bad news. We still see global leaders in the US market and continue to find it attractive.

We believe that equity markets are well supported at current valuations, but expect wide disparity in performance between different companies, sectors and countries in the year to come. With volatility likely to continue, we recommend remaining invested and looking through short term noise for longer term gains.

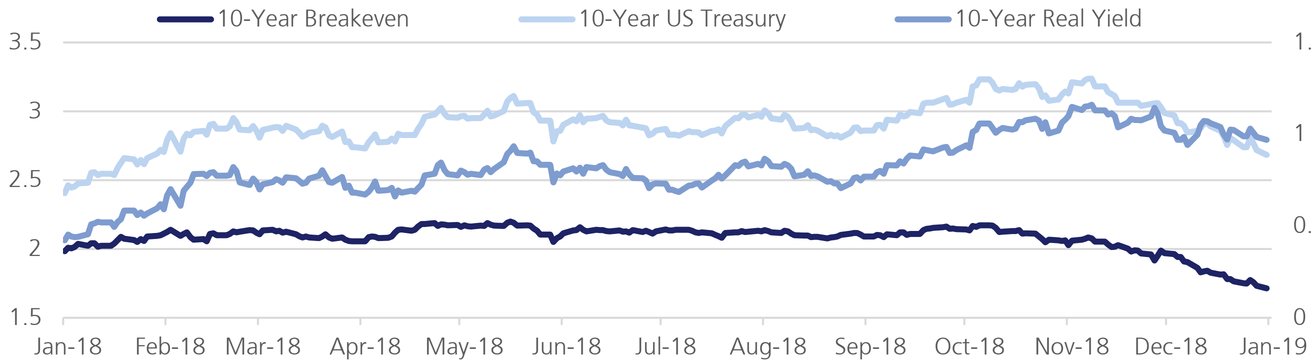
Fixed Income

On the back of President Trump's fiscal stimulus plan which led to stronger growth expectations and thus warranting higher interest rates, the majority of investors would not have expected treasuries to deliver a positive return over the course of the year. The fiscal stimulus led to some stellar second and third quarters which saw growth rates pick up above trend levels. These levels were unlikely to persist for the coming year but the growth expectations for 2019, as implied by markets, have gone from trend growth to a more pronounced slowdown over the last quarter.

The midterms were a focal point for the President, who treated them as a referendum on his presidency, but ultimately they resulted in a divided house. The Democrats won control of the house thus complicating Trump's plans, suggesting that he will need to brush up on bipartisanship. So far this has proved to be non-existent as the government remains in shutdown over his wall funding demands. Compared to historic midterms, the results were still decent for the Republican party. To summarise, the midterms did not result in anything shocking, but Trump's focus on slapping tariffs on China combined with several key departures from the White House raised concerns of a more pronounced shift of the current world order. In this more uncertain environment, it comes as no surprise that large companies have pared back their investment intensions as a shift in the economics of their current supply chains would have significant ramifications.

The uncertain outlook was not helped by a seemingly unwavering Fed who raised rates by 25bps for the fourth time this year. At the same time, the balance sheet runoff accelerated to its fastest pace this quarter, with up to $50bn of liquidity a month being drained from the system. Given rising expectations of a pronounced slowdown, investors moved from pricing in rate increases in 2019 to rate cuts as a policy mistake was now feared. Inflation, which had been a big consideration earlier this year, was no longer an issue as oil prices tumbled quickly. In light of these factors, ten year conventional treasuries fell from 3.06% to 2.68% over the quarter with the majority of the falls taking place in December. However real yields, which strip out inflation expectations, were little changed over the quarter. A decline in inflation expectations is understandable in a quarter where oil prices, as measured by WTI, fell from $73.3 to $45.4 a barrel. However, the extent of the fall implies something more nefarious about the state of the world economy.

