Investment Management Service

April 2019

MAZARS

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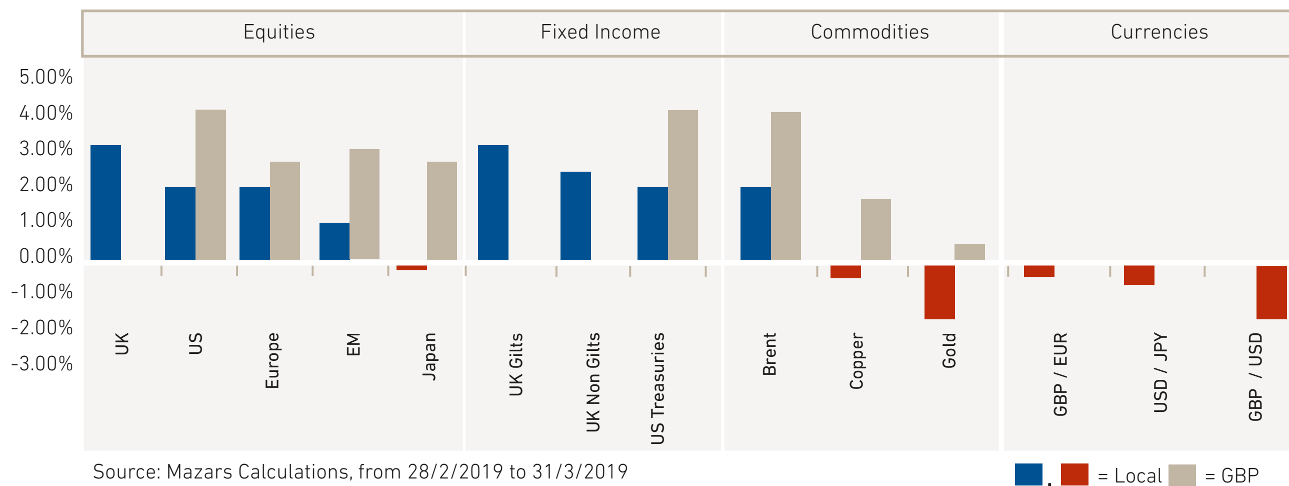
# MARKET PERFORMANCE – IN A NUTSHELL



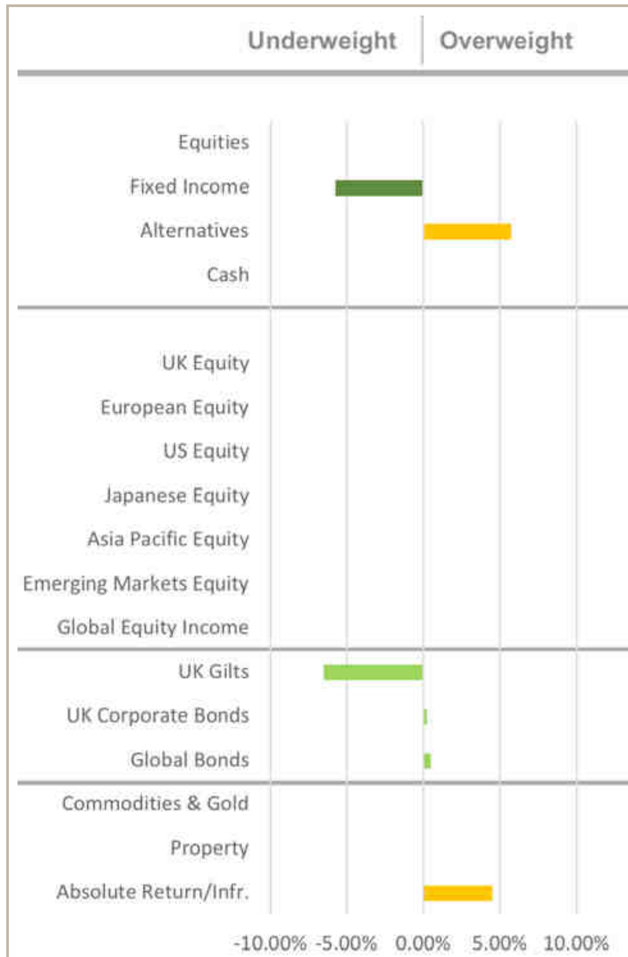

## The month in review: January Rebound

March was another great month for risk assets. We saw the strong performance of stock markets with world equities up 2.4%, US equities up 2.9% and UK equities up 3.4% in Sterling terms, additionally, Emerging Markets posted gains, despite currency scares in Turkey and slowing growth, with the MSCI Emerging Markets index closing up 2.4%. IT and consumer staples were the best performing sectors globally. Financials suffered amid lower rate expectations and idiosyncratic factors such as fines and regulation concerns; Deutsche bank confirmed their merger with Commerzbank. The S&P 500 now trades at a valuation of 17.3x earnings, which is not far from its historical average.

