MONTHLY MARKET BLUEPRINT

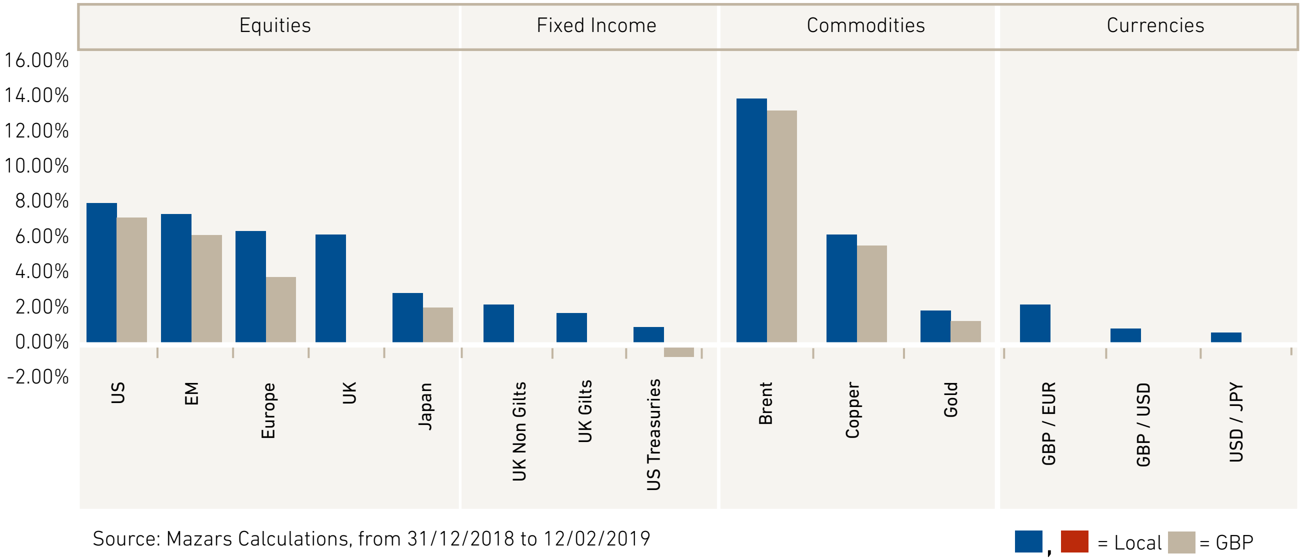
Investment Management Service

February 2019

MAZARS

CONTENTS

MARKET PERFORMANCE – IN A NUTSHELL



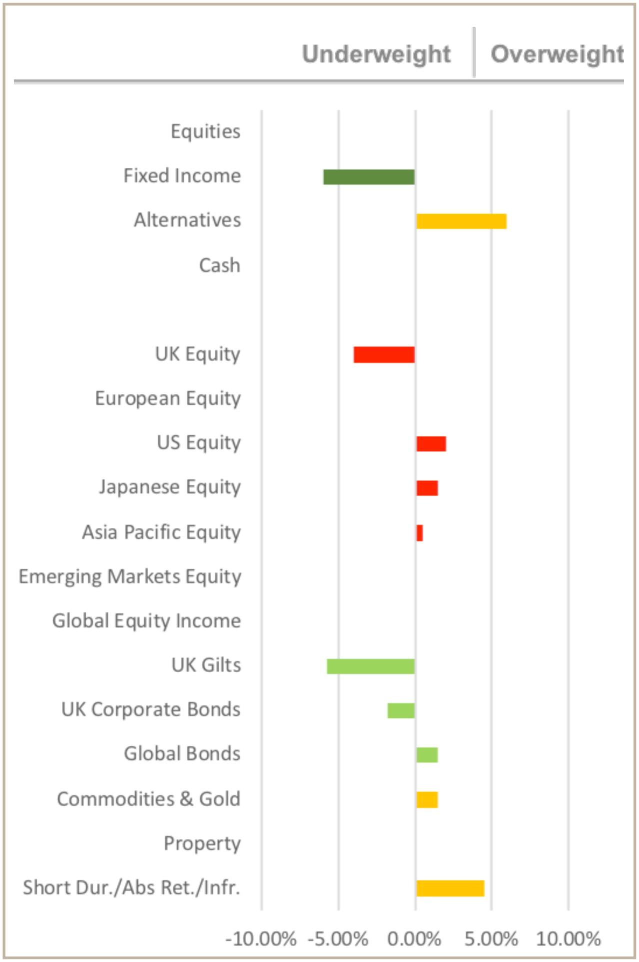
Source: Mazars Calculations, from 31/12/2018 to 12/02/2019