Figure 2: Inflation driving the moves in Treasury markets



Source: Bloomberg, LGT Vestra

Inflation expectations fell across the developed world bar the UK where they were little changed. Given entrenched expectations of above target inflation, the situation for the BoE is challenging. Even though they were able to raise interest rates last quarter, the pending Brexit deal, or even no-deal, has weighed on confidence and clouded the outlook for the economy. The recent leadership contest highlights the difficulty in achieving any outcome and has raised fears of crashing out. The labour market remains very strong with wages picking up over the recent quarters and the unemployment rate hovering around multi-decade lows. These two diverging indicators have affected the gilt market where investors could easily argue for higher or lower yields in the future.

The European Central Bank (ECB) continued to find itself on a difficult footing. It closed its asset purchase program at the end of 2018 and indicated that interest rates would only go up around the third quarter of 2019. Last quarter, we saw a lot of heated negotiations between the European Commission (EC) and the fragmented Italian government. The latter's budget proposal assumed economic growth to remain above trend, resulting in understated budget deficit levels. With fears arising that the EC would slap fines on Italy given this budget and lead into a more pronounced crisis, Italian sovereign yields remained elevated. Investors shunned European banks given the high level of sovereign ownership. Higher financing costs at a time when the ECB is stepping away from buying their bonds proved enough to get the Italian government to reconsider its position. Ultimately, the budget deficit was revised lower resulting in Italy avoiding any action from the EC. The EC's ability to fine Italy in the future should they deviate from the current fiscal trajectory has been complicated by the deteriorating situation in France. The "gilets jaunes" protest movements have resulted in a reversal of President Macron's long term economic reform plan. What initially started as a protest on fuel hikes has since escalated significantly and the president's approval rating has gone from bad to worse in the process. Fiscal discipline has been abandoned and the budget deficit is expected to remain above target next year. Germany was not immune to these populist forces as weaker results for chancellor Merkel's party led to her announcing that she would step down in 2021. Given the backdrop, the ECB has downgraded its growth estimates for 2019 and questions have re-emerged whether they will ever be able to raise interest into positive territory.

As broader risk assets were subject to sharp declines, credit markets were more susceptible to these moves than in previous market wobbles. While oil played a large role for highly indebted credits, the reduction in liquidity provided from both the Fed and ECB, paired with fears of large rating migrations from BBB rated debt into junk, raised wider concerns of the overall health of the market. The composition of the wider investment grade (IG) universe has shifted towards more BBB credit over the past decade. This has been driven by a combination of changes to rating agency methodology in the banking space, large scale debt funded M&A and increased share buybacks. One of the largest issuers in the space, Anheuser-Busch Inbev, announced over the quarter that it would be cutting its dividend to focus on paying back its debt. The company's debt pile ballooned following the acquisition of SABMiller in 2016; the synergy and earnings estimates proved far too optimistic and it has to show a firmer commitment to bring its debt pile down in order to maintain its ratings. This example is one of several companies that went on a spending binge with rosy expectations, only for these to be revised lower. If earnings were to decline in an economic slowdown, the fear is that some companies may fall below IG. Most companies have spread out their debt maturities and with interest rates low, they should be able to weather a moderate decline in earnings. Spreads have moved to levels last seen in June 2016 and thus refinancing has become more expensive. Therefore, this year we may see a change in management attitude as companies prioritise paying back debt over rewarding the shareholders. If this comes to pass, we may expect a better environment for both bond and equity investors.

