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ASSET MANAGEMENT

Overview

The first quarter of 2019 saw a robust recovery in equity markets following the sharp falls in the fourth quarter of 2018. A degree of progress on trade talks and the promise of a stimulus from governments helped to allay concerns over global growth while central banks decided that they would not need to tighten liquidity so much after all. There remain a number of political issues, including here in the UK, and there are as often some wider concerns which may yet impinge on the positive momentum, but momentum is in itself a powerful force.

Markets made a strong start to the year in January, made some further progress in February and mostly improved in March. The US markets performed well, helped by an improvement in technology shares, European markets also rose sharply and a rally in Chinese stocks helped emerging markets, although the UK and Japan lagged a little. There were also decent returns from bond markets if not from all alternative assets.

Economic growth around the world has slowed given the impact of tariff wars and certain individual issues, such as for car manufacturers over diesel engines, yet for now the outlook remains reasonable in the US, if with a mixed picture, and fair in China, the driver of recent global expansion and one country where the government is ready to provide a further stimulus. The International Monetary Fund now expects global growth of 3.3% in 2019, lower than the 3.5% it had forecast and the 3.6% reported for 2018, although tracking such data does not always help. As important will be the level of corporate profits, which do not necessarily follow changes in GDP, and the level of cash generation from companies. The inversion of the bond yield curve in the US has prompted thoughts on the likelihood of a recession (high) and its timing (unknown and probably not immediate) as well as its usefulness as a predictor (fair) and how markets might move as a consequence (up initially, historically).

Besides the willingness of governments to provide a fiscal boost was the readiness of central banks to heed the concerns of markets, if perhaps not political leaders, on the risks to global growth from tighter monetary policy. The US Federal Reserve in particular declared that it would be patient given subdued inflation and might even cut interest rates if the data would suggest. Lower interest rates or rather low interest rates for longer may depress those with cash deposits but can raise equity valuations.

The political issues, which reflect populist pressures and geopolitical strains, are unlikely to dissipate in this fractious world but may ease from time to time. The most prominent remain the Brexit negotiations, the outcome of which remains elusive and leaves few clear drivers to change portfolios. Trade wars have also been important for sentiment, but just as the US has edged towards an agreement with China it raised the prospect of imposing tariffs on $11bn of European goods over subsidies to Airbus.

Outlook

The economic and political factors are mixed and hard to predict with confidence; there are some significant concerns but also a significant possibility that markets will climb the proverbial wall of worry, before falling off it again. We will as before find some benefit in the diversification and defensiveness of portfolios, to help to ensure a degree of resilience, but an important element will be flexibility while accepting the limitations of market timing. We will put some cash to work, as it cannot earn more than a minimal return, but selectively.

Asset returns

The total return from the FTSE UK Gilts All-Stocks Index was 3.4% in the first quarter as ten-year yields dropped from 1.28% at end December to 1% at end March. In the US ten-year yields also fell in the quarter and moved from 2.68% to 2.41%, the same level as at the start of 2018. In Germany yields turned negative, falling from 0.24% to -0.07% in the quarter while even in Italy they are at 2.49%. As with gilts US Treasuries saw a positive return in the quarter, at 2.8% for those with a duration of 7-10 years. Emerging Market debt in local currency was modestly higher in the quarter while higher-yield debt as measured by the Bloomberg Barclays index gained a striking 7.1%.

Equity markets rallied sharply in the period. The FTSE 100 rose over the first quarter by 8.2%, if not quite recouping the 10.4% fall in the last quarter of 2018, which took the index from 6728 to 7279. The FTSE 250 Index of mid-sized companies rose 9.2% in the three months and the FTSE SmallCap Index made a more modest 5.6%. The AIM market was 6.8% higher in the period. For the FTSE All-Share the return in the quarter was 8.3% and 9.4% including income.

In the US the S&P 500 index gained an impressive 13.1% if, as in the UK, not quite recovering in full from the decline in the last quarter of 2018 of 14%. The concentrated Dow Jones index was up 11.2% in the period and the technology-oriented NASDAQ index 16.5%. The Russell 2000 index of smaller companies made 14.2% over the quarter even after a drop of 2.3% in March.