The month in review: January Rebound

January was a great month for stocks as they rebounded after the significant volatility seen in December, driven by the Fed's comments on the beginning of the month, where Jay Powell essentially changed tack in the central bank's monetary policy, suggesting "patience" in interest rate hikes. The dovish comments from the FOMC meeting on the last Wednesday of the month confirmed the Fed's renewed dovishness and, paired with attractive valuations and renewed momentum, drove US stocks up 8% for the month in USD. After May's Brexit EU withdrawal deal was rejected and the probability of a deadline extension or a second referendum reversing Brexit entirely increased significantly, we saw a sharp appreciation of Sterling versus the Dollar and the Euro. This saw returns coming in lower from foreign financial assets. January saw the S&P 500 return 4.9%, the MSCI World return 4.7%, MSCI Emerging Markets up 5.7 % and the FTSE 100 was up over the month climbing 3.6% in Sterling. Japanese stocks returned 3.0% to investors and European stocks gained 2.9% in Sterling terms. Earnings season is upon us. With over half of the S&P 500 capitalisation having reported Q4 earnings, 73% of companies have beat bottom line expectations and 60% have beat sales expectations. Some companies have posted great quarters, such as Bank of America who beat expectations on both revenue and net income and Shell whose profits reached four year highs. Amazon beat on earnings with significant profit coming from its AWS product line as the tech giant looks to diversify away from purely online retail. Conversely, companies –like Apple- with significant exposure to China, have reported sales weakness out of the region. US Sovereign bond yields were pretty much flat over the month, with the 10 year yield down just 2 basis points from 2.68% to 2.66%. Yield curves flattened slightly across the board. Gold gained 3% in Dollar terms, and oil prices rebounded 18.5% to $53.

Source: Mazars calculations

ASSET ALLOCATION



Asset Allocation based on the Mazars Balanced Portfolio, as of 1 February 2019.

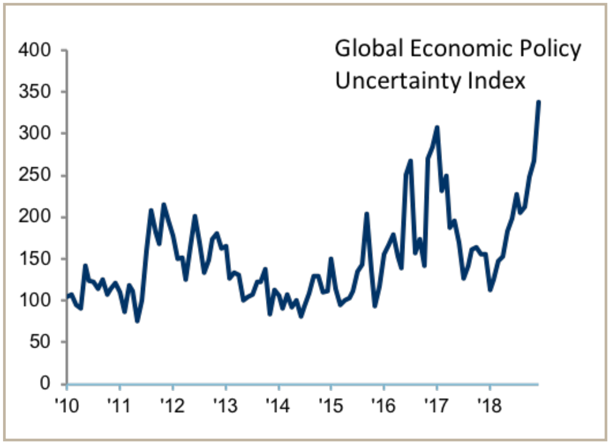
Portfolios and outlook

- The global economic slowdown 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.

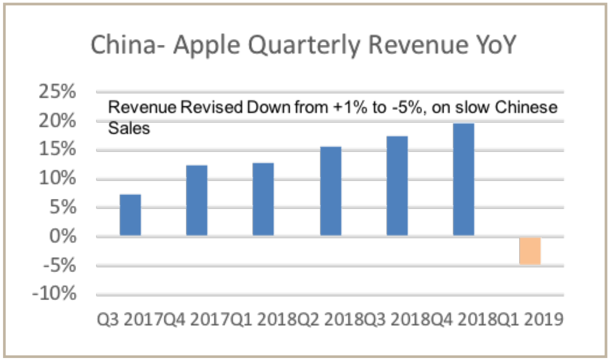
Charts Source: Mazars

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.



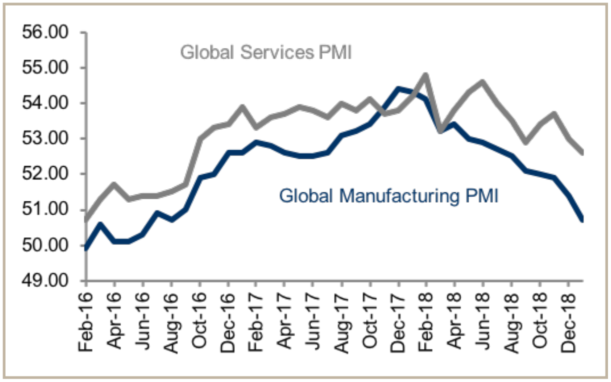
Apple revised down its earnings forecast by $5 Billion for Q1, suggesting a Chinese economic slowdown.

Charts Source: Mazars calculations

THE MACROECONOMIC AND MARKET BACKDROP

GLOBAL

The MSCI world recovered all its December losses.