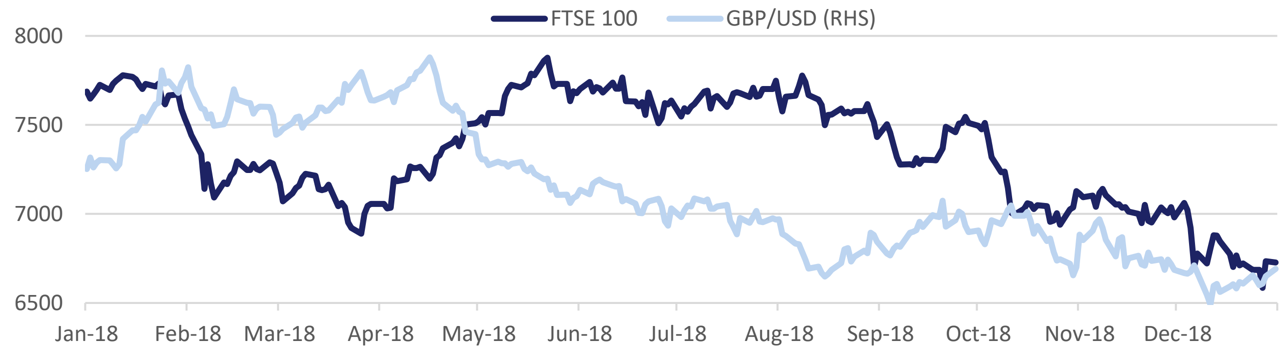
Equities

UK Equities

The performance of the UK market in 2018 was poor. The All-Share Index ended down -13.3% (ex-Investment Companies) with the FTSE 100 Index down -12.5%, the Mid 250 Index down -17.5% and the Small Cap Index down -16.6%. Sectors such as Technology (down -24.2%) and Consumer Goods (down -22.0%) were particularly hard hit and Health care (+9.5%) was the only FTSE industry group to deliver a positive return.

We were concerned about Brexit negotiations throughout the year but found comfort in the fact that uncertainty over the withdrawal from the EU tended to result in a weak pound, and outperformance of large FTSE 100 names who generate most of their sales and profits overseas. In the last quarter of the year, however, this relationship broke down, with ongoing weakness in the pound accompanied by generally lower UK equity prices (figure 3).

Figure 3: FTSE 100 versus dollar/sterling



Source: Bloomberg, LGT Vestra

There would appear to be three reasons for the breakdown in the weaker pound/stronger FTSE relationship:

1. Global growth concerns: As discussed on previous sections, trade wars, tighter financial conditions and a more pronounced slowdown weighed across global markets and the UK was not exempt from this.

The Global Manufacturing PMI Index for December (as produced by JP Morgan and IHS Markit) fell to a 27-month low of 51.5. New order growth was the weakest since August 2016, while new export business fell for the fourth month in a row.

2. Weak oil prices: These fell heavily over the course of November and December in the wake of demand concerns and a surprise 6-month waiver on the US's Iran export ban resulted in supply being much stronger than originally projected. This weighed on index heavyweights such as Shell and BP, but it also undermined sentiment on a raft of economically sensitive names. Oil prices have begun to recover, however, and according to a Bloomberg survey of oil analysts, Brent will average $70 a barrel in 2019. A strong V-shaped recovery is distinctly possible if a reduction in OPEC exports (and a commensurate reduction in inventories) is accompanied by an end to the US-China trade war and generally better economic data.

3. Brexit: This was a big reason for the UK equity market weakness across most sectors in 2018, and portfolio flows suggested that the political impasse had resulted in many overseas investors concluding that the UK was 'uninvestible'.

The key end of March exit date looms, with fewer than 100 days till the clock runs out. The Government has directed £2bn to no-deal provisions, it has hired 10,000 extra officials, and put troops on standby, but the general consensus is that the Country is unprepared for fresh custom and regulatory barriers. The result could be supply chain disruptions – the issue that we have worried about in previous quarterly reports.

One may assume that a hard Brexit will result in eventual acceptance of the draft withdrawal agreement that has been put in front of MPs, but this is not guaranteed. The problem is that the United Kingdom will have no legal route out of the withdrawal agreement if it is ratified, unless the EU agrees to let us out. The key point, halfway through the 585-page document, is article 185. This states that a Northern Ireland Protocol 'shall apply as from the end of the transition period'. Once the Protocol is in force, the UK cannot leave it except by 'joint' decision of the UK and the EU. This gives the EU a right of veto over the UK's exit. This Protocol — which has become known as the 'Irish backstop' — locks the whole UK into a customs union with the EU with no decision-making power. It would force the UK to maintain the EU's high tariffs against competing goods from other countries. It would also prevent the possibility of forging new trade deals with other economies around the world. Article 184 of the agreement maintains that the EU and the UK will use their 'best endeavours' to negotiate a trade agreement in time for the end of the transition. This has given rise to suggestions that the backstop will never be enacted, but 'best endeavours' does not mean eventual agreement to a deal that suits the UK. The backstop is deemed by some to be unacceptable as a customs union and EU 'level-playing-field' obligations would bind the whole of the UK to EU laws relating to goods, customs procedures, taxes, and adjudication by the European Court of Justice.