Brexit continues to present uncertainty to UK investors with the pound volatile and outcomes still numerous; for now Theresa May has secured a delay until October 2019 but this still provides investors little direction to the long term prospects of the UK economy; a delay, a softer deal or a second referendum are still all on the table. This uncertainty has driven UK yield downs, with the ten year offering a yield below 1.0% at one point. This lower yield environment is consistent across both the US and Europe, with German Bunds hitting near term highs and the US ten year yield trading well below 2.5%. This paints an uncertain picture for securities markets as typically bonds and equities see rallies in different conditions, however, owners of multi-asset portfolios have benefited from ownership of both asset classes. The Federal Reserve has pushed on with its increasingly dovish stance indicating that the balance sheet taper programme will come to a halt sooner as they approach tightening more cautiously. The 3-month, 10 year US yield curve inverted, a classic recession signal that investors monitor closely.

Source: Mazars calculations

# ASSET ALLOCATION




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

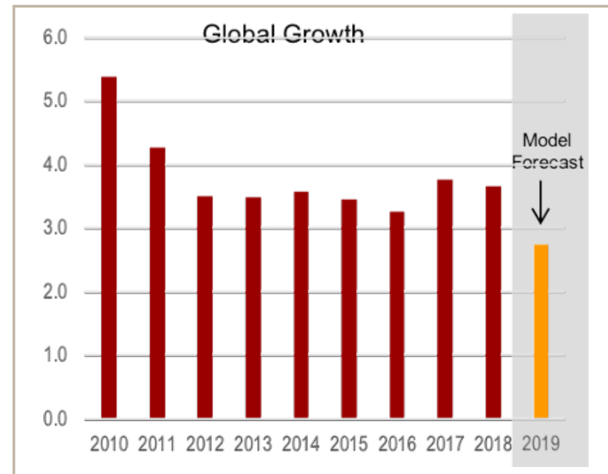
## Portfolios and outlook

- The global economic slowdown persisted, with conditions in the manufacturing sector contracting, especially for exporters. However some improvement in the service sector and evidence of inventory depletion give hopes for cyclical economic rebound.
- Meanwhile trade wars, Brexit uncertainty, weaker Europe 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, but for the first quarter of the year, we have not experienced a profound bout of equity volatility such as the one that rocked markets last December.
- Global equity valuations have returned to slightly above historical averages, especially in the US. Nevertheless, they continue to be overall average and supported by good earnings and low forward EPS expectations.
- Asset allocation was marginally negative while fund selection was a more significant detractor in March. With Fixed Income the best performing asset class and Equities also rallying, our underweight position in Bonds and overweight in Alternative assets cost around -0.2%. However our underweight position in UK MID-Cap Equities, which actually fell while equities rallied in virtually all other areas, dampened the loss.
- Given the extent of uncertainty surrounding Brexit we remain cautious on the UK. However, in April's investment committee we decided to rebalance our portfolios and eradicate our long standing underweight in the GBP, as we now feel that there's significant GBP upside, as Brexit tends toward either resolution or deferment, both of which are Pound-positive events. We don't maintain strong geographical preferences at this point, awaiting for more visible catalysts going forward. We still believe that the cycle, for the time being, remains intact but it is showing increasing signs of maturity.

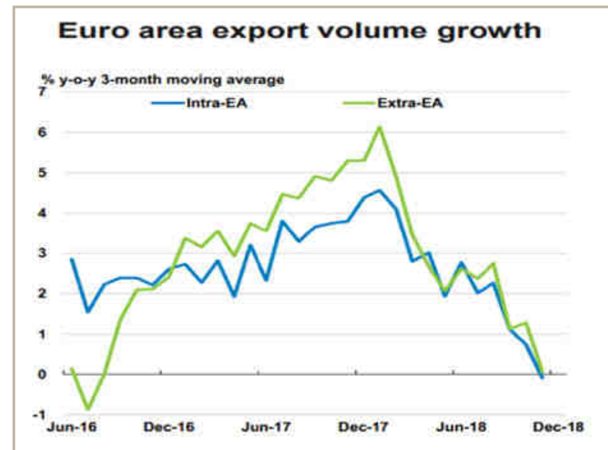
Charts Source: Mazars

# RISKS AHEAD

- Excess demand, which drove output in early 2018, has subsided and has now cycled into weak demand. Global economic growth is slowing. Markets are mostly focused on risks stemming from protectionism, the European and Chinese economic slowdown and global debt levels. The main global risk at this point is economic nationalism and "beggar thy neighbour" policies.
- As fiscal policy initiatives petered out, central banks once again picked up the baton and became more accommodative. While the Fed won't say so directly, Chairman suggests that the "Fed Put" is very much alive. The ECB quickly followed, as a stronger Euro could further hamstring the European economy. The risk from this point is that markets become too dovish about central bank intentions and become disillusioned.
- In the US the main risk is an economic slowdown, after Q2 2019 when the effect of the tax-cut stimulus is expected to expire. 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 and possible volatility around the debt ceiling.
- In the UK we have seen the impact of Brexit uncertainty in the form of slower growth, dented consumption, a slowdown in house prices and companies considering new venues. Further uncertainty lies again.
- In Europe, there are renewed fears over the political fate of the EMU, after the new government in Italy seem set to challenge the dictums of EU institutions.
- In China the slowdown persists, but some evidence suggests a higher probability for a rebound.
- 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.




