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Friday, January 25, 2019

B Capital 2018 Commentary & Outlook Update 1H2019

2018 kicked off with collective optimism that global growth was broadly healthy and that all regions were in a synchronised upswing. This it followed could lead to higher stock markets and improved fortunes for most countries around the world and the possibility of a recession was some way off. Yet by the end of the first quarter the facts had started to change when France and Germany reported a slowing in the pace of growth. It seemed initially that this could just be a blip in an otherwise positive environment but as time progressed we found out - with the exception of the US - that the rest of the world was indeed moving to a slower place.

A slightly confusing picture appeared as the US economy accelerated beyond expectations into the summer months and unemployment there as well as across most other regions continued to tick down in a meaningful way. Indeed the spectre of inflation, which many had worried would rise as a product of ultra cheap central bank money, was and still is not appearing in a worrisome way. The 'good news' from the US combined with not so bad news everywhere else gave many reasons to hold on rather than sell but in the end there were other political factors which would upend markets in the second half of the year.

In fact from February right until the end of 2018 volatility more than doubled, global equities gave investors the worst performance since the Global Financial Crisis in 2008 and also some of the worst individual months in nearly a hundred years. The S&P500 which was showing some resilience to the rest of the world fell -9.6% in December alone.

It is fair to say that the outcome of 2018 was diametrically opposite to expectations and the (hopefully short) bear market for equities coupled with negative returns for fixed income has left something of a bitter memory of the year.

What went wrong? The prime cause lies with the US Federal Reserve, or to be more specific the perception of the Fed's intentions, which perhaps puts the blame partly with the FOMC and partly with investors' interpretations. The healthy growth backdrop gave the US Federal Reserve the impetus to get interest rates on the move up, four times in fact during 2018. This in itself is a vote of confidence in an economy that has been repaired since the huge damage inflicted by the housing crisis a decade earlier. Markets always knew that the time would come and indeed the hikes had already started, but what began to unnerve sentiment was the feeling that the Fed would keep raising rates in spite of a suspicion that global growth was not all that it was cracked up to be at the start of the year.

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Public markets always overshoot. In 2018 it was definitely a case of overreaction and looking back it could be described as "Taper Tantrum Mark II". Investors in both equities and fixed income became increasingly convinced that interest rates were going to head significantly higher whatever bad news came elsewhere in the world. That was not because investors wanted to feel this way, it was because of worrying mixed messages uttered by the new Fed Chairman, Jerome Powell. Through the year suspicion was steadily building that rates were going up too fast and in a way that growth was being choked off, with the added fear that this could end with a recession. To whit, here are a couple of statements by Chairman Powell that put the markets into an unexpected tailspin:

On the policy of quantitative tightening ("QT"):

"*We came to the decision that we would have the balance sheet run-off on* ***automatic pilot*** *and use the rate policy as the active tool of monetary policy.* ***I don't see us changing that****.*"

At the final rate decision meeting of the year, where a "dovish hike" was expected as slowdown jitters were at their height:

"*The Committee judges that* ***some*** *further gradual increases in the target range for the federal funds rate will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2% objective over the medium term.*"

For sure the doubling in volatility cannot all be put at the Fed's doorstep but this is in our opinion the background cause to sentiment being so substantially weakened during the year. With the slightly muddled communication at the same time as slower external growth was being reported - note that the Fed board members have spent the last month issuing many dovish comments to reassure that the autopilot is definitely off - there is the causal background for some negative performance. However the exacerbated level of the market falls are the result of a concentration of different and independent concerns that simultaneously grouped together and triggered an overshoot to the downside.

At this point it is worth reviewing asset class performance in 2018 to provide context.

MSCI All World	-11.18%
S&P500	-5.20%
Eurostoxx50	-14.00%
Topix	-19.84%
Hang Seng	-15.30%
MSCI Emerging Markets	-14.50%
Global Agg (Bonds)	-0.20%
Gold	-1.70%