The political recriminations about such an outcome could easily weigh on investor sentiment. The clock is ticking and from an investing standpoint, the best that can be hoped for is that the draft withdrawal agreement is reworded to reflect new EU accommodation on the points above. We see a lot of value in the market but we are very aware that clarity is needed on a number of fronts for full investor enthusiasm to be restored.

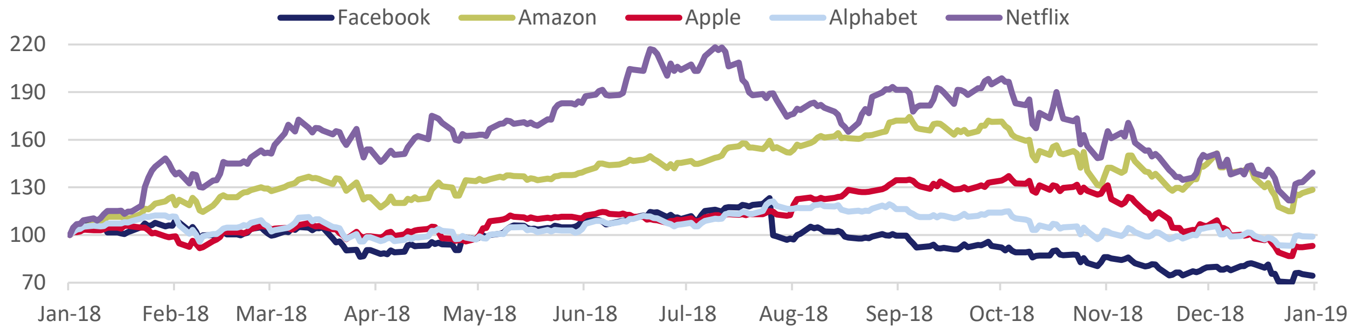
International Equities

The contrast between Q3, when the MSCI World rose +6% in sterling terms, and Q4, when it fell -12%, could not be more marked. Global equities took the lead from the US where robust growth suddenly became a potential negative on fears that the US Fed might continue to raise interest rates through 2019. The concern was that the Fed might be making a policy error amidst signs that the US-China trade spat was hitting growth and delaying decisions on capital expenditure in both countries.

This shift in sentiment hit all market sectors but the US banks sector (-17%) was amongst the most affected. The principal reason for the previous strong performance had been rising interest rates leading to higher profit margins. As the prospects for higher interest rates faded, paired with expectations for an economic slowdown, the support for the sector waned. The tech-heavy Nasdaq Index ended Q4 down -18% having led markets higher through most of the year though there continued to be large differences in individual stocks' performance.

After Apple and Amazon joined the trillion dollar market capitalisation club in Q3, by the end of 2018 they were worth $750bn and $720bn respectively and overtaken by Microsoft at $780bn as the world's largest company. Nonetheless even after this, Amazon was +28% higher over the year and Microsoft +19%. By contrast, scandal-hit Facebook fell -20% during Q4 and lost over a quarter of its market cap over the course of 2018.

Figure 4: Diverging performance of FAANG stocks



Source: Bloomberg, LGT Vestra

US Utilities eked out a +1% gain and consumer staples fell 'only' -6% during the quarter as more defensive sectors outperformed (as would be expected in such a weak environment for equities).

The MSCI Europe ex-UK was not a place to hide during the quarter with its -11% sterling fall, little different to global and US indices. Sectors followed the US market with energy and banks the worst and staples better, but still significantly down on the quarter.

