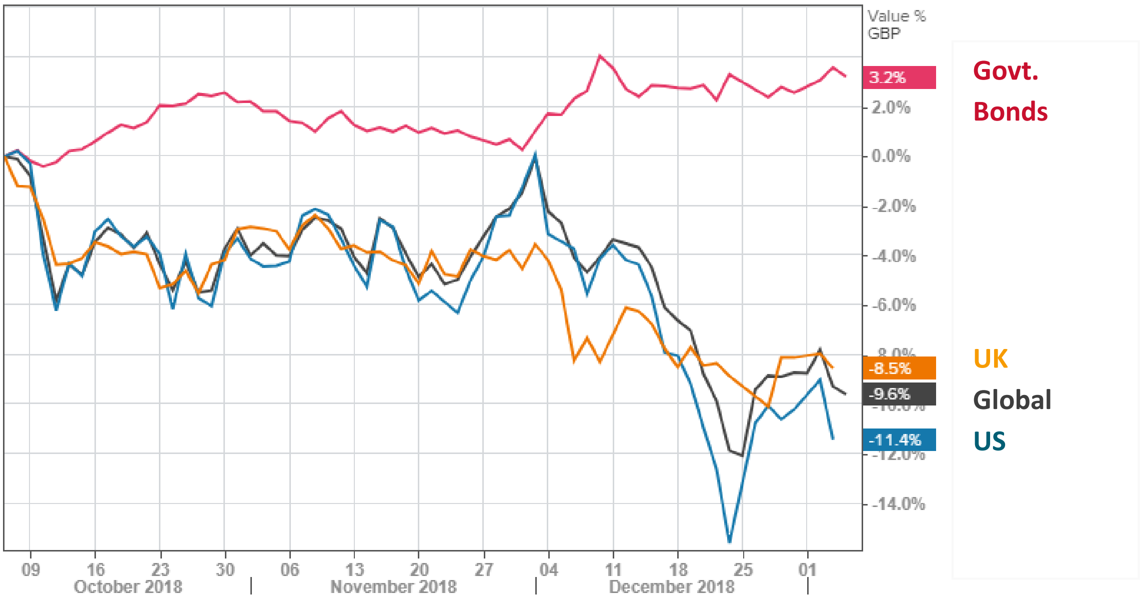
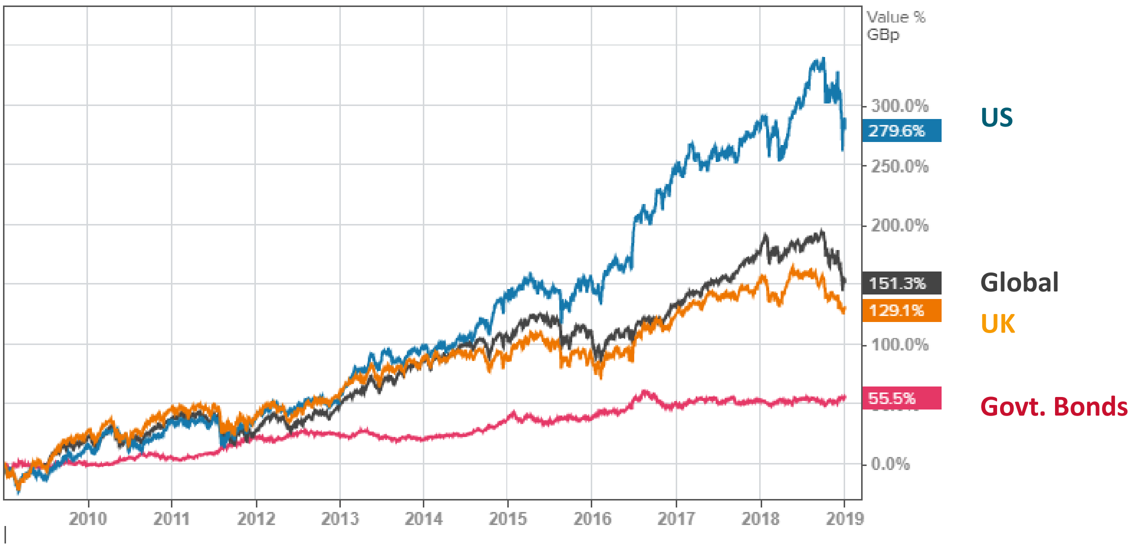
CHARLES STANLEY
Wealth Managers

Pressing the reset button

Unlike a computer glitch, when it comes to issues with markets we can't do the tried and tested "turn it off and on again". However, that hasn't stopped it from trying. The start of a new year is not just a time to reflect on the events of the previous 12 months, but also an opportunity to re-assess where we think the best returns can be made.