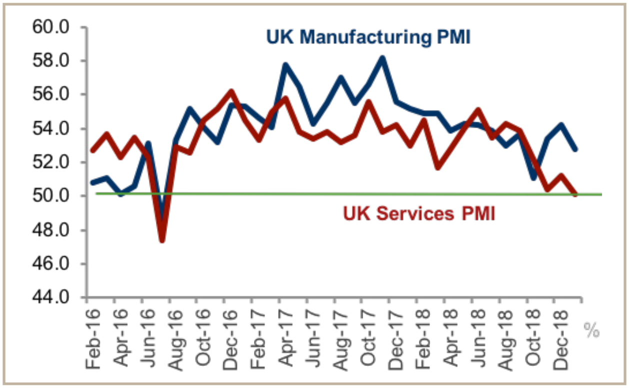


Both the services and manufacturing PMIs indicate slower economic growth.

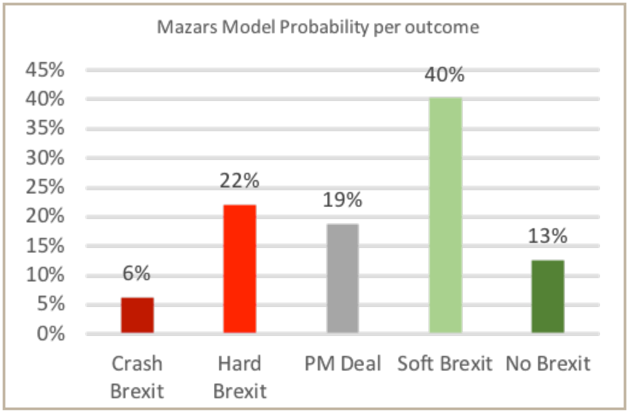
- Global equities were up 6.6% in Sterling terms from the end of December until Feb 12, led by industrials, IT and Energy, while Healthcare, Utilities and Consumer Staples underperformed. Global equities are trading at a 14.8x PE, slightly above 14.6x average.
- The global economic slowdown continued in January across the board. Economic divergence persisted, 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.

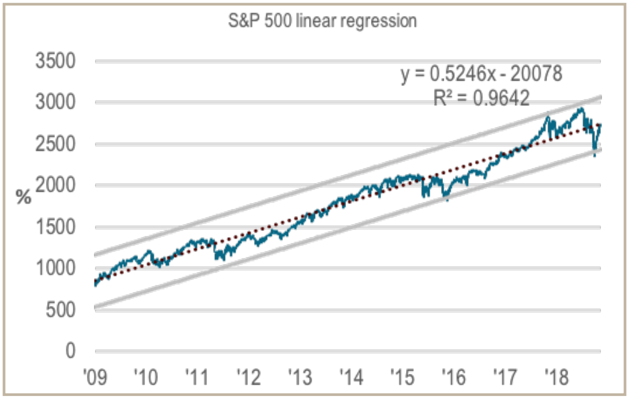


Despite recent strategies near the end of the Brexit deadline, our internal model suggests a slightly less than 1/3 probability of a "Hard Brexit".

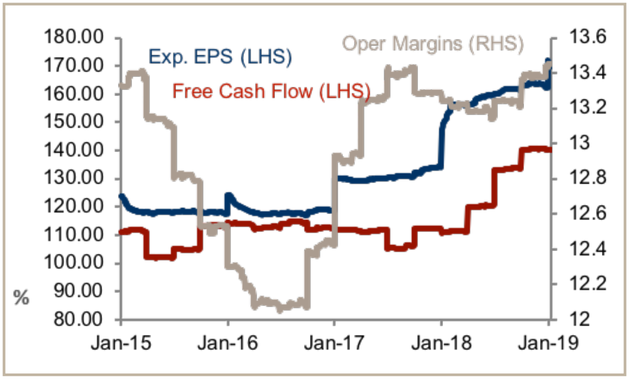
- UK stocks were negative in the period from the end of November to mid-January, losing 1.7%, still less than global stocks. Industrials and materials gained slightly, whereas telecoms and healthcare suffered losses.
- The British economy, long sensitive to the global economic cycle, is still facing 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, BOE

US



The S&P is well back in its longer term trend, after December's bout of volatility.

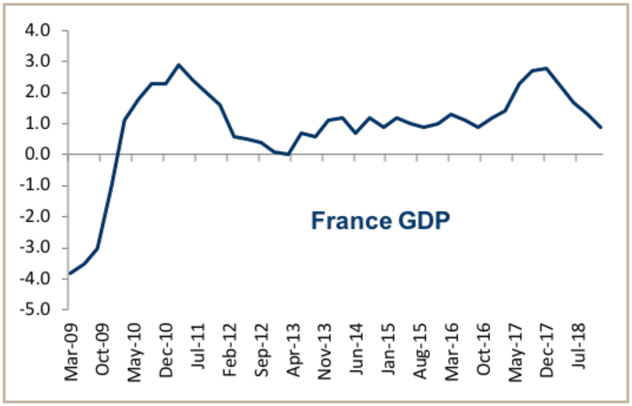


US earnings and earnings quality is improving.