Our PMI model suggests deteriorating economic conditions in 2019




Europe is a particular pressure point for the global economy

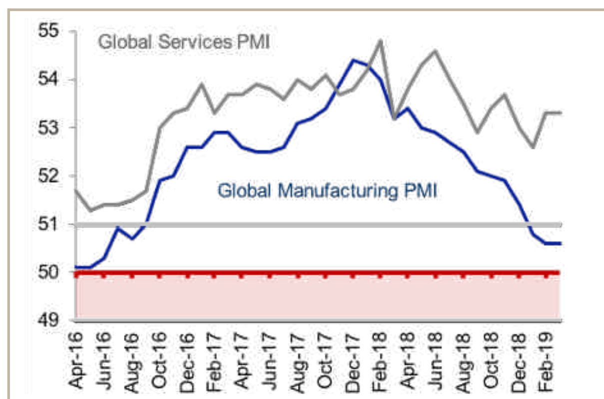
Charts Source: Mazars calculations



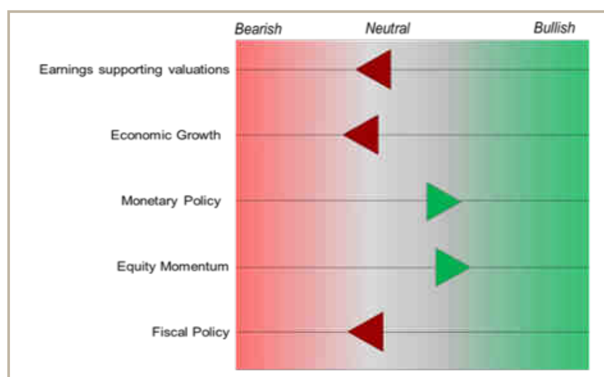
MAZARS

# THE MACROECONOMIC AND MARKET BACKDROP

# GLOBAL




Global manufacturing conditions remained weak, especially ex-US, but the service sector saw pockets of strength

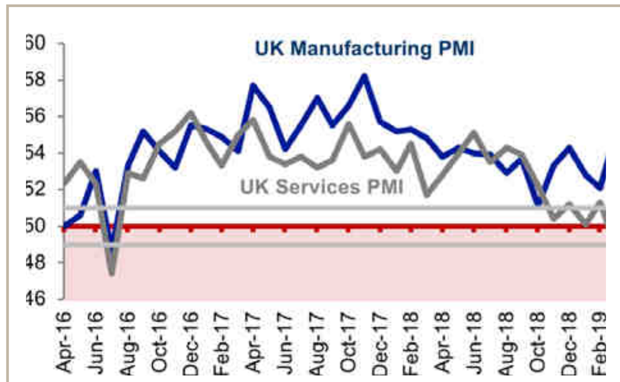



Global conditions deteriorate, but a dovish monetary policy is enough to support equity momentum

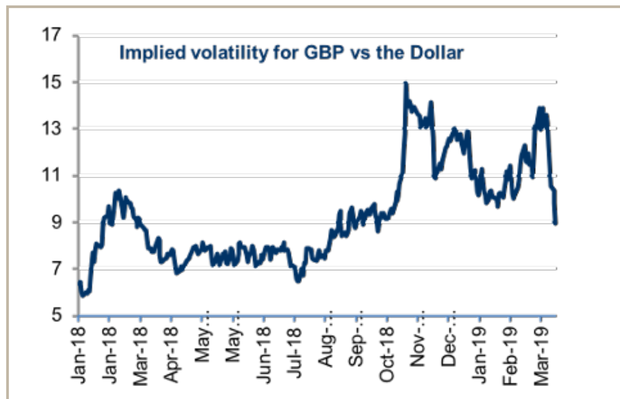
- Global equities were up 3.4% in Sterling terms for March (1.3% in USD) led by technology and consumer staples, while industrials and financials were the worst sectors. They are now up 13% for the year in Dollar terms. Consumer discretionary and energy were the worst sectors. Global equities are trading at a 15.95x PE, above their 10 year 14.75x average.
- The global growth slowdown continued in March across the board. Economic divergence persisted, with the US in a better position than most of its competitors, while Europe manifestly decelerated. Global trade conditions continued to deteriorate, although some pockets of strength could be seen especially in the service sector.
- Liquidity conditions have become more accommodative, after key central banks like the Fed and the ECB revised their recently more hawkish stance, citing weaker external conditions.
- Overall employment conditions remain tight across key developed markets, such as the US, UK and Germany, with wages continuing to increase. However, weakness in manufacturing and the decrease of backlogs suggest that these conditions might not persist in the next few months, especially if inventories are rebuilt before demand conditions improve. Despite tight labour conditions, inflation pressures remain muted, as overall demand is weak and extra income in key countries remains strong, partly because of cautious consumers and partly because of the exacerbation of income inequality, which means a larger accumulation of wealth to top tier consumers, which have a smaller marginal propensity to consume compared to lower incomes.
- Outlook: We feel that the global economy is due a cyclical rebound, evidence of which can be found in Service PMIs and recent Chinese trade data.

