# MONTHLY MARKET BLUEPRINT

Investment Management Service

March 2019

MAZARS

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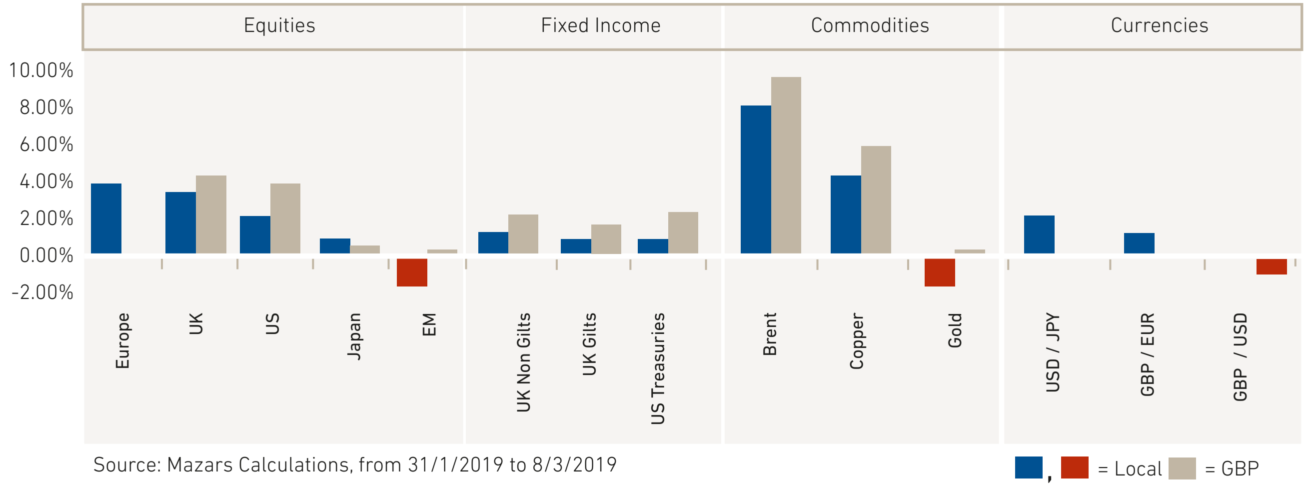
# MARKET PERFORMANCE – IN A NUTSHELL




Source: Mazars Calculations, from 31/1/2019 to 8/3/2019

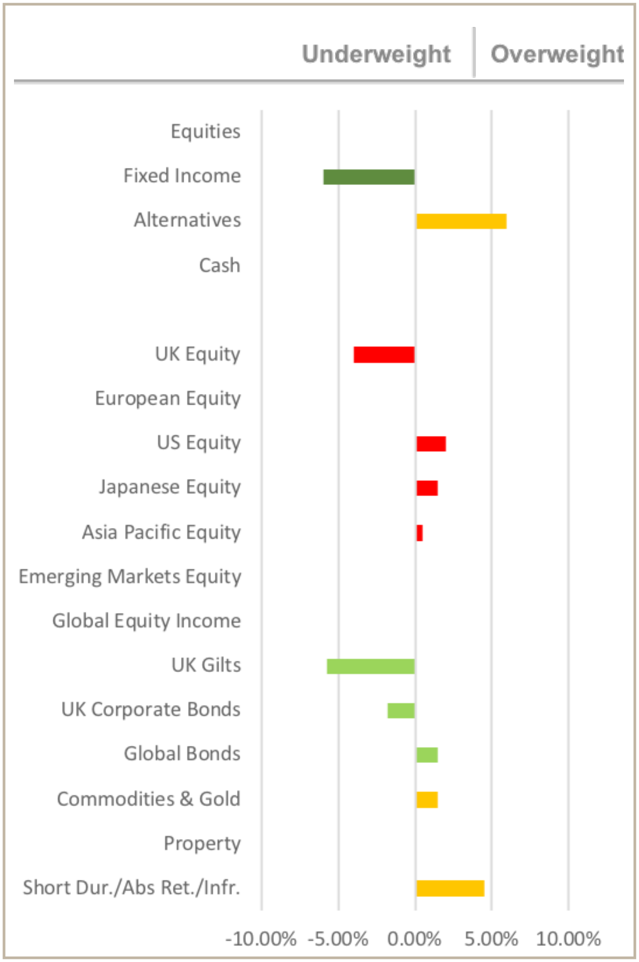
## The month in review: February rebound

