MONTHLY MARKET BLUEPRINT

Investment Management Service
January 2019

MAZARS

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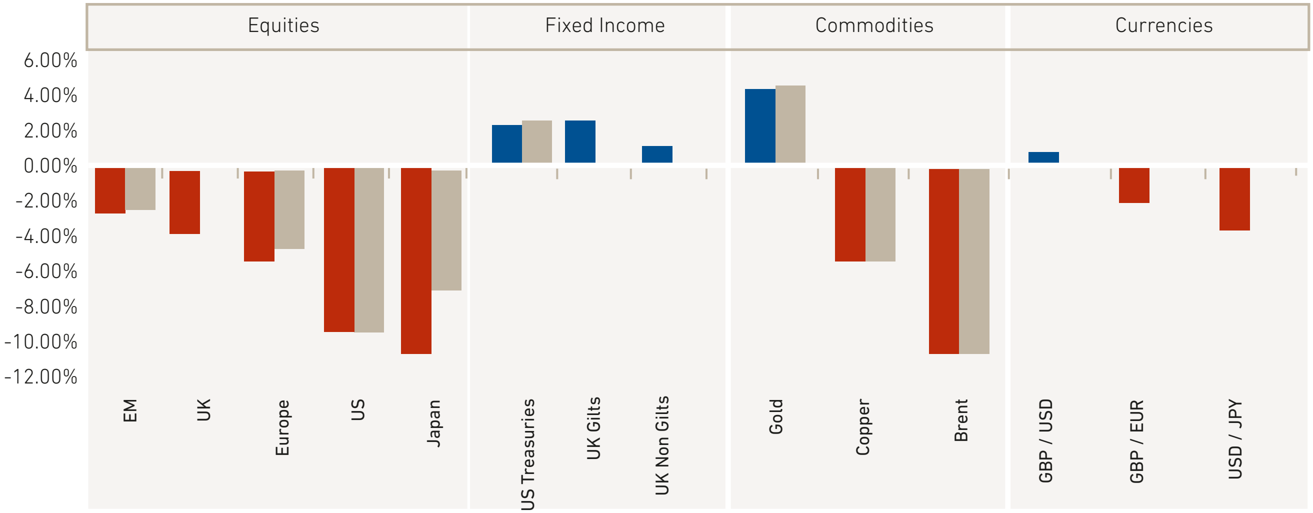
MARKET PERFORMANCE – IN A NUTSHELL



Source: Mazars Calculations, from 30/11/2018 to 31/12/2018

The month in review: Rough December

December was a rough month for markets with equites selling off significantly, as investors worried over a hawkish Fed and Mr. Trump's attacks on its independence. As a result, December saw the worst monthly returns since 1931 with 60% of S&P 500 stocks down by 20% or more. The NASDAQ saw its worst December on record. However, bonds fulfilled their duty as safe-haven assets and effective diversifiers providing much needed stability to multi-asset portfolios. US 10 year yields closed the year at 2.68%, down from 3.01% at the close of November. In the US, the Federal Reserve moved forward with their proposed hiking schedule and raised the funds rate 25bp to 2.25-2.5%.

The Fed announced their strategy is going to be more "data driven" and they believe the current interest rate is just shy of the neutral rate, adopting a more dovish stance leading to the market pricing in less than 1 rate hike in 2019. UK stocks lost -3.5% and are now flat since December 1999 when the FTSE 100 reached 6,724. Global stocks fell -7.4%, led by the US which fell -9.0%. Emerging Markets were down but held up more than the developed markets, posting a -2.4% loss. US Growth outperformed US Value stocks, losing -9.1% and -12.1% respectively. The best performing sector globally was utilities, and the worst performer was the energy sector which is standard in sharp equity corrections.

Source: Mazars calculations

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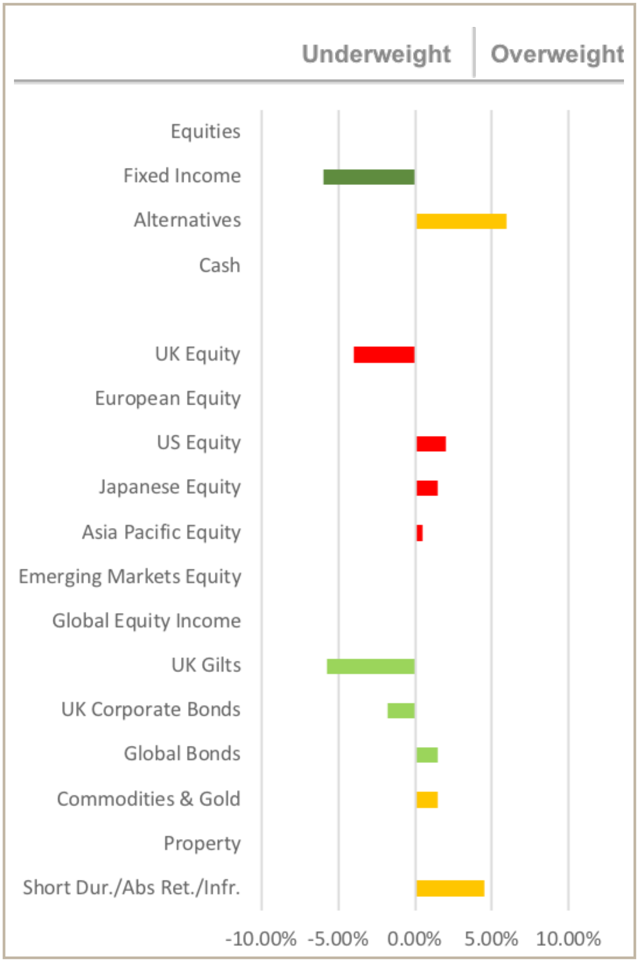
ASSET ALLOCATION