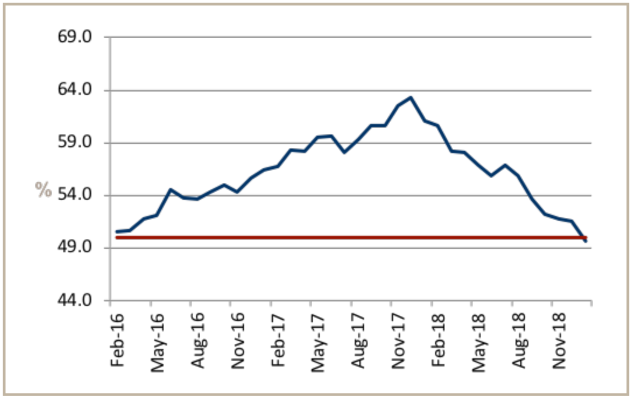
- US equities rose 8.5% in local turns and 7.2% in Sterling terms January and early February, led by industrials and energy, while healthcare and IT underperformed. US stocks now trade at a 16.4 forward PE, higher than their long term average of 15.6x.
- The slowing global economy and lower inflation expectations have prompted the Federal Reserve to put rate hikes on hold, declaring "patience" at the beginning of the year. This stance was affirmed with the central bank's decision to maintain interest rates in January, accompanied by a relatively more dovish language. More accommodative signals have led a 9.7% recovery for US equities.
- The overall economy continued to face challenges, however the data did not show any weakness related to the one month government shutdown. If anything, employment numbers were strong, with the economy adding over 300K new jobs in January. Manufacturing accelerated, on the back of stronger new orders, but the service sector saw the weakest growth since October 2017.
- Earnings continued to improve in Q4. With 66% of companies having reported results, 71% beat earnings expectations and 62% beat sales expectations. Overall earings growth was 13.3%. 53 companies issued negative earnings guidance and 12 companies issued positive guidance.

Charts Source: Mazars calculations

EUROPE



French economic growth is slowing.

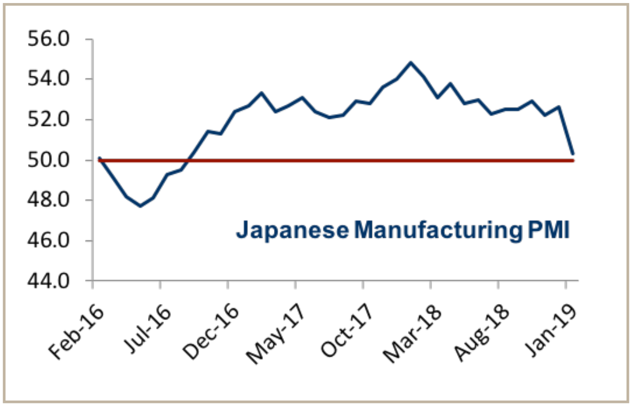


German manufacturing has now gone in contraction.

- European equities posted positive returns in January returning 3.0% in GBP terms and are now trading at a 12.61x forward PE.
- We see continued weakness in the economic data across Europe. The Eurozone Manufacturing PMI was down from 51.4 to 50.5, and is now just shy of a contractionary reading. The intermediate goods and investment goods sectors posted weak numbers, with investment goods recording a deterioration for the first time since July 2013. However, consumer goods continued to see solid growth in January. This weakness stems partly from temporary factors such as the slow down of the auto sector after the new emission regulation was introduced. In particular, the German Manufacturing PMI is down from 51.5 to 49.7 and is the first time a contraction has been recorded for 3 years. Furthermore, sentiment has been weakened by the current political uncertainty in Europe and the rise of trade protectionism. EU GDP growth YoY was down to 1.2% from 1.6% with a large fall in growth posted by France, which grew at 0.9% YoY down from 1.3% and Italy who entered a recession after posting two quarters of negative growth. The EU unemployment rate was stable at 7.9% and is still low by historical standards. EU wide CPI YoY fell from 1.9% to 1.6%.
- The European Central Bank maintained interest rates as expected, with no rate hikes expected before the summer. Draghi commented on continued Eurozone weakness and indicated withdrawal of GFC stimulus would be approached cautiously.
- The Eurozone will have to navigate new waters as the ECB ends its low rate, loose policy stance and liquidity fades. The potential of a no-deal Brexit, continued French tensions and excessive Italian fiscal spending has weighed on future economic growth projections. As Draghi said, risks to growth have indeed “moved to the downside”.

Charts Source: Mazars calculations

JAPAN AND EMERGING MARKETS



Japanese Manufacturing PMI indicated that production in Japan has stalled.