February saw the continued strong performance of stocks with world equities up 1.5%, US equities up 1.7% and UK equities up 1.5%, however, other markets did not fare as well with Japanese equities down -0.2% and EM equities down -1.2%. IT and Industrials were the best performing sectors and Energy was the worst performing sector globally. After the 35 day government shutdown came to a close, data that should have been released in January showed that US economic growth slowed in the last quarter of 2018 to an annualized rate of 2.6%, and is now in line with long term expectations of economic growth which center around 2.5%. With the Federal Reserve taking a more dovish stance, indicating they will approach the balance sheet rundown more cautiously, a far cry from the "auto-pilot" style forward guidance given previously, we saw a return of the asset reflation trade pushing equities higher as P/E multiples expanded. This reinforces our belief that the recent rally in stocks is not driven solely by business fundamentals but by the large scale macro-economic factors, namely, the liquidity in the economy and the discount rate that underpins the system.

Brexit uncertainty has continued to weigh on the British economy, with a wide range of outcomes on the table before the final deadline is passed. The dynamics in parliament continue to shift, but it comes down to three forces: A moderate, crossbench, pro-soft Brexit parliamentary majority, a PM-fostered compromise, and a "Hard Brexit" minority all willing to run down the Brexit clock to press the other sides. Volatility continued to plague the Pound throughout the month; overall Sterling appreciated +1.3% vs the Dollar on news that Brexit could be delayed. Economic conditions continue to deteriorate across Europe, as manufacturing, business and consumer confidence continued to wane, especially in Germany, where the slowdown in global trade is most felt. European inflation data continues to remain low despite the unemployment rate. Oil prices continued to rise as supply remained suppressed and finished the month up +3.5% in USD. Gold finished the month flat in Dollar terms, partly due to flat Dollar projections and uncertain growth forecasts.

Source: Mazars calculations

# ASSET ALLOCATION




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

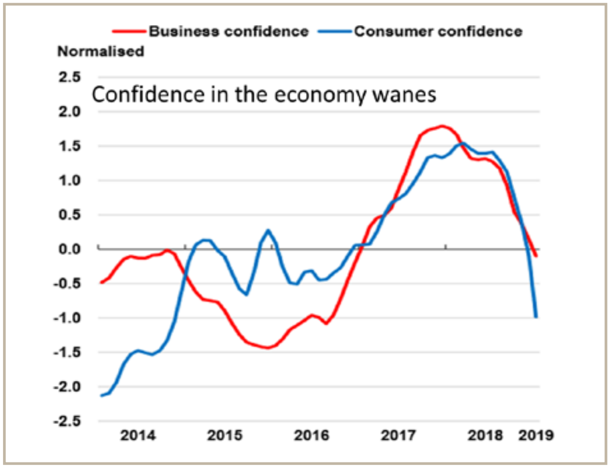
## Portfolios and outlook

- The global economic slowdown persisted, with conditions in the manufacturing sector further deteriorating, especially for exporters. However some improvement in the service sector and evidence of inventory depletion give hopes for cyclical economic rebound.
- Risk asset divergence, a theme of the previous quarter, seems to have abated, as US risk assets 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 the slowdown is broad-based.
- 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 such as the one last December.
- Global equity valuations have returned above historical averages, especially in the US.
- 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 overall.
- Last December our 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.

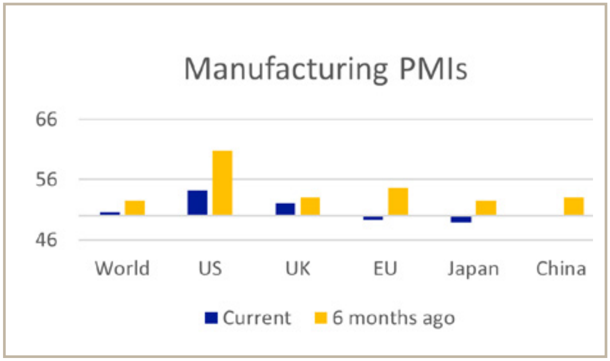
Charts Source: Mazars

# RISKS AHEAD

- Global economic growth is slowing. Markets are mostly focused on risks stemming from protectionism, US rate intentions, a Chinese slowdown, as well as European politics. Global debt levels continue to be a concern, especially. 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 the new government in Italy seems 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 economic uncertainty is growing sharply