Charts Source: Mazars Calculations, Markit

# UK




UK services in contraction territory, as Brexit uncertainties persist

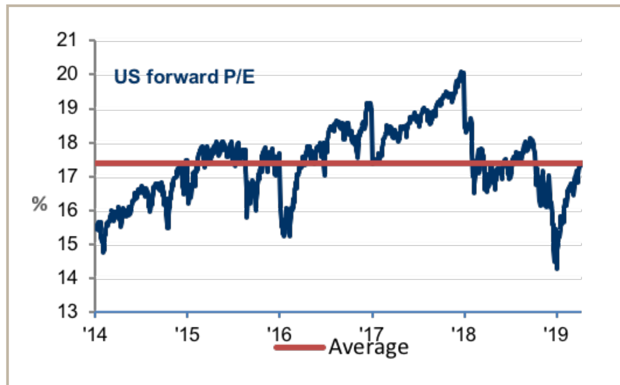



Markets are more optimistic about the probability of a Hard Brexit

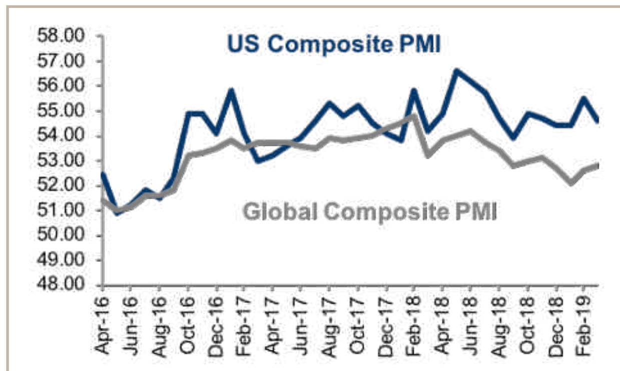
- UK stocks gained 3.3% in March, as Sterling tumbled, led by telecoms and personal goods, while utilities and financials underperformed. Forward P/E was at 13.01, very close to its long term average.
- The British economy, long sensitive to the global economic cycle, is still facing headwinds from weaker 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.
- Overall liquidity conditions are accommodative, and the BoE remains "on hold" for the time being, although this could change rapidly subject to Brexit. The economy continues to enjoy full-employment conditions, although some anecdotal evidence suggest that hiring in key industries, like finance, has become more difficult.
- Inflation remained benign, hovering just below the 2% threshold. UK manufacturing bucked the global trend as industries stockpile goods ahead of Brexit. New business improved from both domestic and export markets. Meanwhile, the service sector has been slightly weaker, mostly due weakness in main street retailers, which continue to lose ground from online stores.
- Outlook: Brexit continues to hover like a Damocles Sword over the economy as key issues regarding the economy, such as trade relations, export conditions, access of financial institutions to the common market and access to skilled personnel are yet to be determined.

Charts Source: Mazars Calculations, BOE

# US




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

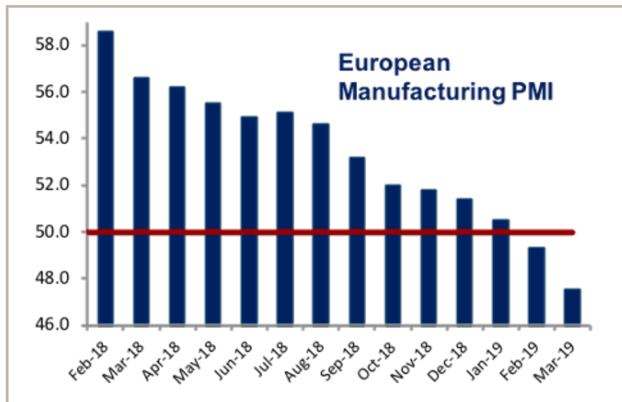



The US economy continues to outperform the rest the world consistently since the middle of last year

