Overview

The last quarter of 2019 saw further progress in world equity markets in spite of continued volatility. Investors responded to the easing of the tension over tariff wars and to a decisive election result in the UK as well as to better economic data and reassuring company results. The outlook looks to be predicated on interest rates that stay low for longer, if not for ever, although renewed tension in the Middle East is one indication of the risks or challenges that persist.

While October has often been a difficult month for markets last year they remained relatively calm, even as the global economy lost momentum. The Federal Reserve cut interest rates by 25 basis points again, for the third time in the year, and indicated that this would be as much as it would do for now. The Fed also moved to buy short-term government debt at the rate of $60bn per month into 2020 in part to ease a cash shortage that saw a sharp rise in banks' overnight lending rates, known as the repo rate and historically a pointer to problems ahead. In the UK Boris Johnson ditched his commitment to secure Brexit by 31st October but secured agreement to hold a third general election in five years. The month of November saw a degree of confidence in markets as investors took heart from slightly better news, on manufacturing or trade wars or earnings, with industrial indicators turning more positive; safe haven assets lost some of their appeal and bond yields moved higher. In December investor confidence grew with the moves by the US and China to reach a compromise on their trade dispute, as well as a decisive outcome to the election in the UK even as Donald Trump was due to be impeached. Domestically-oriented elements of the UK market rallied sharply in relief at the sizeable Conservative victory and Sterling saw a small further rise.

So 2019 saw markets recover from the weakness in the fourth quarter of 2018, when the world seemed a bleaker place. The main factor has been the move by central banks to ease their monetary policy in the face of slower economic growth, a significant factor in which was the escalation in trade disputes between the US and China as well as between Japan and Korea. The European Central Bank also reduced interest rates, taking them to a negative 0.5%, and resumed its purchase of assets while the Bank of Japan continued its own policy. Governments also moved to end austerity and to provide a fiscal stimulus in the face of weaker economic data which saw Germany and Japan narrowly avoid a technical recession. Central banks were helped in their revised policy by a generally subdued level of inflation in spite of a rising oil price and increased employment, while wage increases helped consumer demand even as business investment faltered. For manufacturers there were, beside the trade wars, continued issues at Boeing in the US and at car companies in Europe.

Political issues have remained prominent although there was an apparent decline in the size of the populist vote in elections later in the year and none of the potential flash-points, for example in Hong Kong or Catalonia or Venezuela, seemed as hard to contain as bush fires in Australia. There was a continued focus on the climate, the fragility of the planet and the permanence of plastic which in the investment world was reflected in a substantial increase in the amount of funds committed to an Enviromental, Social and Governance approach.

Liquidity was an important factor in the period, not just in the global financial system but also in individual assets, and it will remain a key factor.

Outlook

It seems easy to reason that markets will continue with their momentum just as it is to be somewhat fixated by political twists and by the latest economic data, much of which is then subject to revision. The numbers for corporate earnings are arguably more important for equity markets, although as with data they can be subject to revision, bias and obsession.

For now the expectation is still of reasonable economic growth around the world, a little better than in 2019 if lower than the average in the last decade. The International Monetary Fund has estimated a rate of 3.4% for 2020, an improvement on the expected 3% for last year on the assumption that emerging market economies pick up. The risks of a recession in the US in the near-term have faded, although they remain, complicated by the run-up to the presidential election in November and dependent to a degree on there being a sufficient compromise on trade wars. While there has been some positive news on the US dispute with China there is for now the threat of tariffs on French luxury goods in retaliation for the proposed digital tax which will impact American technology firms.

Central banks are likely to maintain an approach that is intended to provide a continued stimulus to demand and to try to defer a slow-down. They should still maintain a focus on inflation, which has been subdued but could pose a risk, and to financial stability. Happily the financial sector appears more robust than ahead of the financial crisis following measures to bolster the balance sheets in the banking sector, although low rates have also allowed 'zombie' companies to carry on and thus to minimise the impact of bad debts. The worry for central banks is their limited range of policy options to counter a downturn, as raised by Kristalina Georgieva at the IMF and echoed by Mark Carney as he prepares to stand down at the Bank of England.

