Investment Newsletter

August 2019

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The uncertainty principle

As investors, we spend a lot of time thinking about risk.

Every investment we can buy has risk attached, and it's our job to weigh this up against the potential return. If we invested in a share or bond in an individual company for example, then of course that company could fail and we could lose some or all of our capital.

Much of this risk can be reduced by diversification i.e. buying shares and bonds in multiple companies. We can reduce this risk further by buying multiple asset classes in multiple countries and multiple currencies.

Once we've diversified our portfolios, we can, to some extent, quantify how much risk we're taking as a whole by looking at things like historic default rates, market drawdowns and correlations between the asset classes. None of this is perfect, but it can give us a pretty good idea of risk which we can then weigh up against the potential opportunities.

However, there's a big difference between risk and uncertainty. The types of investment risk mentioned above can be defined as "measurable uncertainty" – what Donald Rumsfeld would have called the "known unknowns".

Meanwhile, uncertainty can be defined as "unmeasurable risk". It is these "unknown unknowns" which give us headaches, and in our view the investment world right now is pretty much as uncertain as it's ever been!

We have been saying for some time that the global economy is clearly slowing. The same can be said for the UK which, in the second quarter of 2019, contracted for the first time in seven years.

However, a slowdown is not the same as a recession which we've generally felt could be avoided both globally and here in the UK. The big rider attached is that political decisions could make all the difference! A policy mis-step could turn a slowdown into a recession.

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The B-word…

The most obvious point of uncertainty for us here in the UK is surrounding Brexit, in particular if we leave the EU without a deal.

There are several reasons why this is problematic for investors. Firstly, it is pretty much a binary outcome and we have no way of predicting whether or not it will occur. In addition, nobody really knows what would happen in a no-deal scenario. There have been all sorts of nightmarish outcomes painted by opponents of no-deal, whilst those in favour dismiss this as "project fear". Truthfully, nobody can say for certain what will happen.

Regardless of the "real" effect of no-deal, there is an element of self-fulfilling prophecy. Because no-deal is seen as dangerous to the UK economy then it will be dangerous. In the event of a no-deal Brexit the pound is likely to fall sharply, along with the value of many UK assets, purely because the UK will be perceived as a less attractive place to invest.

This could then cause a hit to the real economy through higher inflation and lower growth due to lower levels of investment.

On the other hand, if no-deal were to be avoided then the pound would probably rally, as could certain UK assets. In particular, we think some UK shares look very cheap relative to similar overseas companies having been shunned by international investors for some time.

UK shares are therefore either an absolute bargain or a place to avoid. Which they will turn out to be depends on factors outside of our control and which are not within our ability to predict.

Trump and tariffs

Globally, we can say something similar about Donald Trump and his trade war.

Markets have fallen sharply of late after Trump announced a potential increase in tariffs on Chinese goods. This could hit not just the Chinese economy but the American economy as well, since tariffs mean higher prices for American consumers. We also live in world of global supply chains, so a Chinese product may well have components made in Japan or Korea, or even the US itself.

Again, a wrong move could make the difference between a global slowdown or a global recession.

There is a danger that things escalate from a trade war into a currency war, after the Chinese authorities allowed the yuan to devalue in response to the American tariff threat.

Just as we see in the UK, this leaves some parts of the global stock market looking decent value, notably in China, Japan and other parts of Asia. However, as with UK stocks they are cheap for a reason.

Should the US and China reach a trade deal and a global recession be avoided, they could prove to be bargains. Should the world tip into recession, they could fall much further.

Fed up

We can also throw central banks and the potential for interest rate cuts into the mix.

During 2018 the US Federal Reserve (The Fed) increased interest rates four times. The Bank of England increased rates once, and this trend was expected to continue.

However, those expectations have now completely turned around given the weaker economic data. Investors now expect the Fed to cut interest rates perhaps two more times in 2019, having cut them last month. The Bank of England is also expected to cut rates, especially if we see a no-deal Brexit.

Falling rates are generally good for bonds, as their fixed levels of interest become more attractive by comparison. This therefore leads to an increase in bond prices.

Bonds have done phenomenally well so far this year. However, this leaves them with extremely low yields. If you lend money to the UK government for 10 years by buying a 10-year gilt, you will receive just 0.46% pa (as of 14 August).

Even less attractive is the 10-year German bund, where you will receive interest of minus 0.64% pa. Yes, you read it correctly – you will pay for the privilege of lending to the German government.