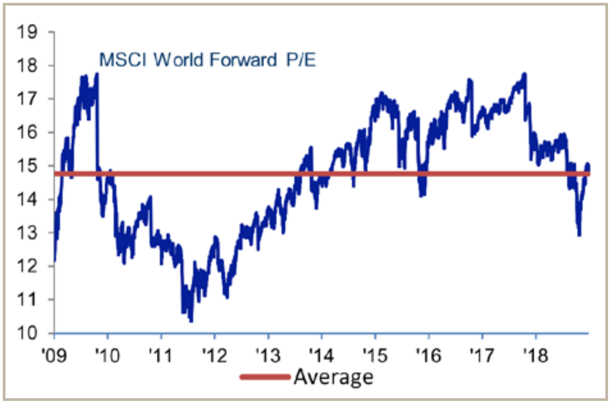



Global manufacturing slowdown persists

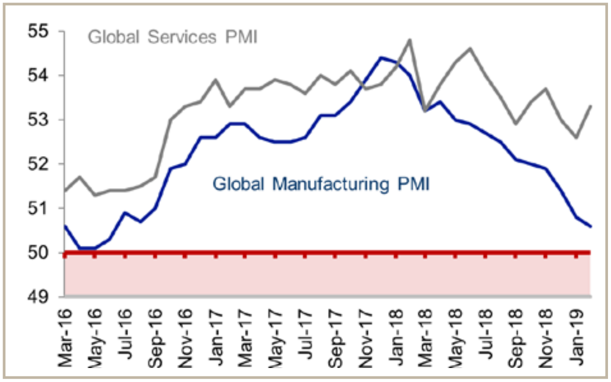
Charts Source: Mazars calculations

# THE MACROECONOMIC AND MARKET BACKDROP

# GLOBAL




Global stock valuations have returned to their long term averages

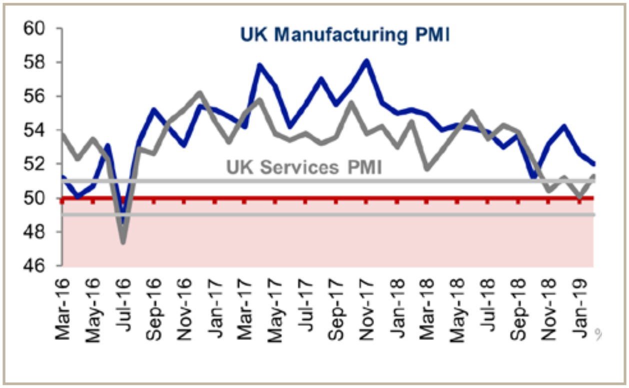



Global manufacturing continued to underperform but the services sector appears to be stabilising

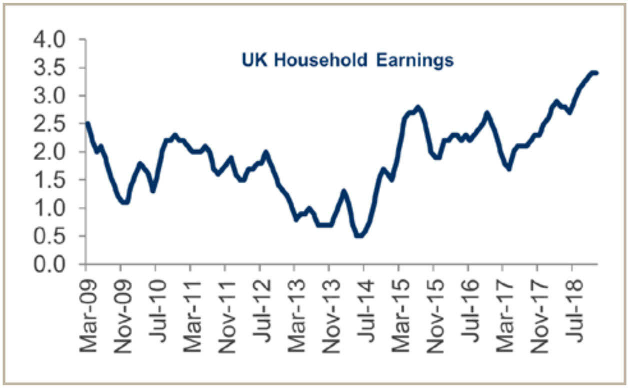
- Global equities were up 2.6% in Sterling terms from the end of January to the 8th of March, led by a rebound in Utilities as well as Consumer Staples. Consumer discretionary and energy were the worst performing sectors. Global equities are trading at a 14.81x PE, slightly above 14.75x average.
- The 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 manufacturing and services continue to struggle as Brexit uncertainty persists



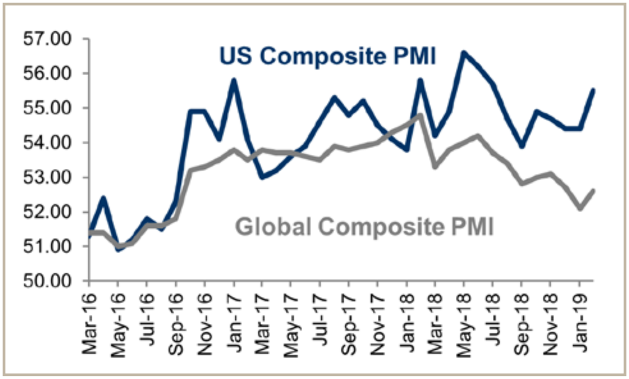

UK household earnings have been consistently climb

- UK stocks gained 2.9% for the period to mid March. IT and Household goods outperformed, while telecoms and energy unperformed.
- 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