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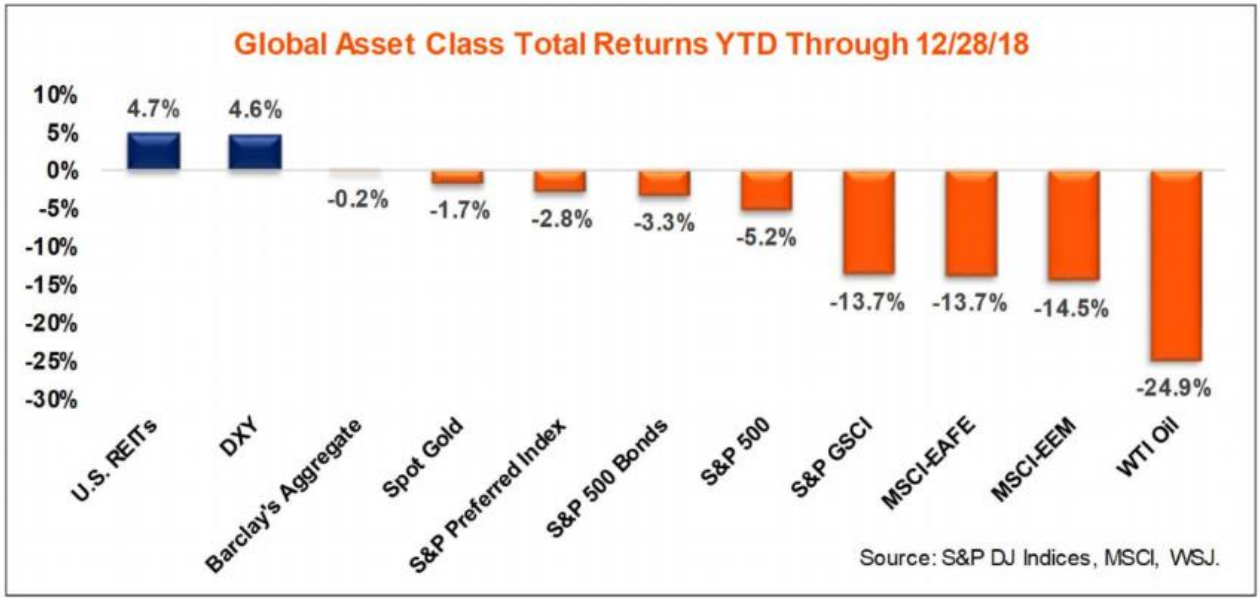

With quantitative tightening providing some background anxiety there were specific threats that proved to be the triggers for the ensuing heavy falls in prices. The main worry is the ongoing Trump tariff war on pretty much everyone, but especially the world's second biggest economy, China. This alone could have rumbled along without necessarily causing the rout that ensued but its escalation and apparent deadlock has become a huge mental block for investors. It started with the usual populist rhetoric from President Trump but instead of producing a quick win it has become increasingly clear that China is a tougher nut to crack than Trump hoped. The result will be a compromise for both parties in the end but with diplomatic relations souring and worrying commercial spats (ie Huawei) looking very politically driven it is not clear when a deal will come.

In Europe where growth has unexpectedly almost flatlined, there have been real reasons to watch more closely. The German coalition led by Angela Merkel has become fractious, the French economy has suddenly stalled and rioters stage violent protests at weekends, Italy has fought with Brussels over its budget plans (raising the worry of a referendum to leave the EU) and in Britain the total chaos caused by hapless politicians over Brexit all contributed to woeful European markets. As we head into 2019 and although Europe equity markets have gained more than 5% year to date it is still unclear if the region can resolve its many issues and play catch up the rest of the world. On balance though and after the sharp slowdown it now looks most likely that the euro-zone economy will stabilize near current levels, and not weaken further.

After finding a good footing in 2017 the subsequent fall in EM equities has been surprising in 2018 mainly because valuations at 12X forward PE were supportive even in the face of a hawkish Fed whose rate rises can be a problem for the more indebted EM economies. After a battering in 2018 it's clear that EM equities are oversold and due something of a relief rally and if the Fed comments remain more dovish as has been seen over the last month then EM currencies should add to total returns in the asset class. It was interesting to note that during the severe downturn in DM equity markets in December the EM indices performed relatively well, which indicates a bottom was being found. A little dollar weakness after its strong rally and an easing of the short term rate rise expectations will definitely be helpful.

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Indeed after a year when markets have fallen quite heavily it is usual for investors to view it as something of a re-set that gives a base on which future gains may be built. It never feels this way and questions are asked as to how negative markets can be avoided more effectively. This is a fair reaction and especially when 2018 gave a very different outcome to the one originally expected. Valuations are supportive and reduce the likelihood of further heavy falls while the Fed is now more attuned to issuing clearer dovish language and probably won't raise rates at the pace feared earlier. One possibility is that equities have fallen to match growth expectations and may have overshot to the downside when the pessimism seemed to be palpable in Q4 of 2018. This leaves 'technical bounce' price upside through a retracement toward long-term average levels and also some positive potential if the macro picture stabilises after hitting an unnerving soft patch last year.

The IMF has along with most institutions lowered growth expectations and warned on the key risks already outlined in this report. It points to risks to the downside as ongoing trade tensions and political populism make it less clear how long term stimuli for growth combined with responsible fiscal measures might be expected in the current environment. In our assessment we first take a step back and try to remember that equities are the long term winner versus fixed income or cash and that it is time in the market rather than timing the market that produces the best results. Three in four years are on average positive and therefore it will pay over time to remain invested, whether more or less so according to the long term objectives. During this soft patch we look to the core portfolio allocations to weather the volatility and remain cautiously optimistic that the combination of some positive price action and dividend returns together will make 2019 a more stable and positive year.

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