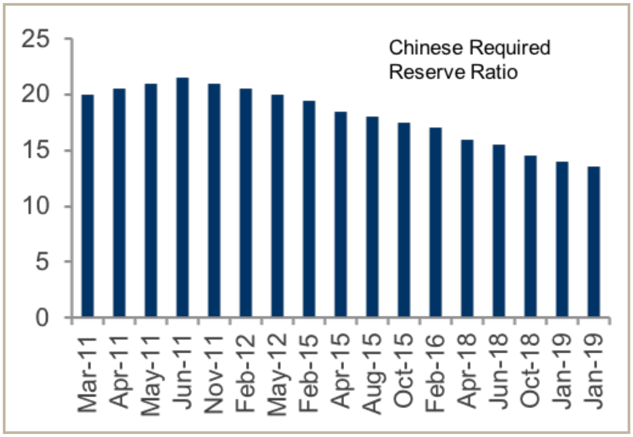
Chinese new export orders PMI indicated.

- Emerging Market stocks were up 5.7% in sterling terms and are valued at 12 PE. Japanese stocks rose 3% and now trade at 15.1 PE.
- Japan's downward trend in business confidence extended into January with stronger deteriorations in international demand. New export orders fell at the sharpest rate since July 2016 as shipments to China tumbled. The Nikkei Manufacturing PMI fell from 52.6 to 50.3 in January. The survey data indicated that the growth in the manufacturing sector has now stalled, ending the longest sequence of growth since the global financial crisis. The decline in demand this month was a stark contrast to last month's expansion. However, the services PMI rose in January to 51.6 from 51.0 in December, indicating a stronger expansion in service sector business activity with higher inflows of new business from domestic clients. Firms are anticipating activity levels to rise over the coming 12 months.
- The Renminbi saw its best month is a year and Chinese equities saw their biggest gains since 2016 despite slowing growth and worries over the trade dispute between the US and China. Trade talks in January saw progress with the Chinese delegation agreeing to increase agricultural imports from the US and increased cooperation on intellectual property protection to facilitate trade and investment. The Caixin manufacturing PMI index slipped to 48.3 in January from 49.7 in December, marking a second month of decline into the contraction territory. Export orders, however, have significantly risen to their highest point since 2018, showing that export orders have rebounded since the truce in the China-US trade war.

Charts Source: Mazars Calculations, OECD

OUR THEMES

MACRO THEME 1: CHINA SLOWING



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

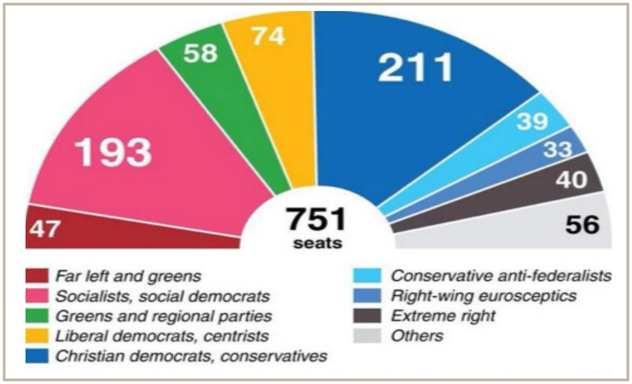
- Earnings growth expectations for the US, Europe and the UK have fallen in recent weeks, with concerns about economic data, rising interest rates and trade wars weighing on sentiment. In the US earnings growth expectations (the amount earnings for the next 12 months are expected to rise compared to the 12 months prior) have fallen from over 20% to below 10%, while in Europe analysts now expect earnings to fall from the levels seen in 2018.
- This is a mixed blessing for equity markets. On the one hand lowered expectations have contributed to the recent fall in equity prices (if stocks stay at the same level of expensiveness on a price to earnings basis, and the earnings fall, the price will subsequently fall).
- On the other hand if equities had fallen while earnings expectations remained high, there would be far more chance of earnings disappointing versus forecasts and causing equities to fall further.
- Instead, if earnings turn out closer to levels originally predicted, it is more likely to spark positive performance.
- The caveat to this positive outlook is that historically analysts have generally been overly optimistic initially and forced to revise down their estimates, which end up being closer to actual figures.
- When investing in equities we are not directly investing in economies, however firms do depend upon the prevailing economic environment to conduct business. Aside from technicalities as to whether these changes make equities more or less attractive, falling earnings expectations are a sign of a slowing global economy, which in turn creates a non-virtuous circle of concerns about future earnings.
- In the early days of the year Apple released a warning on earnings, blaming falling iPhone sales in China. This resulted in a general sell-off in related stocks as it was a strong sign that fears that a combination of US-China trade issues and slowing Chinese growth are starting to affect company fundamentals.

"When investing in equities we are not directly investing in economies, however firms do depend upon the prevailing economic environment to conduct business."

