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February 2019

Global strategy

Assessing the China Factor

As January unfolded, it became increasingly clear what had been unsettling the markets in the fourth quarter of last year. It always felt likely that the key reason was an undesirable combination of higher US interest rates together with weaker global growth, and recent events have only reinforced this. There is a widespread, although somewhat misguided, belief in markets that the Federal Reserve always causes economic cycles to end by raising rates too high. The good news is that the last few months have seen a marked shift in central bank tone, from one of relative hawkishness to relative dovishness. This is covered in further detail below. Fourth quarter company earnings and conference calls have also given us good insight into how different regions and parts of the global economy have been performing recently.

The quarter started with a surprising pre-announcement of earnings from the largest company in the world, Apple. They released earnings earlier than scheduled as they were materially weaker than the market consensus estimates. The company anticipated some weakness in Emerging Markets, but in their own words, and compared to their guidance from two months earlier, they "did not foresee the magnitude of the economic deceleration, particularly in Greater China". It is not the case that the slowdown was entirely attributable to economic concerns, as they have been facing increasing competition from local providers. However, taken together with other indicators such as auto sales, German and Japanese exports and Chinese asset prices, it suggests that growth in China fell meaningfully in the second half of last year.

China is now the second largest economy in the world and is expected by some to overtake the US by the end of the next decade. That growth is slowing should be no surprise, reported growth of 6.4% was the slowest in the last two decades, however the contribution to global GDP growth is now around 40%.

Global strategy

Assessing the China Factor

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For context, from 2000 to 2010, China's contribution to global economic growth never got out of the teens. There is a debate around how much of the slowdown is cyclical and how much is structural. We believe that the US-China trade conflict is a factor, but the dominant factor appears to be a campaign to bring debt levels under control and particularly debt outside of the mainstream banking sector, especially shadow banking, such as peer-to-peer loans.

Balancing deleveraging with a controlled slowdown in economic growth is a challenging exercise, particularly for an economy the size of China's. However, it is not as simple as avoiding investments with exposure to China, as the impacts are very company and sector-specific. Broadly speaking, companies with luxury goods and premium drinks exposure are doing very well, some consumer brands are doing well, industrial companies are generally reporting weakness and parts of technology and auto sectors are significantly weaker. We are spending an increasing amount of time deciphering what is going on in the Chinese economy and its impact on the rest of the world, especially within our equity strategies.

Fixed income

A Lesson in Staying Invested

The rebound in risk assets during January has been an excellent example of how staying invested over periods of market volatility, like that we experienced in Q4 2018, is usually the best course of action unless faced with an impending recession. As active managers, we continually look for opportunities to add alpha and volatility can sometimes be constructive, as mispriced assets are exposed. This recent period was a classic example of what we refer to as good volatility, with risk assets declining without any major change in the economic outlook or monetary policy. The speed and magnitude of the equity sell-off was sufficient for the Federal Reserve to significantly change their language around future rate rises, and this supported risk assets.

During the past month, we have seen oil prices surge back to $54 a barrel (helping inflation expectations to rise), the VIX (a volatility index) decline to 16, the US dollar weaken and bond market volatility significantly fall, all predictable market behaviour as risk assets find support from oversold levels. However, US Treasury yields haven't followed this path and remain at their lows, implying a significant decline in the future growth outlook. This repricing of the outlook for growth remains at odds with most of the underlying data being reported on the US economy. If we dig deep we can find some weakness in corporate balance sheets or the Housing market, however, by and large, the US economy has continued to grow at a healthy clip and above trend as shown by the Chicago Fed National Activity Index. This is a combination of 85 indicators of national economic activity, drawn from four broad categories, which ended 2018 at +0.27 (a zero value indicates the economy is growing at its historical trend rate). With employment markets remaining strong and housing finding a footing due to the recent fall in mortgage rates, this looks set to continue. Although credit spreads peaked on Christmas Eve, US Treasury yields continued to decline and didn't bottom until the first week