Asset Allocation based on the Mazars Balanced Portfolio, as of 1 December 2018.

Portfolios and outlook

- December data indicated that the global economy continues to slow, despite a persistent pick up in the services sector, as trade conditions deteriorate. Risk asset divergence, a theme of the previous quarter, seems to have abated, as US risk asset underperformance closed part of the gap with Europe and Emerging Markets. Oil prices rebounded somewhat in the beginning of the year, but overall investors worry more about deflation rather than inflation. New orders have been consistently slower, especially when it comes to manufacturing export, suggesting a broad-based slowdown.
- Meanwhile trade wars, an uncertain Fed, Brexit uncertainty and growing suspicions of a sharper than anticipated Chinese slowdown, along with the fact that the cycle is entering its tenth year, continue to unnerve investors, causing more profound bouts of equity volatility.
- Global equity valuations continue to hover just above historical averages, especially in the US. Investors are aware of the potential impact of political gridlock following the US mid-term elections.
- Given the extent of uncertainty surrounding Brexit we remain cautious on the UK, as lower valuations are still justified by the overall slowing growth. Otherwise, we have no strong geographic preferences, favouring large-caps.
- Our December Investment committee maintained its “equal weight” stance, while significantly reducing exposure in absolute return funds as we feel that potentially higher volatility could affect performance. In September, we reduced our weight in Emerging Markets and European equities, investing the money in UK and US small caps. We still believe that the cycle, for the time being, remains intact but it is showing signs of maturity.

Charts Source: Mazars

RISKS AHEAD

- Global economic growth is slowing. Markets are mostly focused on risks stemming from protectionism, US rate hikes, a Chinese slowdown, as well as European politics. Global debt levels continue to be a concern. Excess demand, which drove output in early 2018, has subsided.
- Central banks continue to tighten monetary conditions, ending the "Whatever It Takes" era, as inflationary pressures intensify. The Fed is less inclined to confirm the "Fed Put" or its willingness to cater to the global economy. Central banks in the UK and Europe are more hawkish, with the ECB confirming QE will end in late 2019, despite uncertainty over Italy.
- In the US the main risk is a policy mistake, especially if rates increase and inflation fails to keep up. After Q2 2019 when the effect of the tax-cut stimulus is expected to expire, growth concerns could be renewed. Additionally, investors have yet to discover the true depth of recent tax reforms, which could put additional strains on the budget. A Democratic win in November brought back the possibility of gridlock in Congress.
- In the UK we have seen the impact of Brexit in the form of slower growth, dented consumption, a slowdown in house prices and companies considering new venues.
- In Europe, there are renewed fears over the political fate of the EMU, after new government in Italy seem set to challenge the dictums of EU institutions.
- In Emerging Markets the stronger US Dollar is putting increasing pressure on economies with high trade deficits.
- We feel that short-term systemic risks are mostly manageable and liquidity is still ample. However we are closely monitoring the increasing number of headwinds, the confluence of which could upend the economic and financial cycle.

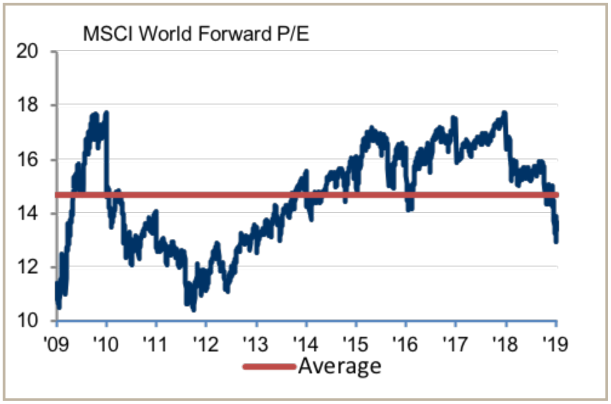
Global policy uncertainty is growing.

Apple revised down its earnings forecast by $5 Billion for Q1, suggesting that a Chin.