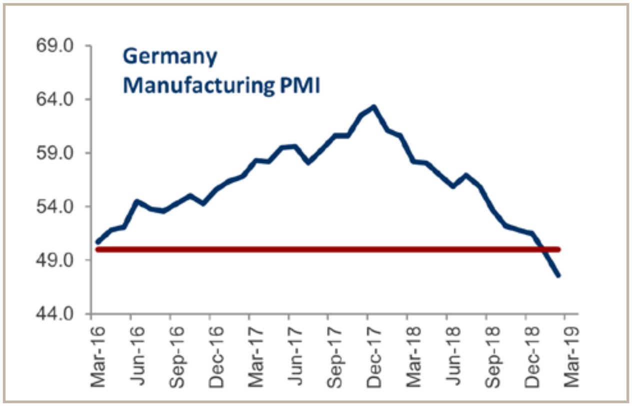



The US economy continues to outperform the rest the world consistently since the middle of last year

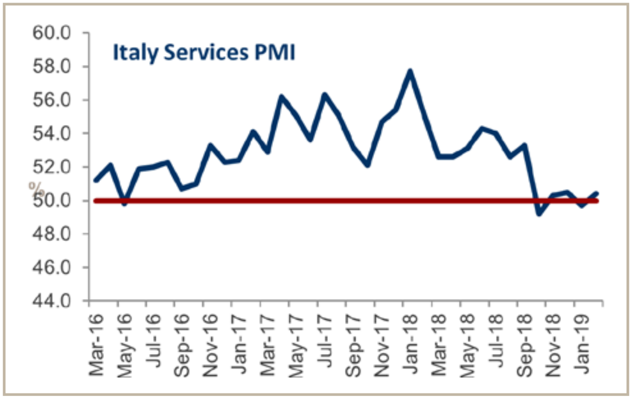
- US equities rose 2.6% in Sterling terms (1.7% in Dollar terms) from the end of January to the middle of March, led by IT, Utilities and Industrials. Healthcare, Consumer discretionary and energy sectors lagged performance.
- The slowing global economy and lower inflation expectations have prompted 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 10% 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 earnings growth was 13.3%. 53 companies issued negative earnings guidance and 12 companies issued positive guidance.