Fixed income

A Lesson in Staying Invested

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of January, so the flight to quality effect was apparent even after markets started to show signs of stabilisation. Fast forward to the end of the month and the reversal has been fairly dramatic; credit spreads have not only regained all of the underperformance seen in December, but almost the whole of Q4. The bout of volatility witnessed in Q4 can largely be attributed to the market recognition of slower growth outside the US and the Federal Reserve signaling that monetary policy is far from being at neutral, with market pricing in September implying a further 85 basis points of US base rate tightening over the coming 12 months. The tightening in financial conditions and extremely dovish language from the Fed at the policy meeting this month have led market participants to price out any further base rate increases. Put simply, this market believes that this tightening cycle is over. This sudden about-turn from the Fed is understandable given recent market events, although we suspect that later in 2019, as global growth and risk assets recover, the Fed will again be faced with the prospect of injecting volatility into markets as the hawks regain control of policy.

Having started the year maintaining our overweight to investment grade credit and inflation break evens, portfolios have had a very rewarding few weeks and have fully taken part in the rally. The dovish surprise from the Federal Reserve in January also led us to tactically upgrade our recommendation on Emerging Markets, as we expect easy monetary policy to boost risk assets and remove the tailwind for further US dollar strength, which should be broadly supportive during the first half of 2019. Given the positive moves in investment-grade credit this month, we continue to dial back exposure to the asset class. This is primarily at the long end of the curve to reduce duration as we expect long yields to rise on any positive data surprises and clarity on Brexit or China trade negotiations.

Equities

Expectations became too negative

Risk assets shook off the fourth quarter's market correction and posted some historic returns. Global equities rebounded from December's lows in a big way, returning 7.8%. Investor sentiment is still mixed. While this was the best January since 1987, the market still has a ways to climb to recoup the -13.4% fall experienced in the fourth quarter of 2018. Hindsight is certainly 20/20, but it does appear now that the recent moves lower had gone too far. The market was falling as if the global economy was entering a recessionary environment – either driven by a fundamental slowing of global growth due to the end of the business cycle, or the knock-on effects of questionable geopolitical, monetary, and fiscal policy.

It is safe to say that some fundamental factors have started to deteriorate, mainly slowing earnings growth in the US. However, the ancillary factors that have negatively affected equity valuations have begun to reverse and are actually supporting risk assets. We are hopeful that there will be an amicable outcome to the trade discussions between the US and China. However, we are cognisant that this so called "trade war" is also a result of fundamental ideological disagreements that will most likely take years to resolve. Finally, it appears the US Federal Reserve has altered its stance on future hikes being on "auto pilot" which has further supported equity prices.

The US earnings season is in full effect and results contrast those of 2017 and 2018 in many ways. Earnings growth has clearly slowed in recent months, but the 13% growth for companies reporting as at the time of writing, is a solid figure and outpaces the 9% growth estimates. Despite many negative revisions, the market reaction to solid reports has been more positively skewed than recent quarters. On a growth basis, this quarter has been a