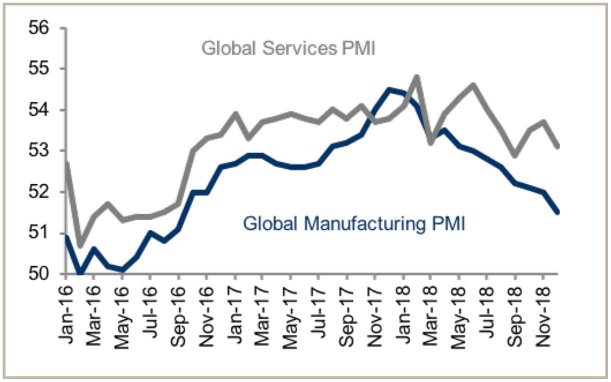
Charts Source: Mazars calculations

THE MACROECONOMIC AND MARKET BACKDROP

GLOBAL



Global equity valuations moved below the 10 year average last month.

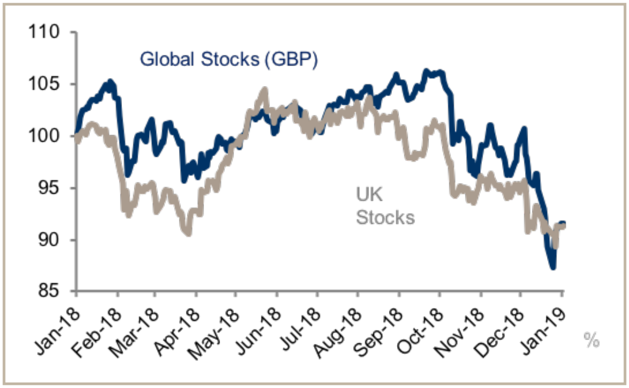


Both the services and manufacturing PMIs indicate slower economic growth.

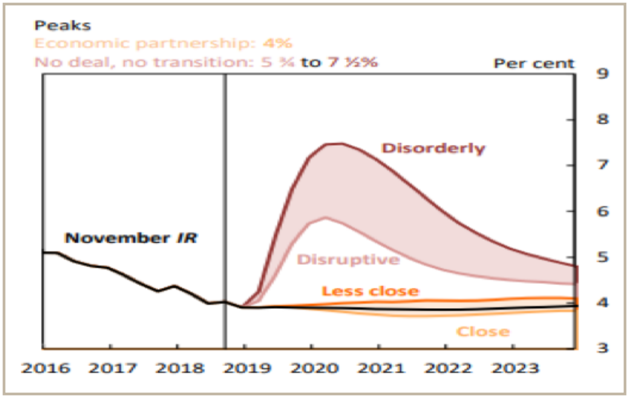
- Global equities were down 5.4% in Sterling terms from the end of November until the 15th of January, with Healthcare, IT and Consumer Staples underperforming and Utilities and Materials less negative than other sectors. Global equities are trading at a 14.09x PE, below their 14.6x average.
- The global economic slowdown continued in December across the board. Economic divergence persited, with the US in a slightly better position and Europe manifestly decelerating.
- On the one hand, the economic backdrop is accommodative. Global inflation conditions are more benign, after oil prices have spent the last two and a half months in below-$60 prices. Global conditions are still very liquid, augmented by the Fed's decision to put rate hikes for the near future. Employment conditions are also good, with the US, Germany and the UK reporting near-full employment.
- However, European manufacturing and services have slowed precipitously. The UK is at the cusp of significant Brexit decisions which have, insofar, delayed investment decisions and the US is feeling the pinch from a prolonged government shutdown and lack of economic catalysts post the tax cut.
- The forward-looking PMI indicators suggested overall weak trade conditions and lower export growth and cost inflation. New orders have been week both in manufacturing and services. Output mostly increased where companies are eating away into their backlog. Export-sensitive economies, such as Germany and Japan are under particular pressure. The service sector, which had so far helped the global economy, is slowing in tandem with manufacturing as activity growth slowed across both the business and consumer services categories.

Charts Source: Mazars Calculations, Markit

UK



UK stocks caught up with global stocks in the last month.



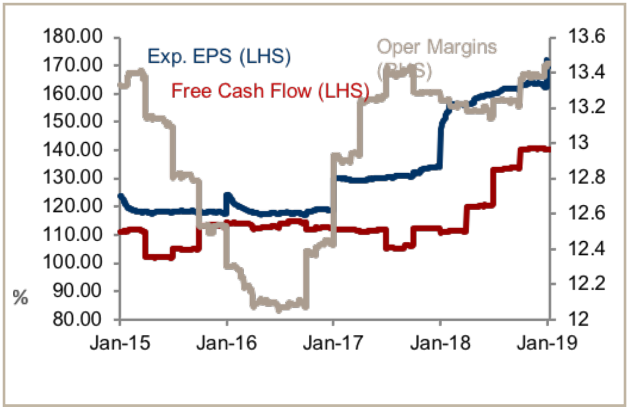
The Bank of England projects a sharp increase in unemployment in the event of an uncontrolled Brexit.