In Europe the EURO STOXX 50 rose 11.7% over the three months while smaller companies, as per the Euromoney index, lagged with a more modest gain of 5.6%. In Japan the Nikkei 225 also rallied only modestly with a gain of 6% compared to the fall of 17% in the fourth quarter of 2018.

The MSCI Emerging Markets index in US$ gained 9.6% in the quarter helped by the Chinese Shanghai index, which rallied by 23.9%. The MSCI Frontier Markets index gained 6.2% which offset the decline of 4.5% in the last quarter of last year.

Sterling strengthened by 2.2% in the quarter against the US$, to close at a rate of $1.30:£ if off its highs in the period. Against the euro Sterling was much stronger, up by 4.5% to close at €1.16:£.

The price of Brent recovered well over the three months, rising 27% to close at $68 per barrel. The price of gold was modestly higher in the quarter with a limited gain of 0.8% to reach $1292 per troy ounce. While the price of silver was down in the period other major metal prices were higher, with the bellwether copper up 11.3%. Agricultural commodity prices were mixed over the quarter and mostly lower again.

The drop in volatility in markets saw the Vix index for US equity fall back by 46%.

UK

- Persistent uncertainty over Brexit negotiations and compromise elusive
- Subdued economic growth and interest rates still on hold
- Valuations attractive even after rally and resilient yield key

The UK market rallied in the first quarter, if held back by the relative strength of Sterling and by persistent uncertainty over the eventual outcome of the Brexit negotiations.

It was a quarter in which the UK passed the deadline of 29th March when it was due to leave the EU and in which there was a series of twists or turns in the process. Theresa May lost a number of votes in the House of Commons on her proposed deal by a large number, there were indicative votes as Parliament sought to take control from the government, which diminished as ministers resigned, and then a number of forays to negotiate with European leaders. The latest has seen an agreement to defer the due date of departure to 31st October, or Halloween for those looking for ghoulish analogies, while Mrs May will continue to negotiate with Labour to try to leave with a deal before the elections for the European parliament in late May. For some the Brexit episode has been a fascinating one, for many now it has become boring, for all it remains unresolved as to the potential impact or benefit.

The range of potential outcomes and the difficulty of knowing how markets might then react makes it seem futile to adjust portfolios. For now we have looked to hedge some overseas exposure against the risk of a further rally in Sterling on a softer outcome and to limit the exposure to areas of the market which might prove sensitive to a harder one, such as property and smaller companies, although airlines have seen the most volatility. We shall continue to re-assess especially should the possibility turn more into the probability of an election and a Labour government under Jeremy Corbyn, as the potential policies would be a challenge to business and markets.

The uncertainty is one factor, against the global background, why economic growth has now slowed, to 0.2% in the last quarter of 2018 and an estimated 1.2% for this year according to the Bank of England, although the recent data has been a little more encouraging, if perhaps distorted by an element of stockpiling. Investment has faded in the automotive sector, at £488m in 2018 down 47% on the previous year and only about a fifth of its previous high, even before the move by Honda to end production at its Swindon plant in 2021. A reluctance to invest might account for the record cash levels held by private non-financial companies which stand at a jumbo £747 billion, up £173bn since the referendum in June 2016 and equivalent to 35% of GDP. Deploying some of this cash should provide a boost as would renewed consumer confidence, which is helped by the robust job market (the unemployment rate is at 3.9%, the lowest since January 1975) and by wage inflation (which was 3.1% in 2018, the highest level since 2013).

Productivity gains are elusive, companies have struggled to pass on wage increases and inflation is relatively subdued. The Bank of England has continued to hold off on any rise in interest rates, in part because of the uncertain outlook.

The UK market has recovered from its lows but remains good value assuming that there will be a degree of resilience in corporate earnings, while the high dividend yield is attractive outside of companies that might need to cut their pay-out.