Equities

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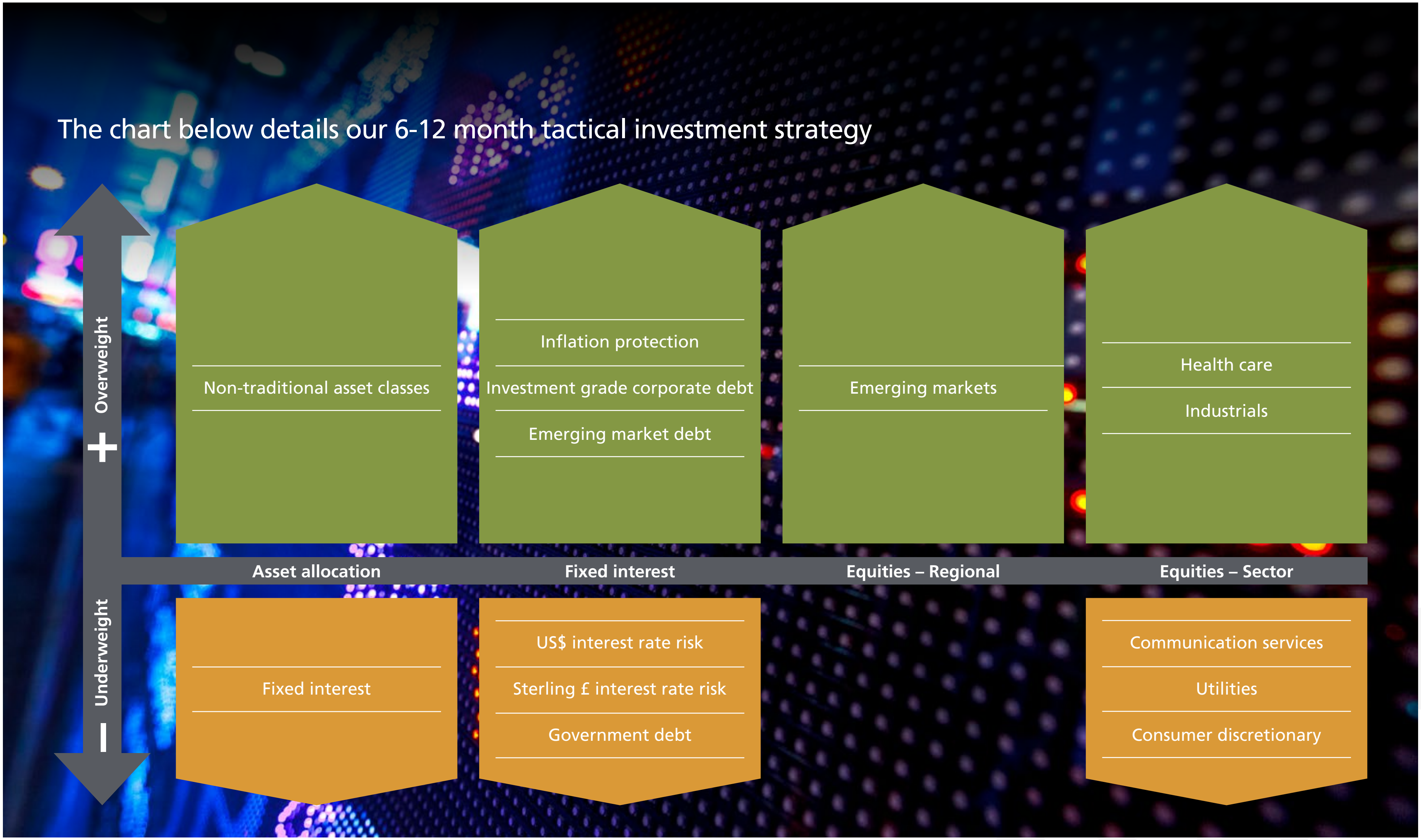
success. However, it has not been all positive news, as the portion of companies reporting upside earnings surprises stands at 69%, the lowest figure in seven years. Also, recent moves in currency and commodity markets are pointing to earnings growth in the first quarter 2019 to be flat or even negative. What will continue to drive markets is the forward guidance and commentary released by large bellwether companies.

Much of the commentary surrounds slowing growth outside of the US, coupled with concerns around the "trade war". This was noted in the following quote from Fedex's earnings call "Fedex is experiencing strong growth in the US where the economy remains solid. However, our international business, especially in Europe, weakened significantly since we last talked with you during our earnings call in September. In addition, China's economy has weakened due in part to trade disputes." There are many companies that have are performing well despite all of the noise in markets. Nike, a recent addition to many of our segregated equity portfolios is a great example, "We have not seen any impact from our business from some of the US, China dynamics that we're all reading about. But in the context of being mindful of those, we continue to see very strong signs of momentum in China." We continue to believe that we can add value by holding companies with strong brands, strong cash flow generation, and have some sort of sustainable competitive advantage not seen in many of their competitors.

Global asset allocation



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