- UK stocks were negative in the period from the end of November to mid-January, losing 1.7%, still less than global stocks. Industrials and materials gained slightly, whereas telecoms and healthcare suffered losses.
- The British economy, long sensitive to the global economic cycle, is still facing headwinds from weaker growth, especially in Europe. Meanwhile, Brexit-related uncertainty continues to hamper growth, as some international companies have already triggered their contingency plans and moved operations overseas.
- Growth was good over the summer, as consumers were more upbeat due to the good weather and the World Cup. In Q3 the economy grew by 1.5%, the second consecutive quarter of acceleration. However these factors were temporary. According to the NIESR “UK economic growth is set to slow to a quarterly rate of 0.4% in the fourth quarter of 2018 from 0.6% in the third quarter”. Inflation remained benign and the BoE remains “on hold” for the time being. The economy continues to enjoy full-employment conditions.
- Growth is mainly being driven by consumption and a resurgent construction sector. UK construction and house prices have shown slight improvement. Manufacturing showed strength, on the back of robust new export orders and stock purchases. The service sector also accelerated, with modest rises in business activity. However, job creation has eased to a 29 month low and business confidence is at its lowest levels in almost a decade.

Charts Source: Mazars calculations

US

US stocks are trading slightly below their long term average.

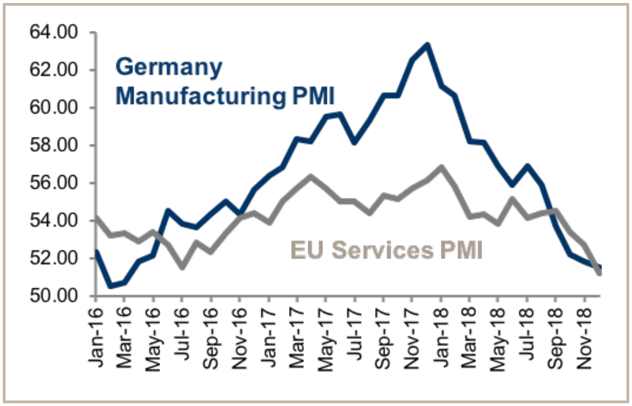


US earnings and earnings quality is improving.

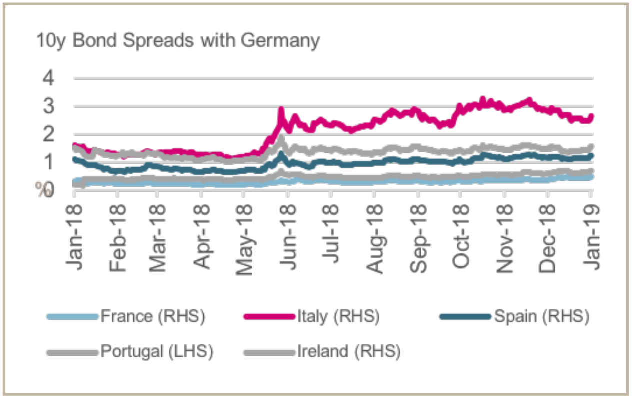
- US equities fell 7.2% in Sterling terms during December and early January. Telecoms and consumer discretionary held out better than the other sectors, while consumer staples, financials and healthcare underperformed. US stocks now trade at a 15.35 forward PE, slightly less than their long term average of 15.6x.
- The US economy continued to grow at a healthy pace in the last few months of the year, boosted by a healthy corporate sector and a fiscal stimulus from the Trump administration. However, clouds are gathering ahead. The benefits of the stimulus are ending and political gridlock has made its reappearance. At the time of writing, the US government was closed for a record-24 days without an end in sight. Manufacturing is slowing, as new orders have collapsed.
- Small business sentiment, the service sector and consumer confidence all remain in high levels but a manufacturing slowdown is usually a leading indicator to those. Inflation conditions remain benign and the economy is at full-employment levels. However, a deterioration of global conditions and global trade (along with a significant drop in oil prices over the past few months), have prompted the Federal Reserve to put rate hikes on hold, declaring "patience" with interest rates, until further notice.
- The outlook for US assets is still positive, as companies continue to deliver on earnings and a "trade war" policy is at least Dollar-positive.

Charts Source: Mazars calculations

EUROPE



European economic conditions are deteriorating.



Italian bond spreads eased somewhat, but risks remain that the country could hurt European cohesion.

- European equities lost 2.9% in Sterling terms. Materials and Utilities, which are bond proxies, outperformed, while telecoms and healthcare underperformed. European stocks trade at 12.57x their earnings, below their long term average.
- Economic data has continued to weaken across Europe. EU wide GDP fell to 1.6% year-on-year in Q3, down from 2.2%. The slowing economy is also confirmed by weakening PMI data with Markit composite PMI falling to 51.1 in December. Germany and France have both seen falls in services and manufacturing PMIs, with the disruption caused by the 'gilets jaunes' movement having a drastic impact on the French service sector in December, while Germany registered its weakest outturn or five-and-a-half years. Italy bucked the broader downward trend, though output merely stabilised following two months of contraction.
- On the plus side unemployment levels have remained stable and low compared to recent year, and CPI inflation fell to 1.6% in December from 2% previously, reducing cost pressure on consumers.
- Italy's populist government struck an agreement with the EU over its budget, which the Commission had demanded Italy change as it would have contributed further to the country's already bloated debt levels. Initially Italy rejected any changes, however under the deal, Italy has agreed to lower its planned budget deficit from 2.4% to 2.04%.