There is an expectation that governments will provide an additional fiscal stimulus, as has been happening in China and Japan and seems imminently greater in the UK, although the German approach is likely to be more austere. To be ready to invest companies need sufficient confidence, which has been dented by uncertainty over trade including in the UK over Brexit, while consumers and governments too need to be careful to control the amount of debt that they take on.

The outlook for corporate earnings remains modest after a challenging year in 2019. Much of the gain in equity markets has come from a re-rating of shares, seen by some as the least bad option in a period of low or negative interest rates. Large technology firms have been a driving force and have seen substantial growth, yet they are facing greater regulation and higher tax.

The state of capital markets is intriguing. International tension was a factor in cross-border mergers fading to their lowest level since 2013 although US companies were active in their domestic markets and accounted for fifteen of the largest twenty deals, while US transactions represented about half of the $3.9trn total value of deals. Private equity firms spent more than in any year since the financial crisis yet seem to hold substantial levels of cash, as does Warren Buffet's Berkshire Hathaway with reserves of over $120bn. New listings on global markets fell by a fifth to 1,237 in 2019, the lowest level for three years with the amount raised a tenth lower at $189bn, of which over $25bn came from Saudi Aramco. There may be a late-cycle surge in deals. Sales of corporate debt were the highest on record at $2.5trn.

It will be a year in 2020 of maintaining a coherent longer-term vision, with some shorter-term flexibility and a focus on countries, sectors and companies that can prove resilient.

Asset returns

The total return from the FTSE UK Gilts All-Stocks Index was -3.9% in the fourth quarter as ten-year yields moved from 0.49% at the end of September to 0.82% at the end of the year, a period which they had started at 1.28% and for which the index return was still decent at 6.4%. In the US ten-year yields also rose in the period from 1.66% to 1.92% at the end of the quarter while in Germany yields turned less negative at -0.19% against -0.57%. While US Treasuries saw a small loss in the quarter of 1.2% for those with duration of 7-10 years, emerging market debt in local currency and higher-yield debt, as per the Bloomberg Barclays index, saw positive returns of 4.5% and 0.7%. All the main bond indices had a strong year.

In equity markets the FTSE 100 rose 1.8% in the fourth quarter which took the index from 7,408 to 7,542 and made for a gain for the year of 12.1%. The FTSE 250 Index of mid-sized companies rose by 9.8% over the quarter and the FTSE SmallCap Index by 8.8% to give gains for the year of an impressive 25% and 14.9% respectively; for the AIM market the quarterly gain was 3.9% and that for the year 11.6%. The FTSE All-Share had a total return including income of 4.2% for the fourth quarter and 19.2% for the year.

In the US the S&P 500 index gained 8.5% in the quarter to make a return for 2019 of 28.9%, one of the better years since its inception in 1873. The concentrated Dow Jones index saw gains of 6% in the quarter and 22.3% for the year while the technology-oriented NASDAQ index made 12.2% and 35.2% respectively. The Russell 2000 index of smaller companies rose by 9.5% in the quarter to make 23.7% for the year.

In Europe the EURO STOXX 50 rose by 4.9% over the three months to December to make a return of 24.8% for the year while smaller companies, as per the Euromoney index, lagged a little with gains of 4.8% and 17.6% respectively. In Japan the Nikkei 225 continued to rally with an increase of 8.7% in the quarter that made for a return of 18.2% for the year.

The MSCI Emerging Markets index in US$ also did well with a gain of 11.4% in the quarter, with Brazil and Russia prominent, which boosted the return for the year to 15.4%. The MSCI Frontier Markets index made 6.5% in the period and 13.5% in the year.

Sterling was notably stronger in the fourth quarter when it gained 7.9% against the US$ to close at a rate of $1.33:£ while against the euro Sterling was up 4.9% to €1.18:£.

The price of Brent oil rose by 11% in the last quarter of 2019 to $66 per barrel, which was a quarter higher over the year. The price of gold gained a further 3% in the period to close at $1517 per troy ounce, helped by central bank purchases, and it was up by 18.3% over the year. The major metal prices were all higher in the quarter, while over the year palladium was up by more than half. Agricultural commodity prices nearly all rose in the quarter if not the year.