George Lagarias
Senior Economist

Charts Source: Mazars Calculations

MACRO THEME 2: EU ELECTIONS



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

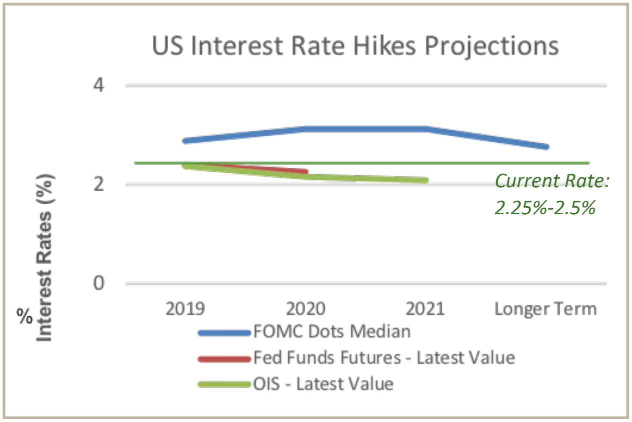
- There are few signs that politics in Europe is headed back to the 'centre', with the recent 'gilets jaunes' riots and Italy's budget fight with the EU further evidence that the status quo may not hold.
- In May, not long after the UK's exit from the EU, come the European Parliamentary elections, whereby 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 in 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: Mazars Calculations

MACRO THEME 3: DID THE FED 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 in October and November.
- In October, the Fed Chair suggest 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.
- Markets got a rate hike in December 2018, but expectations for next year have dropped sharply, from 3 to perhaps even a rate cut. This has reduced volatility significantly in the beginning of the year.
- It lacks clear direction. This makes planning very difficult and is also playing havoc with investment algorithms which would in theory work better with a stable interest rate environment. While in theory its rate policy is "facts based", comments of a strong economy and tight employment conditions are not consistent with a shallower rate path. And while the many voices in the FOMC are a credit to democracy, they add to lack of visibility and market volatility.
- It 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.

"While the many voices in the FOMC are a credit to democracy, they add to lack of visibility and market volatility."

George Lagarias,
Senior Economist

Charts Source: Mazars calculations

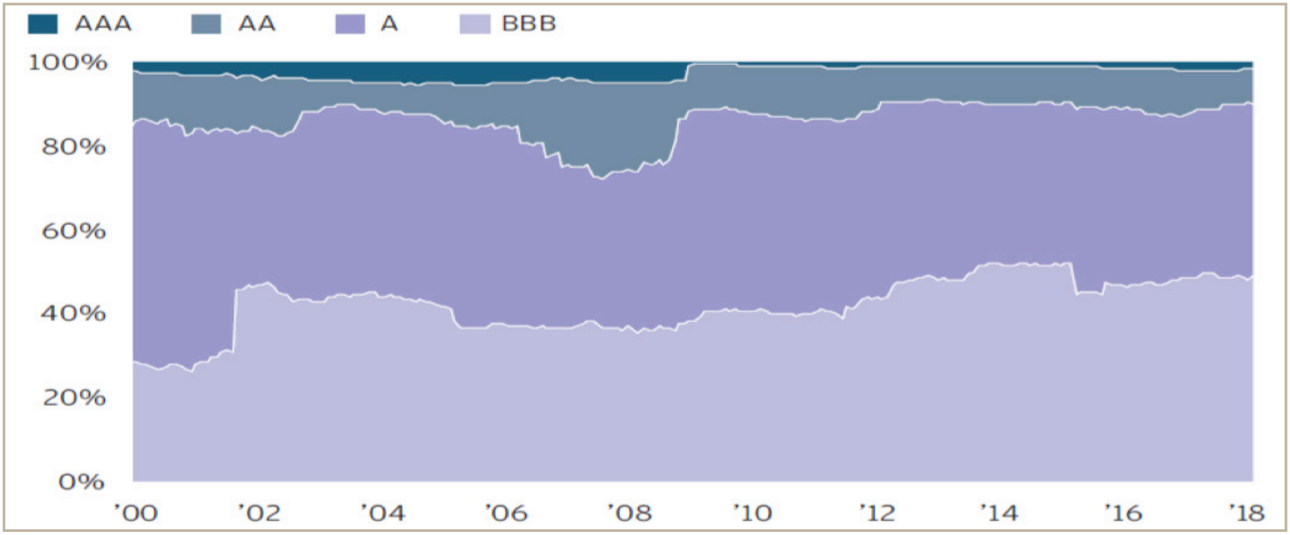
MAZARS

FIXED INCOME SPOTLIGHT: UNIVERSE QUALITY FALLING

An area of rising concern for us when we look at investing in non-government bonds is the quality of bonds that are available. Something that is very hard to measure quantitatively but which we are hearing more and more is that there has been a backlash in the last few months against bonds coming to market with weak covenants. Covenants place restrictions on the borrower, for example restricting how the money is used, or the amount of debt the borrower can take on. These should reduce the likelihood of the borrower defaulting on the debt.