Charts Source: Mazars calculations

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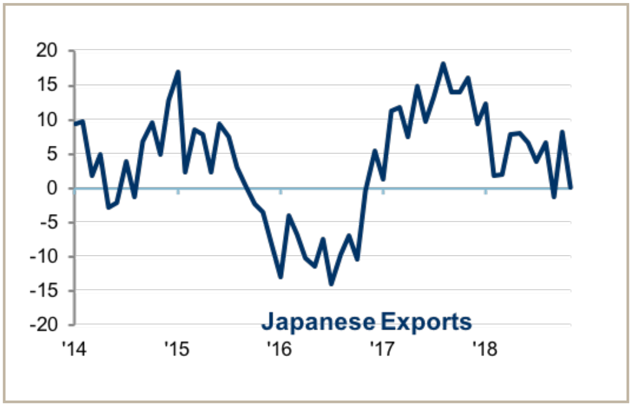
JAPAN AND EMERGING MARKETS



Japanese exports were weaker.

The Chinese economy is slowing down.

- Emerging Market stocks fell 1% in Sterling terms and are valued at a 11.3 PE. Japanese stocks fell 4.4% and now trade at 12.22 PE.
- Japan is one of the countries feeling the brunt of falling demand due to the US-China trade wars, as well as facing the problem that its currency is liable to re-value, and thus make exports less competitive, when investors seek 'safe-haven' assets. The Nikkei manufacturing PMI did actually increase from 52.4 to 52.6 in December, however according to the report demand pressures remain subdued and business optimism is at its lowest since November 2016. The bright side was that output increased at the strongest rate since April 2017, while new order growth also improved. Overall the composite PMI fell from 52.4 to 52, with the services falling from 52.3 to 51 do to weakening growth in new sales.
- Investors are becoming more concerned not just about the US-China trade war, but general growth conditions in China. There are many signs that the economy is slowing, even if it doesn't show much in official numbers. A sign that authorities are concerned is that they will reduce the reserve requirement for major banks from 14.50% to 14.00% on 15 January, and then from 14.00% to 13.50% on 25 January. These levels had previously been increased as part of an effort to crack down on shadow banking, and although the moves should be positive for growth in the near term, reduced interest rates incentivise more borrowing and the likelihood of financial instability in the future. Figures of concern are that the Caixin manufacturing PMI fell to 49.7, signalling contraction in the sector, with signs of softer demand conditions, as total new orders fell marginally.

Charts Source: Mazars Calculations, OECD


Nov
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Apr
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2950,38 +0,62%
Jan
Feb
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Apr
NEW YORK
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OUR THEMES

MACRO THEME 1: CHINA SLOWING

China lowered its required reserve ratio, to boost its economy.

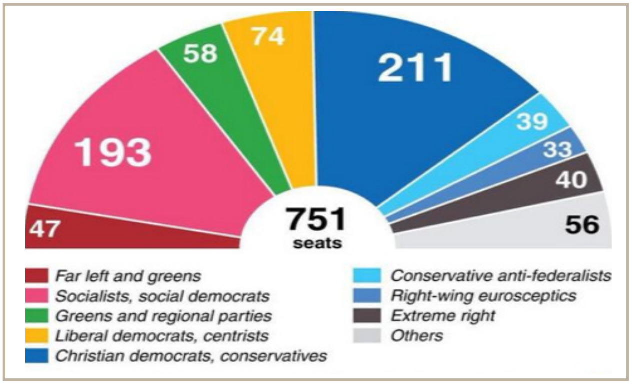
- Nominally, Chinese output continues to grow near a 6.5% rate, however a host peripheral data have given investors cause for concern.
  - Imports and exports are at their lowest levels in two years
  - Fixed asset investment has slowed down significantly.
  - Manufacturing has slowed significantly
  - Consumption figures decelerate
  - Employment date, especially out of the manufacturing sector have been week for many months, suggesting further pressures on consumers.
  - Credit continues to tighten as the government clamps down on shadow banking. Past experiences have shown that the more the main street relies on shadow banks, the more impactful the clampdown on the economy.
  - Companies with exposure to China (like Apple or Jaguar) haver reported lower sales.
- Above everything, the slowdown in global trade is probably correlated to a Chinese slowdown, as the country has, in the past few years, been responsible for about half of the improvement in global growth rates.
- The US government's stimulus package and trade tariffs have dealt additional blows, as Dollar investments fled the country. Investors are now concerned about the government's ability to carry out the difficult transition from manufacturing to consumption.
- We feel, however, that the Chinese government has both the firepower and the will to carry out reforms and retain growth. The PBOCs recent move to lower the required reserve ratio, i.e. increase the amount banks can lend out, is indicative of President Xi's resolve to support the economy. In other words, while we do not dispute evidence indicating an increased probability of an economic hard landing, we don't feel that the government is willing to let this happen.
- For us the question remains a long-term one: Will the transition be successful? If so, our own strategic allocation might allow for higher weights in the economy.