The Market Summary within the latest portfolio valuation highlights the major market events of 2018, in particular the challenging last three months. Any fall in markets is not pleasant and we are wary of over-exaggerated short term movements. Whilst accepting that every investment period is important, we attach greater investment significance to five, ten and twenty year periods that more accurately reflect our clients' investment time horizons, rather than a three month snapshot in time. To put this into perspective we show the returns of four major asset classes over the last 3 months (top chart), compared to over the last 10 years (bottom chart). We believe that equities will continue to outperform bonds over the vast majority of investment time horizons.





Indices, rebased to GBP, FTSE All Share, S&P 500, Thomson Reuters Global, iShares Core UK Gilts.

THOMSON REUTERS

The resetting of markets

The noise surrounding Brexit is understandable, yet still frustrating. The financial media continues to be dominated with political rumours and controversy, when in reality the factors facing markets are much more complex and overarching. As investors in companies and governments, the most important long term factor to us continues to be economic conditions. It is not the most interesting, nor is it the most spoken about; but at this stage in the cycle in our view it is absolutely the most important factor moving markets.

The central bank policies introduced in the years following the last financial crisis, which contributed so strongly to economic recovery, are moderating and stock markets are fading. What's worse for markets is the “normalisation” of interest rate policy, and as a result the quantitative easing (QE) we have seen over last decade has well and truly become quantitative tightening.

On one hand there are various arguments as to why markets could continue to fall and investors will have to accept that it could be payback time after years of QE induced share price success. However, we also must consider the argument that markets are resetting. Of course, this means weaker growth and lower corporate earnings, but does it mean returns cannot be made for patient responsible investors? We don't think so. In fact, we believe that our ability to be more active in this market will be a key differentiator. In a market increasingly focused on the short term, we are determined to invest with a global outlook and longevity in mind.

To help us continue to implement this strategy we do not need to reinvent the wheel; our key long term themes remain exactly the same. Recent weeks have created buying opportunities for long term, patient investors. Continuing in this manner, you will start to see adjustments to portfolios in the early stages of 2019 and potential for reductions in cash balances where and when we feel it is appropriate.

Our long term investment themes

In a world where the media is quick to focus on uncertainty it is ever more important to focus on *what* we know and *how* this can impacts our investment strategy.

We know, for example, that life expectancy will continue to increase across the world, increasing the demand on healthcare and social services. We can be sure that this population growth will be skewed toward cities and therefore the opportunities that complement urbanisation and electrification are important. We will also see rising middle class incomes, particularly in Asia, and increasing demand from consumers and businesses. It is through this demand, as well as world class research and development in developed and advancing economies, that we anticipate further innovations will be delivered.

It is also important to remember that over time the world *is* becoming better off. Of course, there will be shorter term periods that are more painful, but it is also true that these times always represent the best entry point for investment returns. Just look back to the start of the last US equity market bull run way back in March 2009. It would have taken a brave investor to be fully weighted at that moment in time, but for those who were committed the returns were stratospheric. Without stating the obvious, that is the benefit of hindsight though and as we have mentioned in previous commentaries investing based on the past is a bit like driving a car by looking through the rear mirror.

What to expect in 2019?

We expect we will see more volatility within markets. Brexit will continue to be debated. The US and China may or may not agree a trade deal, and even if they do, they will surely continue to engage in a strategic conflict, as each of these world super powers flex their economic muscle. And make no mistake, debt levels are high. Indeed, eye wateringly so in the most vulnerable of countries, such as, Canada, Hong Kong, Norway and Sweden.

However, the most important issue will remain the one that has contributed so greatly to returns since the last financial crisis: interest rates. The financial and economic conditions created and actively encouraged through central banks have seen all types of assets increase, whether that be houses, final salary pensions, fine wine, or indeed, shares and bonds.