In the fourth quarter of 2019 the Vix index of volatility for the US equity market fell by 15.2% which meant that it had dropped by 45.8% over the year. The price of bitcoin was less of a feature, although over the year it was higher.

Asset allocation

As we start a new decade (although some would argue that this has to wait until 2021) and as the economic cycle since the financial crisis stretches on, it might be an appropriate time to offer a review of our approach to asset allocation overall as well as to set out our current position.

Our starting point for asset allocation is to apportion cash to fixed interest, equities and alternatives according to a prescribed mandate, from Cautious through to Equity Growth, so as to seek to generate assumed returns based on those each asset class has produced over the longer-term. In broad terms equities are expected to contribute the greater return but with higher volatility, while bonds or fixed interest might produce a lower return but with lower volatility. There are times when equities fall in value and bonds rise, or vice-versa, although the pattern especially in recent years has been for the two classes to be correlated.

Alternatives are usually by definition any assets that are not equities or bonds and should be able to produce reasonable returns that are not correlated to them, thus serving to smooth the potential volatility in portfolios. These assets have historically been commercial property and commodities, including gold which is seen a store of value (if hard to value in itself given its lack of income), and increasingly recently what are termed real assets, which comprise infrastructure and the like. There are also hedge fund strategies and absolute return funds, although the latter might fail the trade descriptions act, and liquidity is vital.

We do treat cash as an asset class in its own right if one which at the moment offers next to nothing or indeed nothing as a return and so has a role as a means of preserving capital at a challenging time. This is on the basis that the biggest risk to portfolios is not necessarily volatility, which is cited often as it can be readily measured if not always fully understood, but rather the pressure to crystallise a loss when unnerved by too much volatility (which is usually also nothing more than a euphemism for falling markets). We reserve the flexibility to hold significant levels of cash when appropriate while accepting that making short-terms calls on markets is not consistently fruitful and that a long-term time horizon with a higher risk appetite would entail staying fully invested. This would also be our usual approach for income-oriented portfolios to ensure that they can maximise the potential for dividends.

Our short-term call, in spite of the reservations and in line with the conclusion of our latest quarterly investment committee, has been that equity markets can maintain their momentum given an outlook that is broadly similar to the end of last year. We see the potential still in the US given the resilience in its economy and the attraction of new business generation but believe that there is better value in the UK, which has been disdained by international investors, in Continental Europe, in spite of its perpetual challenges, in Japan, with the reinvigorated corporate scene, and in emerging markets, whose share of global GDP is not as yet reflected in the value of their stock markets, which should evolve over time.

Bond markets would also benefit from a combination of modest economic growth and of continued low interest rates, although their weakness in the fourth quarter of 2019 as yields rose from extremely low levels shows that their relative stability may prove less defensive in coming years were there a return to a more typical interest rate environment. We shall favour a UK orientation to limit the exposure to currency risk.

For alternatives we shall trim infrastructure after a strong run and look for further income opportunities, which shall also be reflected in a limited allocation to cash.

UK

- Clear outcome from election and likely spending boost
- Brexit set for end January and trade deal needed by end December
- Market rally and valuations still attractive, with Sterling a factor

The UK market has mostly lagged its global peers given some recent uncertainty and there was a notable rally in relief at the sizeable Conservative victory at the general election, led by the likes of housebuilders. The Queen's Speech included plans for increased spending on education and infrastructure, while the government is expected to review the viability of certain contentious projects as part of a putative wider reform. The hopes are that there will be a boost to investment, not only a fiscal one as austerity ends but also from companies that have been inclined to hold cash. Already in 2019 government spend will have increased by 1.3% in real terms and public borrowing has increased, the first rise in the deficit in ten years. While forecast rates of growth remain modest for now, it should improve through 2020. The labour market has been robust: the employment rate stood at 76.2% in the three months to October and unemployment was down to 3.8%; this was reflected in wage increases above the rate of inflation at 3.5% in the three months to October, if lower than the 3.9% in the previous period. The government has proposed a rise of 6.2% in the national living wage for those over 25 to £8.72 an hour, given that low pay has also helped to explain the sense of austerity. The Bank of England has opted to keep interest rates as they are at 0.75%, while Andrew Bailey from the Financial Conduct Authority was chosen as its new governor to replace Mark Carney in March.