"we don't feel that the government is willing to let [a hard landing] happen."

George Lagarias
Senior Economist

Charts Source: UK Government

MACRO THEME 2: EU ELECTIONS



Parties with anti-EU sentiment could become a majority of the European Parliament.

- There are few signs that politics in Europe is headed back to the 'centre', with the recent 'gilets jaunes' riots and Italy's budget fight with the EU further evidence that the status quo may not hold.
- In May, not long after the UK's exit from the EU, come the European Parliamentary elections, whereby countries elect their MEPs. With populist parties in buoyant mood in recent years, the make-up of the European Parliament could be drastically altered.
- As per the Lisbon Treaty: "The European Parliament shall, jointly with the Council, exercise legislative and budgetary functions. It shall exercise functions of political control and consultation as laid down in the Treaties. It shall elect the President of the Commission."
- The treaty of the text may make it seem that the EU Parliament has a large say over a wide range of issues. However in reality the Council, comprised of the heads of state of EU members plus the President of the European Council and the President of the European Commission, may approve or reject legislation, or propose amendments to it.
- The European Parliament does have a greater say over the EU budget, however on "compulsory expenditures", related to international agreements and agriculture, it is the Council that has the last word.
- The European Parliament has major supervisory powers over the European Commission, which implements EU legislation, and the Presidency of the Council. Parliament can dismiss the Commission which needs to submit regular reports, annual legislative programs and reports on the implementation of the budget.
- While it would be difficult for Eurosceptic parties to derail the European project in its entirety, the oversight powers and ability to stall reforms could frustrate progress if they were able to gain a majority.
- Another issue is that gains by populist parties would further embolden them, providing a further platform and greater confidence in national election, and could force EU leaders to further acquiesce to their demands. Simply vetoing any legislation may come across as anti-democratic.
- These issues come as the European economy has been slowing, margins thinning and general sentiment souring across the bloc. Although not a huge threat for markets, a further fracturing of the EU would be negative for assets in the region.

"The ECB, which has traditionally been a backstop to rising volatility, is taking a relatively hawkish stance."

David Baker,
Chief Investment Officer

Charts Source: US Federal Reserve

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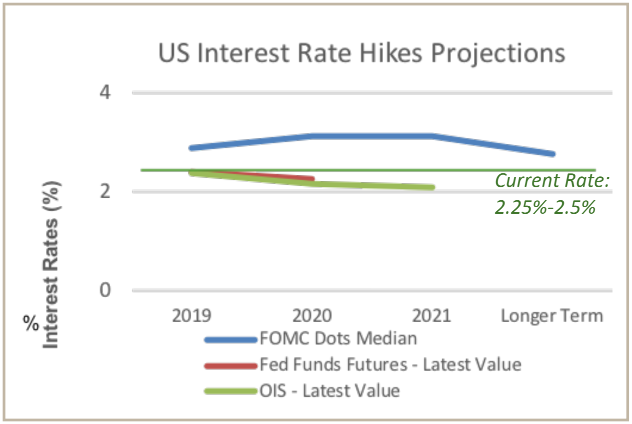
MACRO THEME 3: DID THE FED JUST BLINK?



Markets are not pricing in any further hikes.

- The new Federal Reserve has departed from recent precedent, featuring a more democratic way of decision making and more willingness to compromise with the executive branch of government. This new direction seems to have perplexed investors, especially after Jay Powell's contradictory comments between October and January.
- In October, the Fed Chair suggested that the current interest rate of 2%-2.5% is significantly below the "neutral" (i.e. close to the peak) interest rate. However following an unprecedented rebuke from Donald Trump, Mr. Powell adopted a more dovish tone. The Fed hiked at year-end as expected but, following a Christmas market crash, Mr. Powell and other Fed members adopted a mantra of "patience" regarding future interest rate hikes.
- The Fed's newfound dovishness, while aiding a rebound (already the S&P 500 has recovered all its Christmas and about 40% of is post-September losses) is a mend, but by no means a medicine. The market, addicted to cheap money for over a decade and burdened with large amounts of debt (student loan and auto loan delinquencies are on the rise) is not pricing in any further hikes this year. Until such time as the Fed affirms that outlook volatility could continue.
- And of course there are larger issues which remain unresolved: the new Fed is manifestly more inward looking. Mr. Powell has in fact publically questioned the Federal Reserve's importance for the global economy. As a result, the impact of policies fostering a stronger US Dollar on weaker emerging economies, or the effects of tightening, become less of a concern for the Board.
  - Its independence comes under question, especially after the Chair's apparent change of direction following Mr. Trump's comments. This is significant for investors as independent central banks have long been considered a pillar of financial stability.
  - Investors will need more clear direction from the Fed and evidence of independence before they universally consider the central bank an asset, rather than a potential liability.