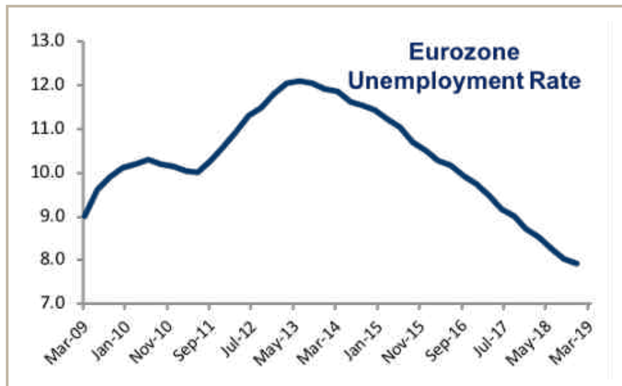
- US equities rose 4.1% in Sterling terms (1.9% in Dollar terms) led by technology and consumer staples, while industrials and financials were the worst sectors. US stocks trade at a 17.3 forward P/E, above their 15.5 long term average.
- Growth conditions in the US moderated slightly, as manufacturing lost some impetus, but overall the economy continues to outperform its developed market peers. Nevertheless, 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 and use a dovish language in March as well. Quantitative Tightening is set to pause also in September.
- Despite central bank dovishness, inflation continues to be benign and near the Fed's long run 2% target. The overall economy continued to face challenges, however the data did not show any significant weakness related to the one month government shutdown. Employment remains relatively strong overall, and wage growth is increasing consumer confidence –in not their actual spending. Manufacturing has not recovered substantially since the end of 2018, bit overall production is still at a good level. The service sector continues to expand at a healthy pace, however actual retail sales, which slowed significantly at the end of last year have failed to accelerate.
- Outlook: We are positive on US equities, but cognisant of the fact that after the passing of the tax plan, there could be a dearth of significant growth catalysts going forward. We expect growth to be challenging after H2 2019.

Charts Source: Mazars calculations

# EUROPE




European manufacturing conditions have further deteriorated to a 6 year low

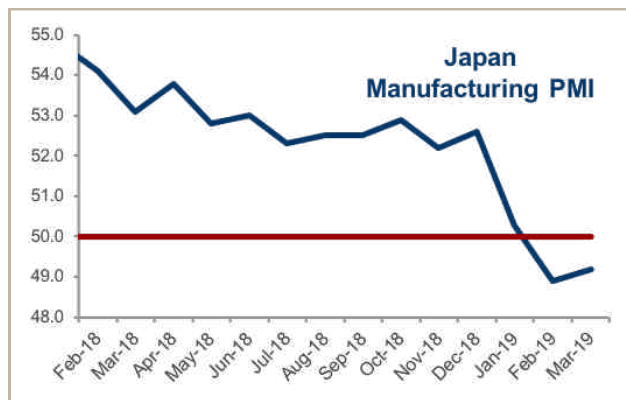



Eurozone unemployment rate is 7.8%, its lowest since October 2018

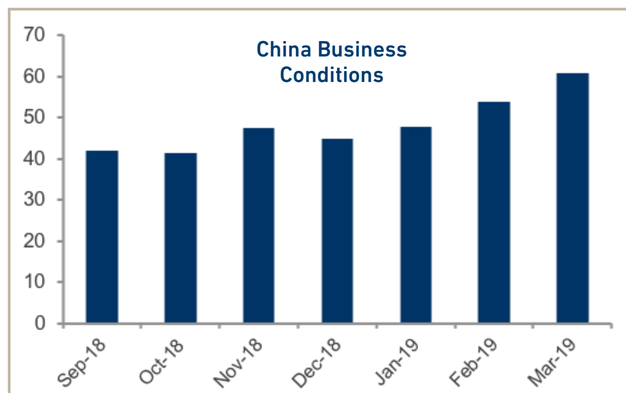
- European equities were up +2.0% in March in sterling terms. The automobiles, metals and mining sector declined for the sixth consecutive month in March. The beverage and food sector was the strongest performer in the period.
- GDP growth remains at 0.2%, consistent with the current business environment in the Eurozone. Manufacturing activity deteriorated in March to the lowest level in nearly six years. IHS Markit Eurozone Manufacturing PMI posted a level of 47.5, down from 49.3 in February. The overall downturn was led by Germany where operating conditions are at an 80-month low. Eurozone's services sector expanded further in March, reaching a level of 53.3, up from 52.8 in February. New work orders increased and helped the services sector grow.
- Private sector employment in the euro area continued to increase at a solid rate. The software sector registered the strongest rate of job creation in March while automobiles and auto parts posted the steepest reduction. The unemployment rate remained unchanged at 7.8%, the lowest since October 2008.
- Consumer prices rose by 0.3% in March, up from -1% in February. The M1 and M2 supply are both currently at an all time high in the euro area and loans to the private sector have increased significantly.
- The goods producing sectors point towards a further slowdown in growth as regulations such as those surrounding new emissions are affecting producers while customers continue to pull back on spending.

Charts Source: Mazars calculations

# JAPAN AND EMERGING MARKETS




Japanese manufacturing conditions remain weak : Red line indicates 50 level




Chinese Business Conditions rebound in March

- Both Japanese and Emerging Markets equities posted positive returns in March returning 2.48% and 2.70% in GBP terms respectively.