Charts Source: Mazars calculations

# EUROPE




Germany Manufacturing PMI is now in contraction territory

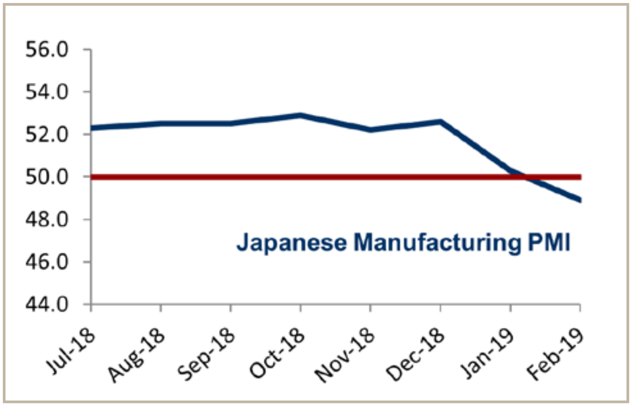



The Italian Services Sector is stabilising

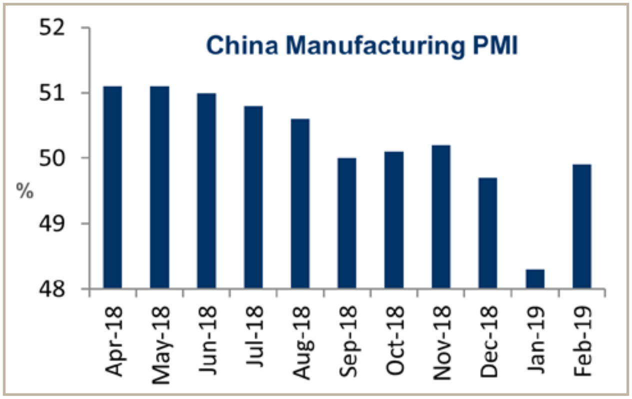
- European equities posted positive returns in February returning 2.6% in GBP terms and are now trading at a 13.1x forward PE.
- We see continued weakness in the economic data across Europe. In particular, data out from the manufacturing sector has been poor. The Italian Manufacturing PMI is down from 47.8 to 47.7. Italian new orders contracted at the fastest pace since 2013 and output fell for the seventh consecutive month. Germany's manufacturing sector, which given Germany is the third largest exporting country behind the US and China is of great global importance, has seen continued deterioration in conditions through February.
- The Germany Manufacturing PMI is down to a 74-month low of 47.6 and output fell for the first time in six years; only consumer goods recorded an increase in output. Additionally, post-production inventories were accumulated for the fifth consecutive month. On the other hand, business activity in the services sector has rebounded slightly, with the Italian Services PMI up from 49.7 in January to 50.4 in February and the German Services PMI up from 53.0 in January to 55.3 in February, with a renewed increase in activity across Hotels & Restaurants, which are more discretionary in nature.
- The European Central Bank downgraded growth forecasts and took a more dovish stance by not hiking rates in the summer. EU unemployment remained low at 7.8%, and as noted previously we have not seen strong inflation as the Philips Curve would suggest. However, German services input prices and prices charged have remained high throughout the start of 2019.

Charts Source: Mazars calculations

# JAPAN AND EMERGING MARKETS




Japan Manufacturing PMI has now entered contraction territory



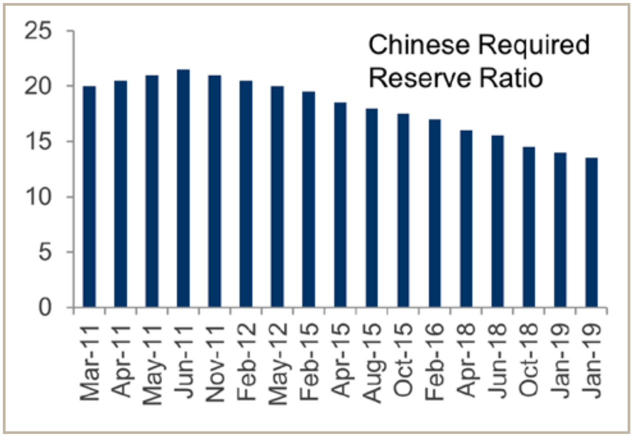

China manufacturing PMIs rose in February after a near three-year low

- Emerging Market stocks were up 4.9% in sterling terms and are valued at 12.8 PE. Japanese fell 4.4% and now trade at 16 PE.
- Japan continued to bear the brunt of the US-China trade war through the month of February. Trade wars have caused Japan's exports and factory outputs to fall since it ships electronic parts and heavy machinery to manufacturers in China. The Nikkei Japan Manufacturing PMI fell to 48.9, from 50.3 in January, pushing the sector into contraction territory for the first time since 2016. The survey data showed a second straight monthly decline in production volumes by Japanese manufacturers. However, the services sector activity expanded in February as new business grew at the fastest pace in almost six years. The service PMIs rose to 52.3 in February from 51.6 in January. New product launches, successful tendering and stronger sales performances helped lift order book volumes. Overall, service providers reported a strong degree of confidence in February while weak business confidence was recorded for the ninth successive month in the manufacturing sector.
- China lowered its target for economic growth this year, after admitting that trade wars have indeed had a negative impact on the economy. China is now aiming for growth in the range of 6-6.5%, down from a hard target of 6.5% over the past two years. The manufacturing sector in China picked up in February, with both output and total new orders expanding slightly. The Caixin General manufacturing PMIs rose to 49.9 in February 2019 from a near three-year low of 48.3 in January. In contrast, services PMIs fell to a 4-month low to 51.1 as new orders rose the least in four months, new export order growth slowed to a five month low and employment grew only marginally.

Charts Source: Mazars Calculations, OECD


# OUR THEMES

# MACRO THEME 1: CHINA SLOWING



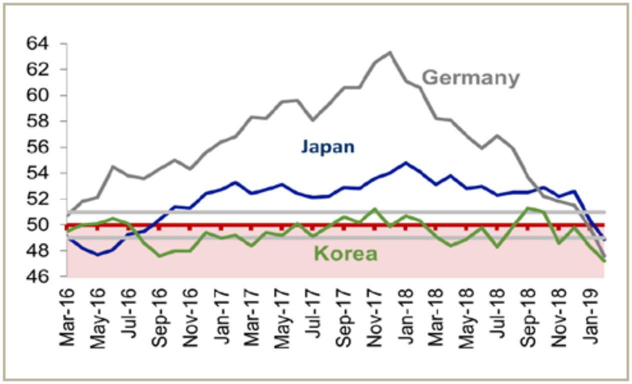

China lowered its required reserve ratio, to boost its economy.