"Investors will need more clear direction from the Fed and evidence of independence."

George Lagarias,
Senior Economist

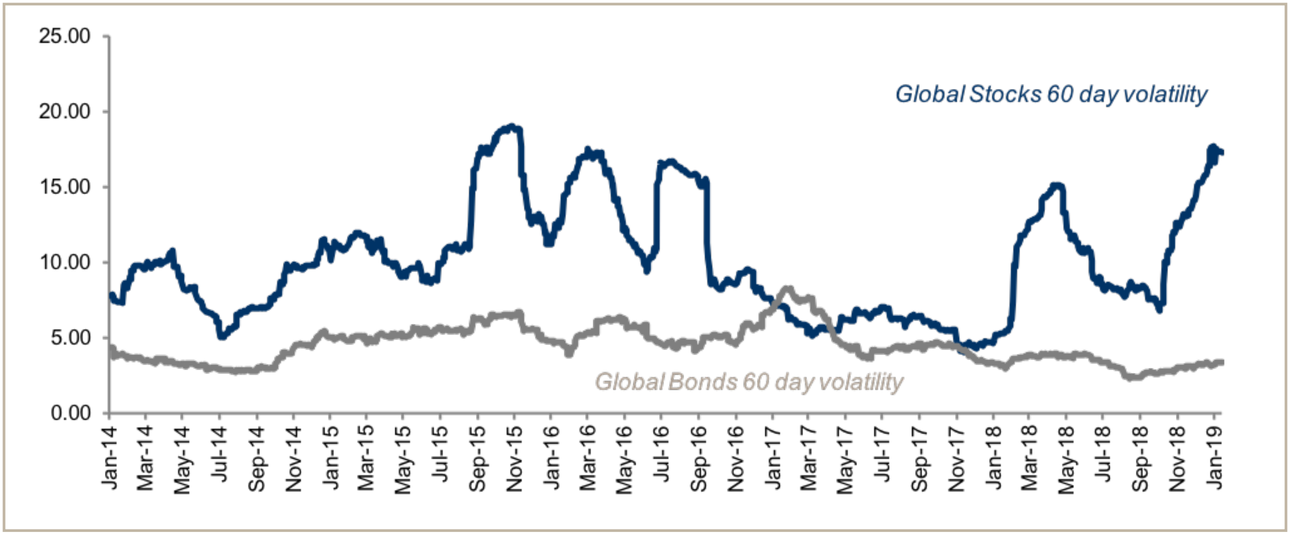
Charts Source: Mazars calculations

EQUITY SPOTLIGHT: RETURN OF VOLATILITY

Until the last couple of months, the main theme for investors for the year had been divergence, with US equities slightly up for the year and most other regions struggling. Donald Trump's trade wars have been the main reason for poor equity performance, although US equity returns, certainly in Sterling terms, had been largely insulated due to the strong US economy and perhaps a belief that US firms could in some way benefit from a rebalancing of the global trade order.

The market sell-off in recent weeks has been indiscriminate, with US equities suffering along with global equities. Markets are becoming more and more concerned that trade wars could spark a recession while rising interest rates in the US, where the yield curve has already inverted at certain maturities, are causing jitters. Economic indicators in the US remain fairly robust, however economic figures from the rest of the world, particularly Europe, are signifying that the goldilocks period of growth of the past two years is likely over.

The reality is that actually not all that much has changed in terms of economic indicators, however markets are lacking for many positive catalysts in the near future. The Federal Reserve will need to tread carefully in its next few meetings, not wanting to make it seem growth is slowing by failing to raise rates, while avoiding a pace of hikes which could undermine growth in future.

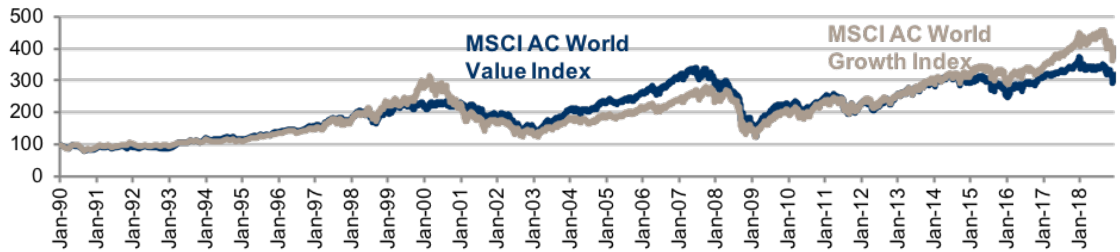


Charts Source: Mazars calculations

EQUITY SPOTLIGHT: GROWTH Vs VALUE

- In recent years 'growth' stocks have been outperforming 'value' stocks. Investors have particularly backed firms in growing industries, notably tech companies, while those in structurally challenged industries, such as high-street retailers, have fared relatively badly.