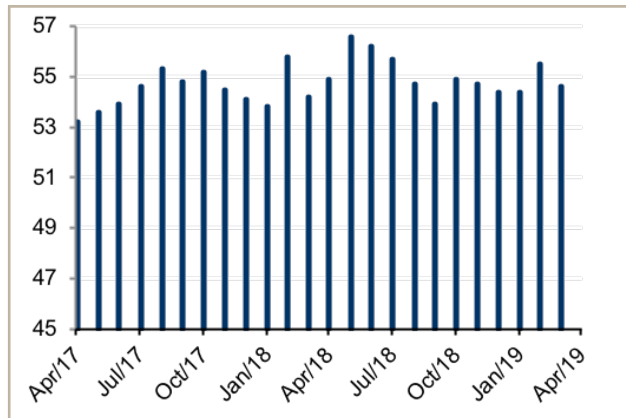
  Throughout Q1 2019 we observed a steep decline in Japanese Manufacturing conditions, with output falling at the fastest rate in almost three years. Firms have been clearing their backlogs due to a lack of new work signalling weaker demand going forward. New orders from both domestic and international markets fell during March. Employment was up only slightly and business confidence was among the lowest on record. The headline PMI figure recorded 49.2 in March, which was up versus the February figure of 48.9 but still below the contractionary reading of 50. Panellists linked the weaker sales to Chinese and Taiwanese clients, and overall exports fell in March. On the other hand, Japanese Services expanded in March but business confidence dipped to an 18-month low. The BOJ has kept to its ultra-accommodative monetary policy stance, with any hawkish shift downgraded in likelihood.

- The MSCI China index returned 3.5% in GBP terms in March, and LVMH, the luxury brand Louis Vuitton that derives a large amount of its business from Chinese consumers is up 7.87% vs 1.89% for its benchmark in GBP terms. The Caixin China Composite PMI was up from 50.7 in February to 52.9 in March, the strongest rebound in activity since June 2018. Average input prices were up and both services and manufacturing companies signalled an increase in new business. These positive findings indicate that the “Great Chinese slowdown” fears may be overdone in the near term and there is scope for a cyclical rebound. The required reserve ratio for major banks is forecasted to end 2019 at 12%, and at present sits at 13.5%; such accommodative monetary policy might just provide the support needed to prevent a Chinese crash-landing.

Charts Source: Mazars Calculations

# OUR THEMES

# MACRO THEME 1: US GRIDLOCK




US confidence wasn't much affected by the government shutdown in early 2019. Failure to raise the debt ceiling would likely be far more serious.

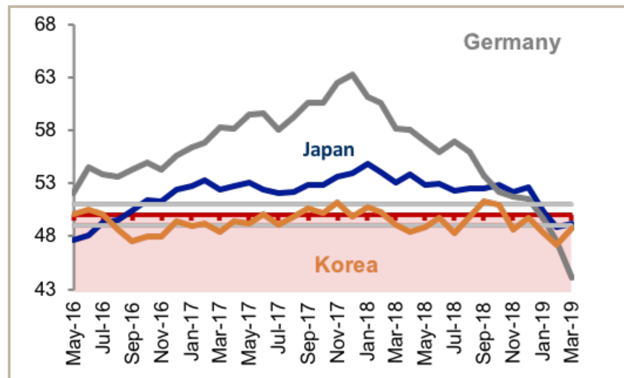
- We are ignoring for now the Mueller report and whether its release could prove embarrassing for Donald Trump, who will hope it doesn't contain much beyond what was summarised in the Attorney General's summary, or Democrats, who are pressing for full release and really hope it does.
- Of more concern is a potential battle ahead over raising the debt limit, which is the ceiling on overall Treasury borrowing.
- Before 1917, each loan issued by the Treasury required authorisation from Congress. Upon entering WWI, however, Congress changed the law to allow the Treasury to sell bonds as needed, provided that bond sales didn't exceed a specific amount – the debt limit.
- Over the years Congress has repeatedly increased this limit, although political wrangling is generally involved if the House or the Senate are lead by a different party than that of the President, with how the money is spent part of negotiations.
- The US actually went through the debt ceiling in March, however the deadline to increase the ceiling is the end of September as the Treasury is able to use special measures to draw out spending for around six months.
- This time the White House looks set to insist that defence (i.e. military spending) is increased but that non-defence spending isn't. This would be unpalatable to Democrats who hold the House of Representatives. With presidential elections in a year both sides could dig in so as to appeal to their respective voter bases.
- The US recently had its longest ever government shutdown over Congress' refusal to fund Trump's wall, which was only ended when he announced a national emergency in an attempt to use money already earmarked for other areas of defence.
- A shutdown here could be much more calamitous as failure to lift the ceiling would mean that the US is likely to default on some of its debt.
- Such an event would almost certainly lead to a credit-rating downgrade for the US, a major stock-market sell-off, and disastrous ramifications for the global economy.
- This is another example of how politics, which for years has been a minor concern for investors, is becoming a much greater consideration as populism moves policies away from the centre.