- 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: EXPORTERS FEEL THE US PRESSURE




Manufacturing for exporters has precipitously slowed down

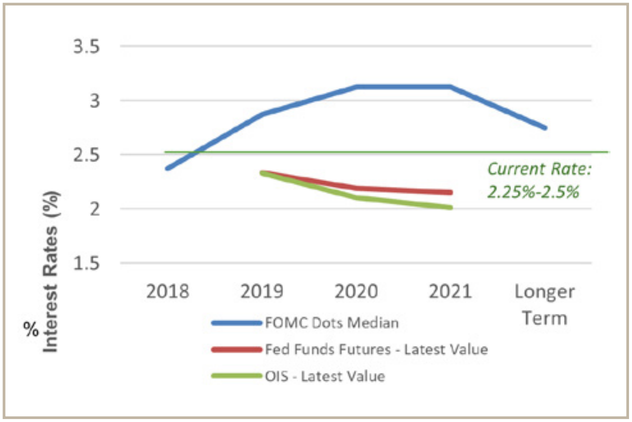
- Global trade conditions have steadily deteriorated in the past two quarters, partly because of heightened trade tensions between the US and its trading partners and partly because of a Chinese slowdown. The former is not completely disassociated from the latter.
- In its bid to share less of its growth with the rest of the world, the US has launched an aggressive campaign to get more concessions out of its major trading partners.
- The trade spat with China, which began at the outset of Donald Trump's presidency, came at a particularly crucial junction for the Chinese economy. Growth was already set to slow down as the economy is transitioning from a focus on manufacturing to a focus on consumption.
- Additional trade pressures, as well as a clampdown on shadow bank lending may have contributed to the Chinese economy feeling more pressure than originally expected
- When China sneezes, global manufacturers tend to catch a cold. This has been the case in the past year. Europe, and Germany in particular have felt the impact of the global trade slowdown more severely, as the auto industry has additionally been affected by stricter emissions standards.
- The question is where do we go from here? Is the downturn and the divergence with the US set to continue ad infinitum? Our analysis suggests that the trade slowdown certainly has some structural characteristics (the Chinese economic refocusing) but is also cyclical in nature. The emissions standards are only temporarily disruptive and China is already increasing social financing which should eventually help imports. Additionally, GDP figures in Europe suggest a depletion of inventories. Inventories are usually cyclical in nature and when demand rebounds they tend to build up very quickly.
- The cyclical component of the slowdown should eventually buck the trend and it is possible that we could see the figures improving in the next few months. However, the possible impact of fully-fledged trade wars, as well as the pullback in globalization has been well documented. These forces could put pressure on long term growth which is already hamstrung by large amounts of debt, threatening to "Japanise" developed economies.

**When China sneezes, global manufacturers tend to catch a cold.**

David Baker,
Chief Investment Officer

Charts Source: Mazars Calculations

# MACRO THEME 3: A MORE DOVISH FED




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 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.
- Markets got a rate hike in December 2018, but expectations for next year have dropped sharply, from 3 hikes to perhaps even a rate cut. This has reduced volatility significantly in the beginning of the year. The trend has supported equity returns but it lacks clear direction. This makes planning very difficult and is also causing havoc with investment algorithms which would in theory work better with a stable interest rate environment.
- While in theory the Fed's 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 a lack of visibility and therefore increased market volatility.
- The current policy is manifestly more inward looking as 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.
- Hence, the Fed's 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 a more clear direction from the Fed and evidence of independence before they universally consider the central bank as 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