The size of the Tory majority in parliament has, however, also raised concerns that not only will the government get Brexit done promptly this time on 31st January but that it will increase the risk of leaving with no deal. Trade discussions may be inconclusive by the current due date for an end to negotiations of 31st December, an optimistic target.

The limited rise in Sterling after the election reflected these concerns as well as its rally before the vote. The currency looks to be approximately 10% under-valued on a purchasing power parity basis and the scope for it to strengthen argues for the continued use of hedged share classes for some overseas positions. Sterling remains a significant factor given the dominance of overseas earnings for the UK market and also for the dividend yield, which may also be under pressure from further cuts in pay-outs.

Continental Europe

- Modestly improved outlook for manufacturing with consumer resilience
- ECB continuing its stimulus and wanting governments to do more
- Political pressures and resistance to reform

The mainland European economy has shown some resilience and a degree of improvement. Although the IHS Markit survey for December at 43.7 indicated that German manufacturing output was still contracting, the rate had improved from the lows in the summer. The economy is dependent on global trade and is still caught up with the emissions issue in the car industry, although there was a short-term boost to sales in December as the auto makers tried to shift energy-inefficient vehicles before tighter regulations came into force. There remain challenges in France, where widespread strikes to protest over pension reform have had an impact on production.

Christine Lagarde, who replaced Mario Draghi as president of the European Central Bank at the end of October, has ordered the first review in two decades of the strategy for the ECB's monetary policy. She is likely to continue the current policy of asset purchases and a negative deposit facility rate for bank funds overnight of 0.5%. The latest indication of inflation put the rate at 1.3% in December, up from 1% the previous month and a figure that provided some relief given the risks of deflation. Ms Lagarde has called on wealthy countries with a low deficit, notably Germany and the Netherlands, to spend more to provide a stimulus. This may not persuade the Germans, who last year were still saving 11% of their disposable income, as in the year before, even with negative interest rates; they hold an estimated 27% of their financial wealth in current accounts.

The political landscape is complex: in Germany as politicians look to carve out their position as Angela Merkel cedes power, in Spain where the further general election in November was again inconclusive leading to a minority coalition between the Socialists and the populist Podemos, and in France where President Macron is entrenched in the pensions dispute.

North America

- Increased focus on election campaign with impeachment and foreign policy
- Economy robust with consumer demand strong
- Federal Reserve looking to hold interest rates

The year is likely to be dominated by the campaign for the next presidential elections in November although in the meantime there are the associated issues of the impeachment proceedings against President Donald Trump, underway if seen as underwhelming, and the geopolitical issues with China and in the Middle East. January should at least see a first-phase deal done in the White House with China: the US has agreed not to impose duties on a further $156bn of Chinese goods and to halve the tariff rate on $120bn of imports that it imposed in September.

The data on the US economy has become more mixed although domestic demand has stayed robust with an indication that retail sales rose by 3.4% as against 2018 between 1st November and Christmas Eve to some $880bn, helped by a rise of nearly a fifth in online sales which grew to account for 15% of the total (although it is not clear how the figures account for all those product returns). The non-farm payrolls figure for December was again a little shy of expectations at 145,000 new jobs although the previous month had been strong and the overall level for 2019 is expected to have exceeded 2m for the ninth consecutive year. Rises in average wages have slipped to 2.9% which is the lowest level since mid-2018. Investment and bank lending was broadly flat in the second half of 2019, in large part due to a decline in capital expenditure which was estimated to have increased at just 1% for S&P500 companies in the fourth quarter after the tax-cut boost the previous year

The Federal Reserve has said that its moves to cut interest rates should be seen as part of a new strategy until there were a significant increase in inflation, rather than as a temporary measure to insure against slower growth.