**"The White House looks set to insist that defence (i.e. military spending) is increased but that non-defence spending isn't. This would be unpalatable to Democrats who hold the House of Representatives."**

George Lagarias
Senior Economist

Charts Source: Mazars Calculations

# MACRO THEME 2: EXPORTERS FEEL THE US PRESSURE




Manufacturing for exporters has precipitously slowed down

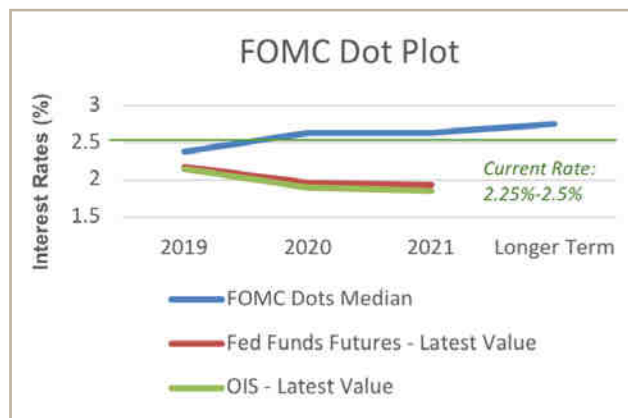
- Global trade conditions have steadily deteriorated in the past two quarters, partly because of heightened trade tensions between the US and its trading partners and partly because of a Chinese slowdown. The former is not completely disassociated from the latter.
- In its bid to share less of its growth 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 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 three hikes to perhaps even a rate cut. This has reduced volatility significantly in the beginning of the year. The trend has supported equity return.
- 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.
- The Fed is now 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