- However historically the inverse has been true: value tends to outperform growth. The reason is that the level of expensiveness is generally determined by how many multiples of a company's earnings the share price is valued at. If all else is equal a cheaper share is more attractive and will be purchased, and the more expensive shares shunned, until valuations are equal.

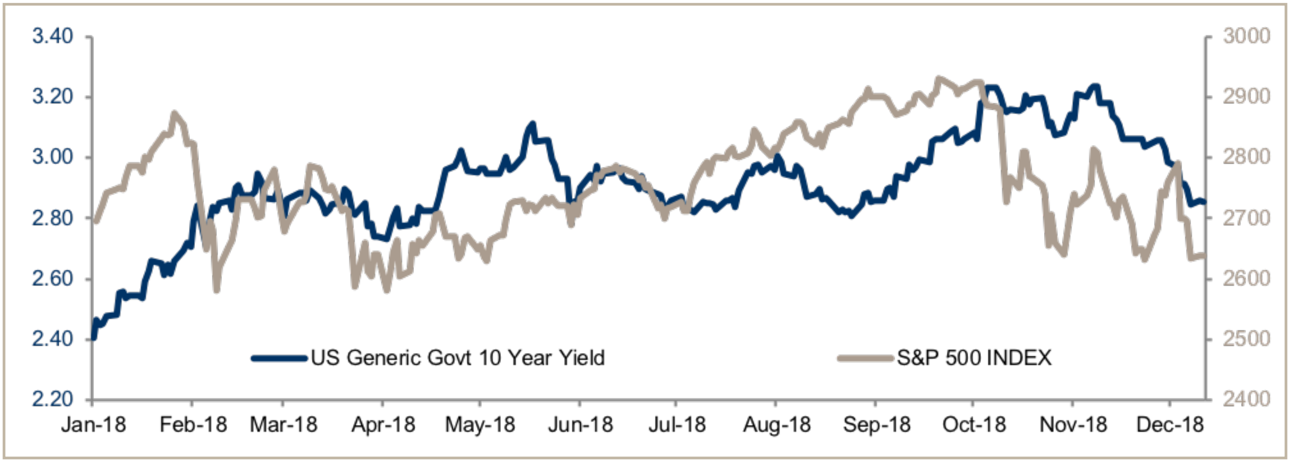


- There are many reasons for growth performing well recently. Two theories with particular traction are: a) the low growth rates in recent years means that any companies that can grow above average have become more attractive, and b) significant technological advances means that firms in certain industries are unlikely to survive in the long term.
- What defines a company as growth and as value is a hotly debated topic. In the previous monthly blueprint we stated that a continuation of the current bull market was likely to see growth continue to outperform, while a significant sell-off was more likely to affect expensive growth stocks more – this is what we have seen in the recent market volatility.
- We are generally agnostic when it comes to growth vs value, preferring to select managers which excel within their style.

Charts Source: Financial Express

FIXED INCOME SPOTLIGHT: TREASURIES REGAINING SAFE HAVEN STATUS?

- Up until late 2016, bonds had been on a 20 year bull run as interest rates fell consistently across the globe.
- In December 2015, the US Federal Reserve finally started the process of trying to normalise markets, raising interest for the first time since the GFC, and late last year began the reduction of its bloated balance sheet.
- Returns for bond investors haven't been quite so rosy in the past 18-months. Global yields have generally been dragged higher by US yields, where the 10Y Treasury yield has been as high as 3.26% as the economy has continued to perform well.
- In the recent market volatility, the 10Y Treasury yield has fallen as low as 2.85%. This fall, preceded by the rise while markets rallied, implies that developed market government bonds, particularly US Treasuries, are once again behaving like safe haven assets.
- This has been generally helpful for asset allocators, since the low/negative correlation with equities adds diversification and reduces the downside risk to portfolios.
- However there are two big issues:
  - If a recession/significant equity bear market were to occur, Treasury yields can't fall as much as they have in previous cycles, and thus cannot offer as much protection, since they have a much lower starting point. This is even more of an issue in the majority of other developed nations which have much lower yields.
  - The fall in yields at the longer end of the curve hasn't been matched by the short end of the curve, so that the US yield curve is very close to inverting, an event which has often preceded recessions in the past. The question this time is whether the unorthodox monetary policy of the past decade renders an inversion meaningless, or whether this is a warning sign of a coming recession.



Charts Source: Mazars Calculations

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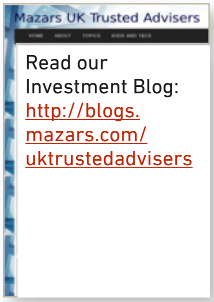

Investment blog

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