Continental Europe

- Manufacturing slow-down in Germany and Italian economy soft
- Potential impact from populism and UK's departure from EU
- Interest rates low as ECB plans renewed stimulus

The European stock markets recovered strongly in the first quarter, with the French market helped by the exposure of luxury good companies to revived demand in China although other exporters have struggled.

The negotiations with the UK over Brexit have shown how the core central relationship in Europe between France and Germany has been strained: neither Angela Merkel nor her successor as leader of the Christian Social Union, Annegret Kramp-Karrenbauer, seem to share Emmanuel Macron's passion for a renaissance in the European Union, as they fear it is more likely to force it apart. The elections in May for the European parliament will most probably reflect continued populist pressures and before then come elections on 28th April in Spain, after the collapse of the socialist-led coalition and the rise of the populist Vox party.

The potential issues over the UK affect Ireland, Belgium and the Netherlands for whom the UK is an important importer of goods and services. The German economy has faced issues in the car industry and export markets especially the UK, Turkey and China. Factory orders declined in February by 4.2% in the latest data, the steepest decline since January 2017. Data this month showed that exports fell in February by 1.3% to €109 bn while imports were 1.6% lower at €91bn. Business surveys show some resilience in domestic services, however, and consumers might appreciate the pay deal for some one million workers in the public sector of about 8% over three years which was agreed in early March.

The Italian authorities now expect a much lower rate of growth at only 0.2% for 2019, so it is likely that the country's budget will easily exceed the 2% cap agreed with the European Commission. Conditions have been better in other parts of the south. Of the larger economies it is Spain's that has been doing best, making the largest contribution to the increase in eurozone GDP in the fourth quarter of 2018, a year when it grew 2.5%. Portugal has seen an economic turnaround, with unemployment more than halved to 6.7% and scope to end the budget deficit for the first time in forty years; debt is high but a declining proportion of GDP. The prospects of renewed drama or crisis in Greece have eased and yields on ten-year government bonds are at the lowest since January 2006 having dropped under 3.5%.

Bond yields in Germany turned negative in the quarter on concerns over global growth and the European Central Bank has had to adjust its plans to tighten policy. Mario Draghi, the ECB president who will be standing down later in the year, said following a significant cut to 1.1% in the forecast for growth in 2019 that it would revive the nattily-named stimulus programme Targeted Longer-Term Refinancing Operations, to encourage bank lending, if on less favourable terms. Interest rates are likely to stay negative at -0.4% for deposits.

For European markets, while not as markedly as in the UK, short-term pressures on growth and political issues have created a degree of longer-term value, especially in companies that are exposed not so much to the challenges in the region as to opportunities elsewhere.

USA

- Political issues after mid-term elections as presidential polls loom
- Economy softer if resilient and data mixed
- Federal Reserve volte-face from raising rates

In the US markets enjoyed a sharp recovery in the quarter from the significant declines at the end of 2018.

The government shut-down came to an end (it had been the longest on record at thirty-five days) while the more difficult relationship between the Trump administration and the Congress now controlled by the Democrats continues. Attention has been turning to the next presidential elections, which always seem to come round quickly and are due in November 2020; Donald Trump's position has been helped by the judgment of the Mueller enquiry and the divisions for now on the Democrats' side.

The Federal Reserve has now downgraded its forecast for growth in 2019 to 2.1% and it is this more subdued rate together with minimal inflationary pressures (at just 0.1% month on month in the latest data) that has enabled the Fed to take a more patient approach on interest rates, with no expectation that it will raise them this year. Its Chairman Jay Powell is in a difficult position and faces pressure from President Trump, including his potential nominations and his call to cut rates.

The job creation numbers have been mixed: from 312,000 announced for January down to an unexpectedly low level of 33,000 in February and then a recovery to 196,000 in March. As important might be the jobless claims number, which usually needs to see a sharp rise in the order of 40,000-60,000 to show an incipient recession, whereas for now the rate is still falling and stands at 207,000 at the lowest level for nearly fifty years. Wage inflation remains at a robust 3.2%. Earnings forecasts for 2019 are important. Company margins have been boosted as the economy rallied and by tax cuts. Margins slipped in the fourth quarter and are unlikely to be at a level to meet earnings expectations. FactSet has estimated that earnings for the S&P500 fell by 4.6% in the first quarter, although they are still forecast to grow this year and next; the strength of the oil price will provide a boost to that sector.