The dollar, as the world's truly global currency, is going to be a key factor to watch for in this regard. We expect that signs of reduction in the earnings of US companies (evidenced already this year through a more cautious update from Apple) will prompt investors to act. This may see reduced US allocations, in favour of regions with more attractive relative valuations, such as, the Emerging Markets, Asia and Europe. Even if we see little movement in the dollar at the start of 2019, the potential for less liquidity later in the year means we may start to see greater share price volatility around growth and earnings expectations. Of course, we must remember that as with any dramatic shifts lower in share prices, we may also see dramatic moves higher in this new market dynamic.

It against this backdrop that we are working to protect and grow the value of portfolios over the long term and to meet investment objectives from a role with which we are entrusted.

Wishing you a healthy, happy and prosperous 2019 from all at the Leeds office of Charles Stanley.

CHARLES STANLEY
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2019 major asset class map

The below gives a measure of our thinking going into the new year and includes some of the areas that we will likely cover in more detail in future market commentaries.

UK

The UK equity market is relatively cheap, and has largely been ignored by global investors for a number of years. However, after the recent sell off it now provides an even more generous dividend yield premium over UK bonds. However, the market has a high degree of dividend concentration in a limited amount of equities, so diversification remains crucial. We think that as the year progresses greater certainty from Brexit will likely see sterling and UK listed multinationals rise in value. However, some of the short term pain may persist.

US

For some time we had been concerned that the overvalued US market would have to correct. Indeed, we reduced our US exposure too early and missed out on some of the upside. At the end of last year the US Federal Reserve's hawkish commentary on interest rates prompted a reassessment of US stocks, in particular the highly valued FAANGs – Facebook, Amazon, Alphabet, Netflix and Google. The challenge is to balance a potential lower purchase price for US shares, with the prospect of further weakness in 2019. To help us with this we will be watching the dollar closely, as weakness may prompt investors to switch to Asia and Emerging Markets, which in comparison look cheaper still.

Europe

An Italian government, hostile to the euro scheme and austerity, has plans to boost spending and borrowing. Their ambitions to cut taxes will put them in conflict with the disciplines of the Eurozone, and we are already seeing concessions being made from both the European Central Bank and Italian government. However, we are closely monitoring the wider European banking sector which could be stressed by this internal debate.

Emerging Markets

The dollar strength in 2018 has been negative for emerging market equities. Valuations are therefore now significantly more attractive and better economic and earnings growth is expected. Whilst we were early in adding to our Emerging Market exposure, the long term growth prospects for the region are undeniably strong.

Asia ex Japan

As the largest economy in Asia, China may be hit by trade concerns in the short term. We continue to favour a diversified approach to investing in the region, taking advantage of structural growth opportunities offered by the rising middle classes. We will be watching for clarity on Donald Trump's trade war with China, as a resolution to this may see significant inflows to such a demographically attractive region.

Bonds & Cash

We can look at these two areas together as where we are committing money to bond markets, we do so with a short time horizon and promise of repayment of capital. Although we expect equities to outperform bonds in 2019, fixed interest securities still perform an important role in portfolio diversification and providing a yield premium above cash. The key to avoiding permanent capital loss will remain the same as 2018 in our view: keep bonds at short duration because interest rates are rising.

In recent years, tactical holdings in index-linked gilts have seen standout contributions to the performance of portfolios. However, at current levels, the poor yield and the absence of new inflationary pressures make these bonds less attractive, so we retain preference for conventional fixed coupon gilts.

Alternatives & Property

Interest rate rises can be a negative for property, although yields remain attractive. Economic growth may support rental yields. Commercial Property, particularly warehouse distribution centres and healthcare premises, are attractive in terms of providing relatively high rental yields. In addition, property offers the potential for attractive long-term returns as a result of the capital appreciation and rental uplift.

Commodities

The US-China trade war is negative for agricultural and industrial commodity prices. After the recent sell off industrial metals, such as copper and aluminium, are looking cheaper and demand is supported by trends for urbanisation. The resolution of current trade issues may prompt a reassessment of the sector's fortunes. Lower oil prices will benefit most businesses (apart from the oil majors) through lower input costs. Rising US interest rates are negative for precious metals, such as gold and silver, and we continue to prefer assets that generate an income.