The Japanese Topix Index was amongst the worst performers in falling -18% over the quarter, as the Yen rose +4% against the dollar as a safe haven, hampering prospects for the country's many exporters. Thus, the electrical appliances sector fell -21% and autos -15%.

Amongst emerging markets, China matched the US decline given its place at the heart of US trade action and uncertainty over the potential solution. The Shanghai composite fell -12% and the Shenzhen -14% in local currencies. Elsewhere in emerging markets, Brazil once again led the way up with the Bovespa index +11% as investors believe the populist new Trump-esque President will be market-friendly.

Alternative Investments

Hedge Funds/Targeted Absolute Return

Absolute return funds had a mixed quarter, however during a tough environment for equity and risk assets, alternative investment styles like macro, event driven and systematic provided diversification for portfolios. Manager selection was crucial as the trend reversal from growth to value and equity sell off/bond rally caught some investment managers off-guard, whilst some were positioned to benefit from increased market volatility. Event driven was the top performing style during the quarter, as some major mergers came to fruition in November 2018 (Disney/Fox, CVS/Aetna, United Technologies/Rockwell Collins). Systematic funds benefitted from trends in fixed income and commodity markets. Long/short equity funds had a mixed quarter with some managers benefitting from increased stock dispersion whilst others were negative having been caught in the growth/value rotation. Multi-asset funds were broadly unchanged over the quarter as the negative bond/equity correlation mitigated losses from the equity portfolio.

Looking ahead, we expect volatility to remain elevated as Central Banks continue to retreat from their ultra-accommodative stances. This provides opportunity for active management, and when executed well, as seen over the quarter, can provide a source of uncorrelated positive returns. In this environment, our preferences among alternative strategies remains mainly unchanged. We favour macro strategies where investment managers can benefit from increased fixed income and equity volatility. Systematic funds are well positioned to adapt to market regime shifts and therefore can also generate diversified returns. As we are at the later stages of the current economic cycle, we expect increased corporate activity as companies acquire targets to generate growth. In addition, this investment style should benefit from corporate balance sheet restructuring. We expect long/short equity to have increased opportunity set as stock dispersion is expected to remain high, as the market differentiates between winners and losers.

A well-diversified portfolio of alternative investment styles should be a welcome complement to portfolios invested in bonds and equities.

Property/Infrastructure

Consistent with the wider trend in risk assets, listed property returns were negative across the quarter, and this effect was magnified in the UK by Brexit uncertainty. That same uncertainty also impacted prime property prices and data suggests that the weakness is spreading down the price spectrum, and across the country, as the divergence between the South East and rest of the country continued to shrink. Despite high employment, wage growth and historically low mortgage rates, the need to raise a significant deposit and wider affordability constraints seem to be taking effect despite limited new supply.

The global real estate cycle is at mature stage and limited further capital growth is expected. Property prices are still supported by the attractive income component. The retail sector in the UK and the US remains challenged as the move towards online shopping gathers space. We expect this trend to continue for the foreseeable future given the dominance of online retail. Against this background, it is hard to increase rents on high-street retailers. Therefore, it is important to be aware of the type of commercial real estate investment in the portfolio. Although there are signs of a slowing global economic growth, a recession does not seem imminent, therefore we expect office space to hold up better.

As we enter a period of political and economic uncertainty, the investment vehicle used to access real estate exposure becomes very important. We are mindful of the 2008/post-Brexit periods where redemptions from open-ended property funds were either adjusted downwards, or suspended altogether therefore we are generally cautious of such investments.

As governments of the world over try to revive the slowing global economy, we may see some positive technical support for infrastructure investments. However, in the UK, the small but palpable political risk around even the possibility of a Labour government led by Jeremy Corbyn provides asymmetric downside risk at the moment. Diversification continues to be key given the disasters that have impacted Italian motorway operator Atlantia and the Californian utility Pacific Gas and Electric.

In summary, although bond yields have come down in the last quarter, real estate is attractive at the moment only for its income yield. However, changing nature of commerce and a slowing economy increases the downside risk and therefore we recommend a selective approach to niche real estate investments in appropriate investment vehicles.

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