Upon first reading that is insane. However, the reason that this is the case is because interest rates in Europe are currently minus 0.4% pa and many expect the European Central Bank to cut rates further into negative territory. If you are a European institution, you are already paying to keep your money in cash, so you may as well pay for the security of investing with the AAA rated German government instead.

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Growth at any price?

There is a strange dynamic going on in some parts of the stock market.

As economic data gets worse, the chance of further interest rate cuts increases which then, paradoxically, increases the value of certain stocks.

With bond yields so low, investors are willing to pay a premium to buy high quality companies that they think will see above average long-term earnings growth. As rates and bond yields fall, the price investors are willing to pay increases.

What we describe as a "growth stock" is one which trades on a high multiple of current earnings. However, those earnings are expected to grow faster than the market as a whole in the future.

To work out what the company is worth, an equity analyst will estimate what revenues or profits they think that company will make in the future, and discount that back into today's terms using an appropriate discount rate. Often, the discount rate used is the domestic government bond yield.

Over the past decade, growth stocks have massively outperformed "value stocks" (those companies who trade at a discount valuation to the market as a whole). Historically, value stocks have outperformed over the long term. It is unlikely to be a coincidence that the past 10 years has seen such historically low interest rates.

The US stock market is dominated by a number of large growth stocks, particularly in the technology sector. Again, the US market has outperformed the rest of the world over this time period by a significant margin.

As a result, the US stock market trades at a high multiple of current earnings relative both to its own history and to the rest of the world.

An optimist writes…

That's enough about the risks, but what about the opportunities?

At Equilibrium we are realistic, but we like to be optimistic! In our view, there are good reasons to believe that the US and China will eventually come up with a trade deal. Not least because Trump wants to be re-elected next October! We also remain optimistic that a no-deal Brexit can be avoided for similar reasons.

If so, then hopefully the UK and the global economy can recover from their current slowdown and avoid a recession. In this scenario we think UK and Asian stocks could do very well.

However, if we're right then it also means the interest rate cuts that are currently priced into bond markets might not happen. This probably would lead to a sell off in certain types of bonds. It may also lead to some of the high growth stocks such as US tech stocks to fall, or at least underperform.

Right now, we're cautiously positioned for such an outcome, with less fixed interest and less in US stocks than usual. We have slightly more than usual in the UK and in Asia.

It does feel like we're getting closer to a tipping point for some of these issues, but for now we must acknowledge that things could still go either way. We must therefore be extremely careful to balance out the opportunities against this uncertainty.

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General economic overview

The global economy is definitely slowing, particularly in the manufacturing sector. This is partly due to concerns over trade, and an escalation in the trade war could make things worse. The trade war has hurt Asia in particular but also in Europe where Germany is on the brink of a recession and where the car industry is really struggling.

The UK economy contracted in the most recent quarter. Business investment remained weak, whilst the stockbuilding that had boosted the economy in the first quarter, ahead of the original Brexit date, was unwound. Despite these concerns, employment on both sides of the Atlantic currently looks pretty healthy with improved wage growth.

We think central banks may cut rates but perhaps not to the extent that is now being priced in.

Equity markets

We think there are some very good value areas of the stock market, particularly in parts of Asia and the UK. However, US stocks still look very expensive to us and the risk of a further sharp pullback is rising. We are cautiously optimistic taking an 18-month view but expect it to be a bumpy ride.

Fixed interest

After such a strong move in fixed interest so far this year, yields are very low. As such, we'd expect future returns to be lower but still expect positive returns over 18 months. We like very flexible funds which can move between government and corporate bonds and move up and down the maturity spectrum as market conditions change.

Commercial property

Commercial property has been hard hit by Brexit-related uncertainty. This is particularly the case in the retail sector. Given the rising risks and concerns over liquidity, we have reduced exposure to around 5% of most portfolios.

Cash

With interest rates remaining at record lows, returns on cash will remain below average for the foreseeable future.

Balanced asset allocation

For a typical balanced portfolio, we are underweight fixed interest, property and traditional equity. This is balanced by additional holdings in defined returns and alternative equity, giving an overall risk/return profile roughly in line with our long-term average position.

These represent Equilibrium's collective views and in no way constitutes a solicitation of investment advice. The value of your investments can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested. We usually recommend holding at least some funds in all asset classes at all times and adjusting weightings to reflect the above views. These are not personal recommendations, so please do not take action without speaking to your adviser.