Of course the backlash is a good thing for bond quality going forwards. However it does highlight that much of the debt raised previously is light on a covenant basis compared to history, which could spark trouble for investors if/when a serious slowdown does occur.

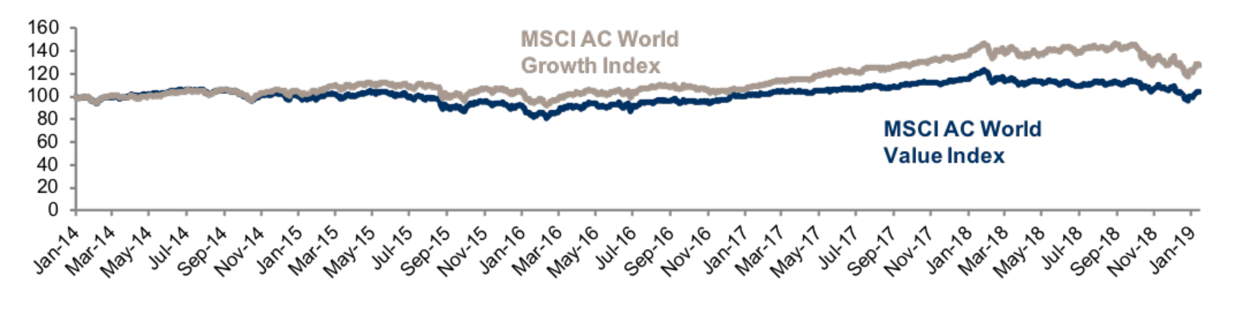
Another issue is that back-tested models may say that we should hold x amount of investment grade bonds based on their historical risk and return. However this ignores the fact that the quality of the investment grade universe has fallen according to ratings agencies. Looking at US data, pre-2007 about 40% had a rating of A and 33% BBB. Today more than 50% has a debt rating of BBB and only about 25% has an A rating. The pace of the credit rating decline over the last five years has been the fastest, outside of a recession, since the mid 1990s.



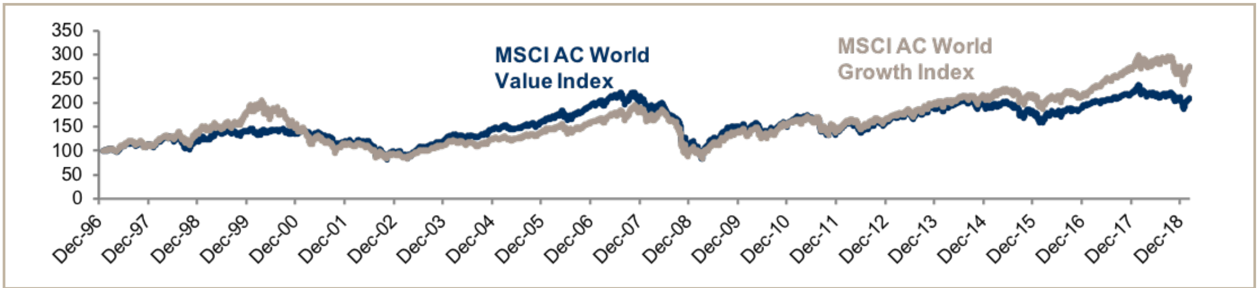
Charts Source: ICE BofAML Credit Indices

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.

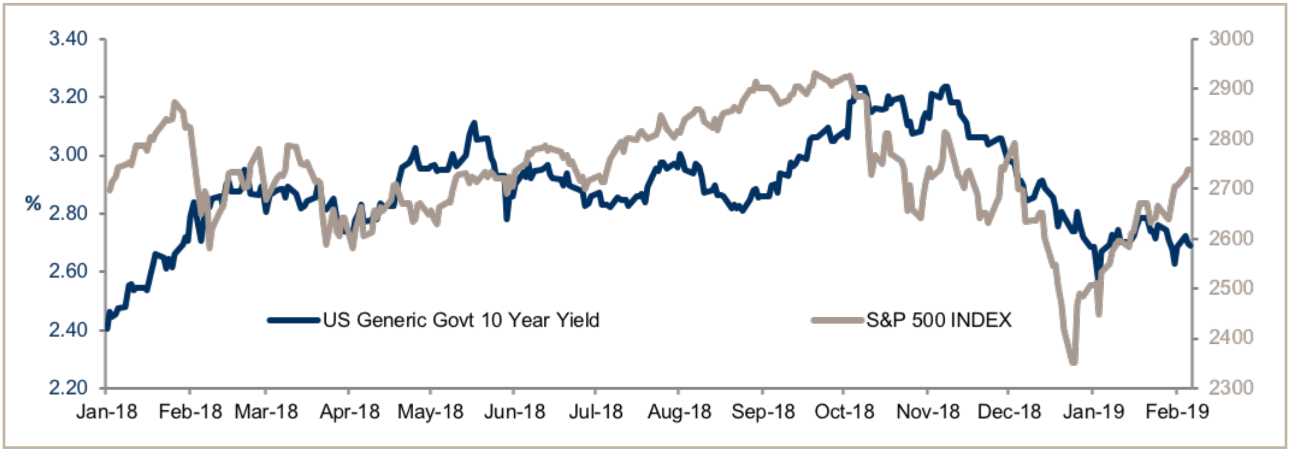


- There are many reasons for growth performing well recently. Two theories with particular traction are: a) the low growth rates in recent years means that any companies that can grow above average have become more attractive, and b) significant technological advances means that firms in certain industries 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.