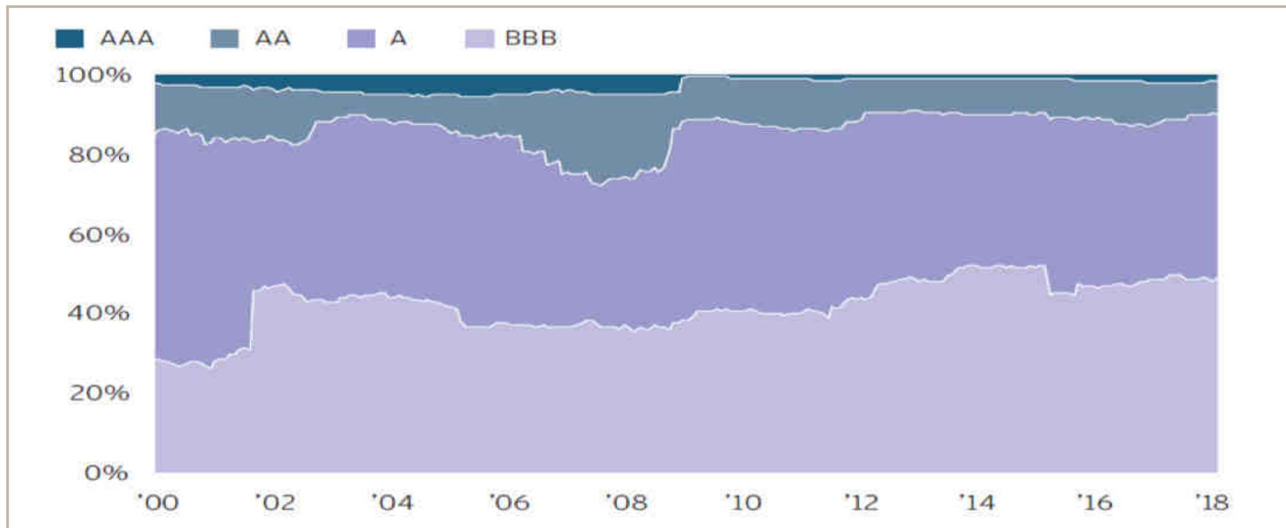
Charts Source: Mazars calculations

# 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.

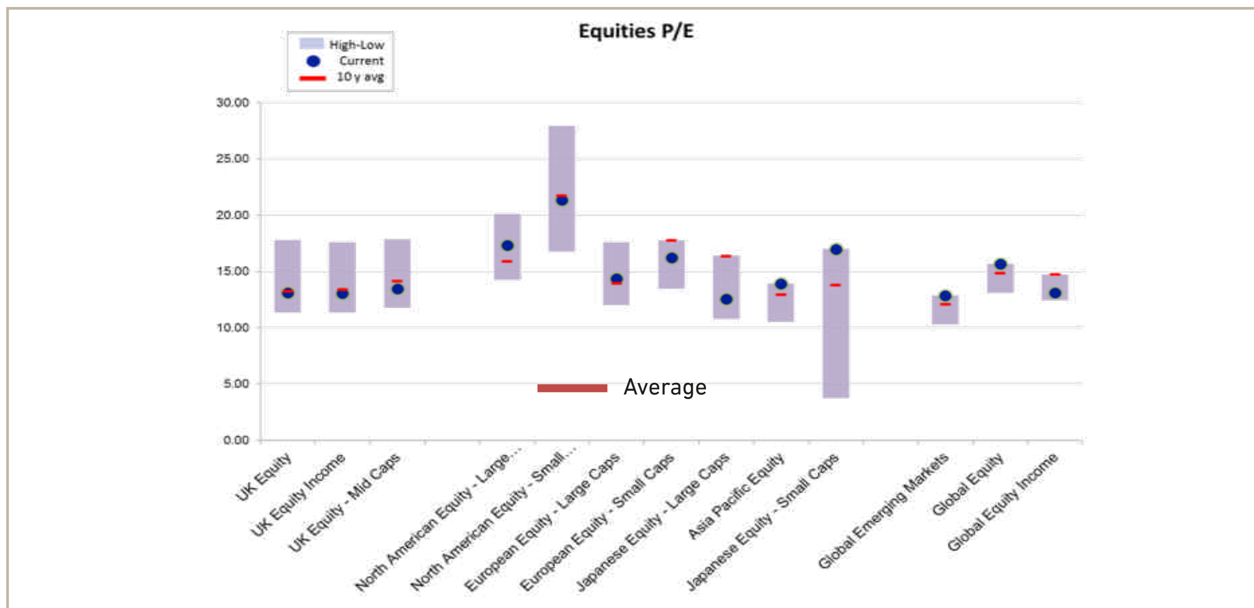



Charts Source: ICE BofAML Credit Indices

# EQUITY SPOTLIGHT: VALUATIONS STILL MODERATE

- Despite the equity rally observed in Q1 2019 which saw risk assets rebound sharply after the Fed's new dovish tone, valuations across the globe are still moderate. The S&P 500 currently trades at a 12-month forward P/E ratio of 17.3, which sits marginally above its long term average of 15.9, additionally, the MSCI Emerging Markets index currently trades at a P/E ratio of 12.9, also not far from its long term average 12.1. Japanese large cap equities continue to trade at a low valuation, both on an absolute basis and a relative basis vs the MSCI World, trading at a P/E ratio of 12.6. This moderate and by no means excessive valuation environment gives rise to the opportunity for positive economic or political catalysts, such as an earnings beat or a resolution to trade wars, to push equity markets higher.

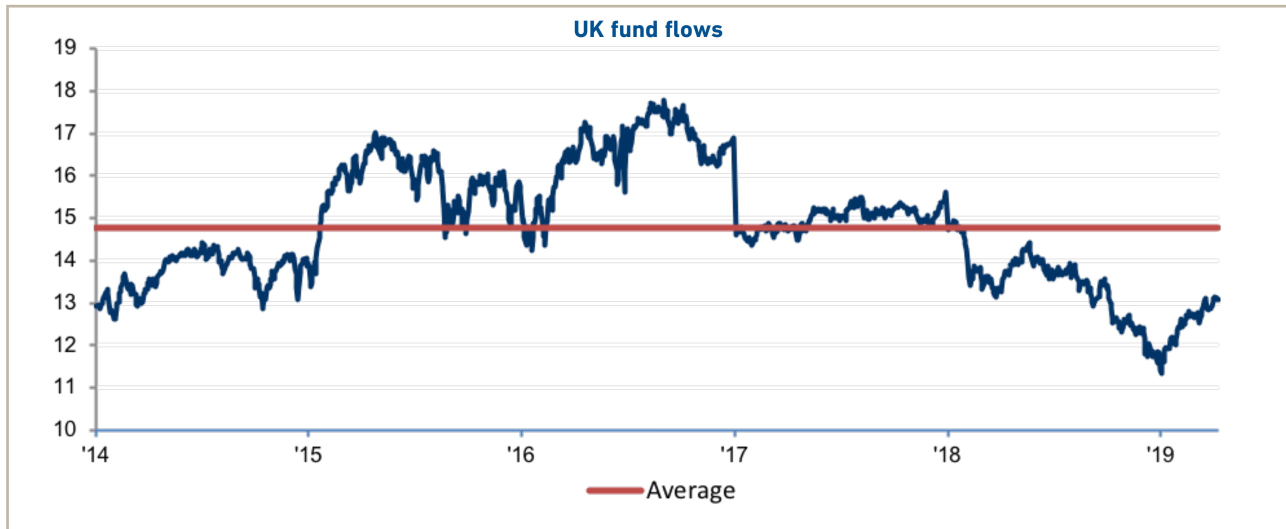
- For Q1 2019 the estimated earnings decline for the S&P 500 is -3.9%. However, this number is the result of significant downwards earnings revisions; on 31 December the expected earnings growth was +2.9%. Though a gloomy picture, this does present the chance for significant earnings outperformance, in particular, in the Technology, Materials and Energy sectors where the largest downwards revisions have taken place. To conclude, valuations do not provide a headwind to equity performance given where they stand based on historical data, and positive surprises, paired with a continued dovish Fed could push equity markets to new all-time highs.




Charts Source: Mazars Calculations

# FIXED INCOME SPOTLIGHT: OUTFLOWS FROM THE UK – AN OPPORTUNITY?

- According to date from the Financial Times and Bloomberg, investors have withdrawn more than £20bn from UK Equity funds after the Brexit referendum. The number dwarves the £4bn 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: Mazars Calculations

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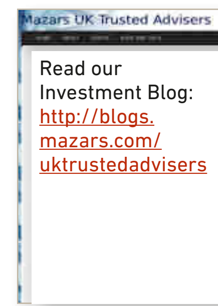


Investment blog


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