Japan, north-east Asia and Australasia

- Further stimulus in Japan ahead of boost from Olympics
- Trade wars key to the region

* Challenges in Australia where economy weakening

In Japan consumers have been a key part of demand in what has been a sluggish economy overall and the further increase in the sales tax, which rose from 8% to 10% on 1st October, has had less of an initial impact than feared. The Bank of Japan may yet cut interest rates (the benchmark one has been at -0.1% for four years) and remains active in its asset purchases, including in the stock market, to stimulate growth and inflation, which both remain at modest levels. Shinzo Abe's government has provided a further economic stimulus of ¥13.2trn (£90bn) to offset the typhoon damage in October and to boost digital technology in the country. The hosting of the Olympics in the summer after the Rugby World Cup last year will provide a further boost to tourism and perhaps to immigration: the native population is in decline with births expected to have fallen below 900,000 in 2019 so that with the death rate at a post-war high of 1,380,000 the net impact is close to a decline of one inhabitant per minute, a figure long feared but one that arrived sooner than expected.

The tariff wars have dampened growth in South Korea, which at least has seen an easing of its dispute with Japan, and in Taiwan where relations with China will remain strained following the election victory of its president, Tsai Ing-wen. Her Democratic Progressive party rejected the 'one nation, two systems' that has become discredited in Hong Kong and had been advocated by President Xi of China.

The pressures have also mounted in Australia as its exceptional period of robust economic growth fades further, even before the impact of the devastating fires which have also raised issues on the challenge of climate change and the country's role in mining coal for China.

China, India and Emerging Markets

* Chinese economy hurt by tariffs and Hong Kong if helped by stimulus
* Slower if decent growth in India where political tension increased
* Latin America and South Africa struggling in part

China remains emblematic both in economic terms and in stock markets with a greater number of domestic China A shares being included in world indices. Its economy has struggled with the protracted trade wars with the US as well as with the disruption from the unrest in Hong Kong. The authorities have taken to a renewed fiscal stimulus by adding liquidity into the banking system and increasing infrastructure investment, while being mindful of some of the excesses of previous spend and the increased level of debt, including off-balance sheets for local authorities. There has been less attention to the currency, which has retreated to a level of less than seven yuan to the US$. Growth is expected to be in the order of 6%.

In India economic growth had briefly surpassed that in China but then slowed to some 5%; it is not as yet clear that the tax cuts the government introduced have encouraged companies to invest in production. Much more clear has been the political unrest following its new Citizenship Amendment Act in December, which granted accelerated citizenship to religious minorities in neighbouring countries but not to Muslims, who have protested at the move.

Other emerging economies and emerging markets offer the potential to grow at a faster rate as well as to benefit from powerful shifts in demographics, industrialisation and urbanisation. There are individual countries that flourish while others face continued challenges, as particularly in South Africa.

Property, commodities and other alternatives

- Property helped by yield relative to low interest rates
- Oil price higher, gold gaining and other commodities resilient
- Income-generating real assets highly valued

The retail sector is troubled but other elements of the UK's commercial property market have shown resilience, with signs of increased confidence after the election. Yields have remained attractive relative to those on gilts, while international markets offer opportunities. In the UK open-ended property funds saw a record £2.2bn of outflows in 2019 and a sizeable amount in December alone, after M&G's halted trading in its one; the sector calls for a degree of selectivity but also for investing through the right structure.

The price of oil rose in 2019 and has moved higher in January reflecting tension in the Gulf as well as resilient demand given global growth, in spite of robust production levels in the US and elsewhere. Metal prices have also reflected industrial demand while being even more susceptible to changes in supply. Agricultural commodities have been more variable if still offering the potential for uncorrelated returns. Gold made a further gain in the quarter, even as interest rate cuts in the US have ended for now, given its appeal as a safe haven and some central bank purchasing.

Real assets have performed strongly in part due to the relentless search for yield as interest rates stay low, which has led to some high valuations in the infrastructure sector where there was relief that Labour did not win the election. A focus on income is one reason to be more wary on certain hedging strategies which generate little and have also struggled to make target total returns, although the market environment may yet shift.

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