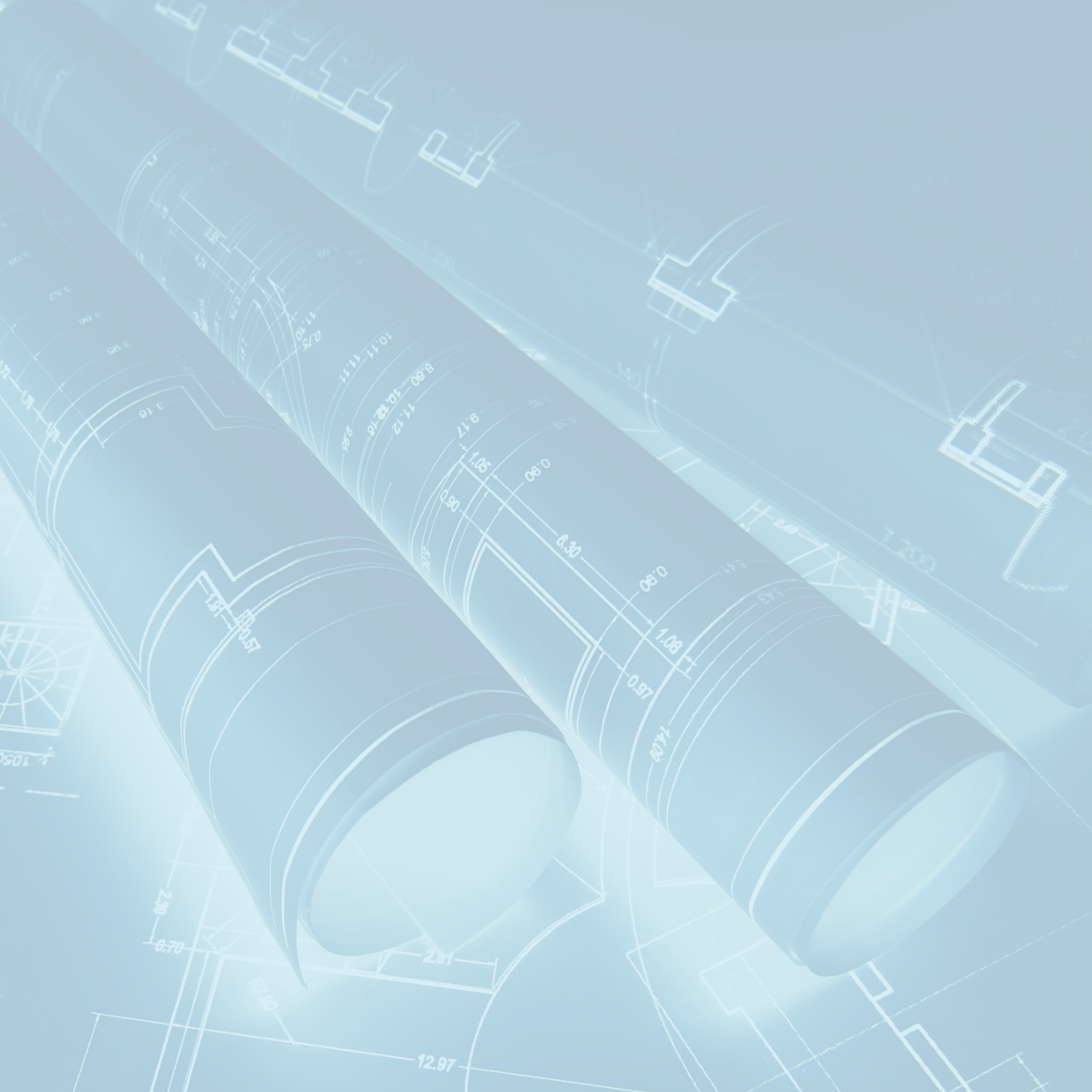
Charts Source: Financial Express

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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2.81
6.30
1.05
1.08
0.97
0.57
1.91
0.70
9.17
3.16

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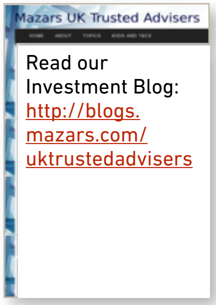

Investment blog

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