While the next US recession is not imminent and might never happen, according to some, at a late stage in the cycle there is often a resurgence in corporate activity and a move by venture capitalists to tap the stock market. The unicorns, technology start-ups valued at $1bn or more should be rare (or mythical) by definition but they number some 130. The Lyft initial public offering seemed to start well but has since stalled. Uber has announced that it will proceed with its own IPO that would value it at $100bn and it seems to have stressed the importance of investing so that it might never make a profit. Apparently Saudi Arabia has provided $15bn to US start-ups since 2016. Meanwhile the relative rating of US technology shares is back to where it was in 2018, before the sharp fall.

Debt levels have been increasing. One of the issues is the profile of the debt, as some $3.3trn of investment grade bonds are due to mature by 2023, nearly half of the total outstanding.

So politics, earnings and technology will be key. The US market has seemed expensive before and still performed well, even with better value elsewhere.

Japan, China and north-east Asia

- Stimulus from Chinese authorities and concessions on tariffs
- New era in Japan if still some traditional challenges
- Weakness in China's economy hindering exporters

In the first quarter the Chinese stock market rallied strongly, having fallen by over a fifth in 2018, although the recovery in Japan was less marked.

In China the indications are that the annualised growth rate was as low as 4% in December as credit tightened but was more robust, in the order of 6%, in recent months. Confidence has been helped by discussions over a trade deal with the US, which are expected to resolve most issues if not how quickly or completely the $250bn of tariffs imposed in the last year are removed. Another boost has been a looser economic policy, including the issuance of debt in part to fund infrastructure and a substantial reduction in VAT payments. The authorities have eased the required reserve ratio for banks by 1%, which might allow the release of some $117bn of liquidity. The manufacturing purchasing managers' index turned marginally positive at a level of 50.5 in March although industrial profits have been falling at the fastest rate for a decade. Inflation remains low at 2%.

The sharp rally in Chinese stocks has seen Hong Kong again become the third largest stock market (behind the US and mainland China, and as before the Chinese share bubble popped in 2015) ahead of Japan. In Japan the Heisei era will end this month and the Reiwa one take its place. In the short term the recovery in the economy has slowed given lower industrial production and weak exports, which fell in February for the third consecutive month; machinery orders were notably lower although the Tankan survey suggests capital spending has held up. The Bank of Japan has lowered its assessment of the outlook for the first time in three years and its latest survey showed consumer confidence is low, with only 5% seeing an improvement in economic conditions and some 24% anticipating a deterioration, making a planned further rise in the country's consumption tax from 8% to 10% a risk.

The case for Japan still rests on the reform process of prime minister Shinzo Abe with Haruhiko Kuroda at the Bank of Japan, following their fiscal and monetary stimulus. There is a much higher female participation in the workforce and overall wages have increased as the workforce has grown, although wage inflation has been modest (companies like Hitachi and Toshiba have offered increases of 0.3% this spring). The labour market is tight with the number of jobs half as high again as the number of applicants. Increased tourist numbers have provided a boost to growth in GDP. A weaker Yen has helped manufacturers and corporate profits, with the rise in margins to nearly 9% for larger companies. Stock market firms have been increasing dividends or share buy-backs and reducing cross-holdings (as at Bank of Kyoto whose portfolio was worth four-fifths of its own market value), encouraged by the government and prompted by activist shareholders. Consumer price inflation remains well below the target of 2% with the strength in the Yen a factor. It is a country with modest GDP growth, although the per capita rate is greater and a persistently low level of inflation (the Nobel prize-winning economist Simon Kuznets noted that there were four types of countries: developed, undeveloped, Argentina and Japan).

An improvement in China would help exporting companies in the region and the longer-term potential is there, if with concerns over geopolitics.