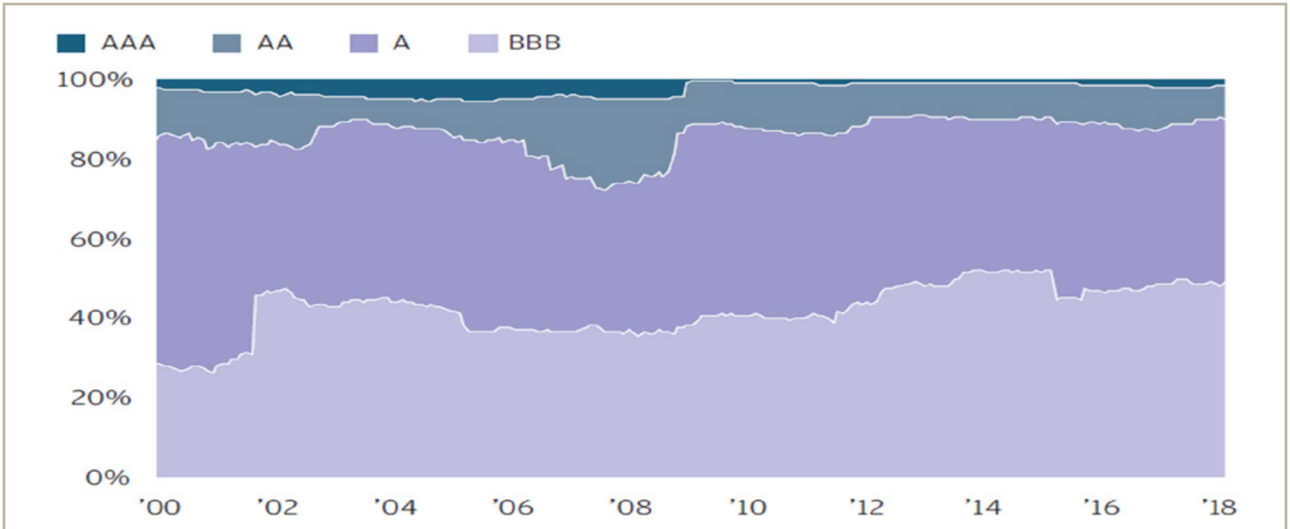
Charts Source: Mazars calculations

# EQUITY 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.

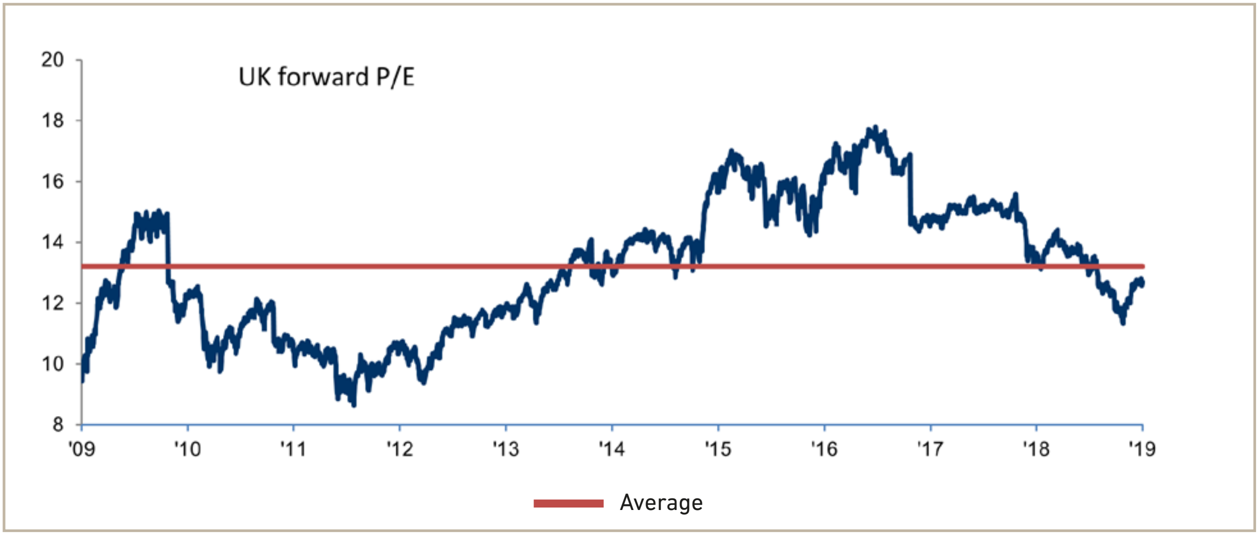
Another issue is that back-tested models may say that we should hold x amount of investment grade bonds based on their historical risk and return. However this ignores the fact that the quality of the investment grade universe has fallen according to ratings agencies. Looking at US data, pre-2007 about 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: OUTFLOWS FROM THE UK - AN OPPORTUNITY?