Emerging Markets

- Global outlook mixed if pressures eased
- Key elections in India
- Range of issues in Turkey, Brazil, Russia and South Africa

Emerging Markets as an investment class (which includes China in the standard indices) also recovered in the quarter and confidence has improved; markets and currencies are sensitive to expectations on global growth and the impact of tariff wars.

Politics are as usual prominent. In Indonesia up to 187m voters will participate in one day on 17th April to choose between the incumbent Joko Widodo or Prabowo Subianto as their president. Voting started on 11th April in India, where there will be seven phases in the national elections. Narendra Modi's BJP is expected to win and markets would respond well, although the country should benefit even from a different result from the momentum of reforms already made in biometric identities, a new bankruptcy process and the goods and services tax as well as infrastructure spend, if still short of the benefit from investment in logistics as well as a stronger banking sector. Reforms have helped the poorer regions of India especially and contributed to reported annualised growth of 7.3% in 2013-18, if as yet little above the average 6.7% over the last thirty years. The Reserve Bank of India cut interest rates further to a level of 6% and it has been another central bank under political pressure.

In other elections President Recep Tayyip Erdoğan's AK party lost the vote in the major cities of Ankara and Istanbul largely due to challenging economic conditions, and the Turkish lira has been under pressure too. In Brazil Jair Bolsonaro's honeymoon period has seemed brief as the reality of reform and his contentious politics prompt concerns. In Russia the higher oil price should help President Putin's position, although gas prices in Europe have fallen and as elsewhere the investment picture is variable. For South Africa the most pressing challenge seems to be in providing steady power to industry and consumers alike.

The potential remains remarkable in developing countries, especially in Asia, as they grow in wealth, and while still likely to be volatile emerging market equities and debt are attractive.

Property, commodities and other alternatives

- UK commercial property still resilient outside of retail
- Oil price rally and other commodity prices mixed
- Gold a sort of safe haven
- Income-generating alternatives doing well

The retail sector, either on a High Street that will need to be re-imagined or in out-of-town centres, continues to face the challenge of a shift to e-commerce. Other elements of the UK's commercial property markets have held up well, particularly outside of London, with their yields attractive and resilience in revenue especially in areas such as healthcare. There has to date been no particular impact evident from the uncertainty over the UK's deferred departure from the EU, a region which has its own challenges but which has also seen some

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positive returns from property.

The price of oil has rallied with revived hopes for global growth and as the production cuts that OPEC co-ordinated had an impact. The sensitivity remains to a potential drop in demand as well as to increased shale production in the US, although in time the larger question is the role of oil as technology and regulation changes the nature of the automotive, shipping and other industries. Metal prices were also helped in the quarter by the improved outlook. There seems for now to be little compelling about such commodities nor agricultural ones, which might offer uncorrelated returns but do so with a degree of volatility or unpredictability. Extreme weather conditions might yet prompt a rally from their lows for agriculture but it could be that new technologies, from drones to genetics, have offset some of the historic pattern.

Gold made a small gain in the quarter, maintaining a little momentum from the last quarter of 2018 when its appeal as a safe haven came through. It retains some appeal as such, while an end to rises in interest rates in the US also help an asset that generates no income, although gold mining shares can do so. There has been an intriguing rally from its lows in the price of Bitcoin but this does not appear to be a realistic option for investors, even if the interesting potential in the underlying blockchain technology might prove otherwise.

The alternative assets with an attractive yield and the potential for a steady net asset value include infrastructure and renewable energy funds, although they can face political and other issues.

There remains a wide universe of alternative assets intended to help to smooth returns and to add a defensive element to portfolios, if a narrower one when there is a requirement for daily liquidity. Steady alternatives might be able to offer an option in place of cash, which still has a role in preserving capital but seems unlikely to generate much of an income yet.

Julian Cooke – Director **14th April 2019**

Vintage Asset Management, 7a Wyndham Place, London W1H 1PN
Tel.: 020 7989 3110
Email: info@vintageassetmanagement.co.uk
www.vintageassetmanagement.co.uk

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