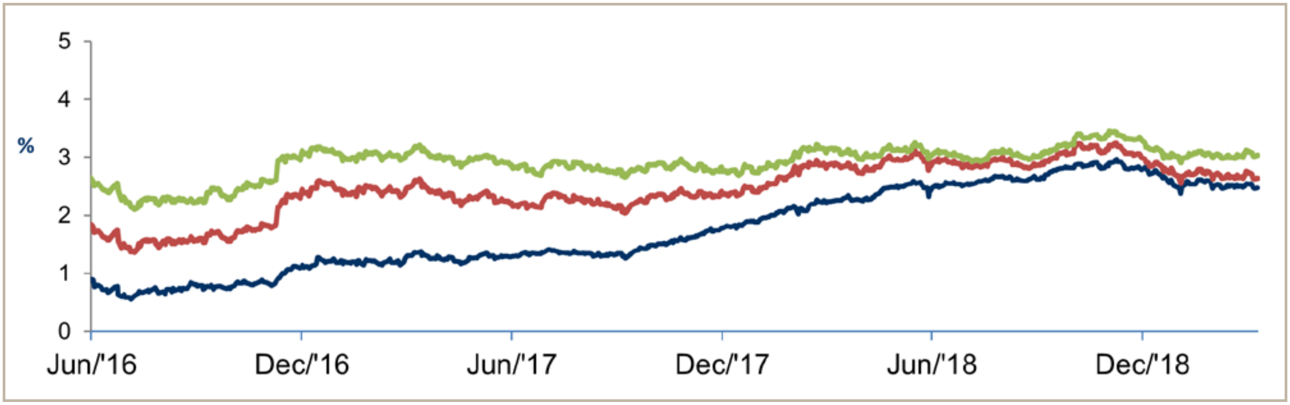
- According to date from the Financial Times and Bloomberg, investors have withdrawn more than £20B from UK Equity funds after the Brexit referendum. The number dwarves the £4B estimated net inflows from ETFs during the same period.
- Outflows from funds and inflows from ETFs suggest that the "slow money" is moving away from UK equities, leaving more room for speculative investors. The main characteristic of the latter is that they are likely to withdraw quickly, either following very good or very bad returns. Conversely, the former is invested for the long run and tends to add to stability.
- Currently valuations are below average, discounting significant risk despite the fact that UK large caps only get a third of their earnings from the UK economy.
- We believe that a positive Brexit event, or even the current Theresa May solution could see the return of visibility and therefore the return of the "slow" investors.




Charts Source: Financial Express

# FIXED INCOME SPOTLIGHT: HAVE WE SEEN THE PEAK YIELDS FOR US TREASURIES?

- US yields, along with many global sovereign yields, hit historical lows in mid-2016, with the 2-year at 0.55%, the 10 year at 1.36% and the 30 year at 2.10%. US 10Y Treasury yields are often considered the global risk free return.
- The extraordinarily low figures had been driven by a combination of low federal Reserve interest rates and quantitative easing. These had been used to try and kick-start growth in the aftermath of the Global Financial Crisis and try to stave off deflation.
- With a Republican sweep in the 2016 US elections the US was expected to, and did enact, massive tax cuts intended to drive economic growth. Indeed there was a marked uptick in US GDP and the unemployment rate has continued to tick down. Indeed there was an acceleration in interest rate rises with the upper bound reaching 2.5% in December 2018.
- Higher growth is expected to foster higher inflation, which the Federal Reserve generally attempts to contain by raising interest rates. The result has been a significant rise in yields for US government bonds, especially shorter dated yields, as these are a function of the level of interest rates and where interest rates are expected to be in the next few years. This is also a factor for longer dated yields, however these are more affected by expected levels of inflation, which have a greater effect on the real value of coupons further into the future.
- The Federal Reserve had been talking about a further 3-4 rate hikes in 2019, to get interest rates to c.3.5%, a level no longer considered expansionary. However signs of a slowing global economy, combined with explicit pressure from President Donald Trump, have seen the Federal Reserve become far more dovish. Markets are now pricing in 0% of further rate hikes in 2019, and in fact a 16% chance of a rate cut.
- US 10Y yields hit a peak of 3.25% towards the end of last year and have since fallen back significantly. Despite the Federal Reserve continuing to reduce the size of its balance sheet, which should put upward pressure on bond yields over the long run, it now looks unlikely there will be any more rate hikes before we see a rate cut. As it stands 3.25% may be the limit 10Y Treasuries can reach in the current environment of low growth and low inflation.




Charts Source: Mazars Calculations

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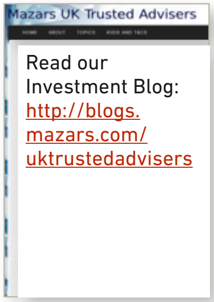
Quarterly outlook




Investment blog

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