MAZARS WEALTH MANAGEMENT INVESTMENT NEWSLETTER

Winter 2020

> "Leading economic indicators, particularly in the manufacturing sector, gave no reason for optimism with the evidence suggesting that companies were completing backlogs with lower expectations of new business."

Following a flat third quarter, global equities rallied to the end of the year with the MSCI World index up over 7%. Returns for unhedged Sterling based investors were broadly flat as the Pound strengthened following the Conservatives' decisive general election victory. The late final rally was primarily driven by renewed optimism for a 'phase one' trade deal between the US and China, and left global equities up 25% for the year. It is of course important to note that, by contrast, markets ended 2018 in very pessimistic mood, and therefore a global equity return figure of around 8% from September 2018 is a more useful measure of equity returns.

Trade deals (or not) aside, it is indisputable that the real driver for these spectacular returns was the Fed's complete U-turn on interest rate policy. This turnaround, together with the continued loose monetary policy still adopted by the world's other major central banks set the environment for equity price inflation as yields on 'safer' asset classes once again became unattractive.

Thus 2019 ended with equities looking 'expensive' once more. Economic fundamentals played no part in this stock market reflation, as what growth we saw was paltry at best, and leading indicators of future economic activity gave no reason for optimism. Investors once more find themselves forced into buying equities despite a lack of corporate profit growth. Some days this feels uncomfortable, but thanks to the stance of central banks this discomfort can be easy to ignore.

And so to Brexit. Whatever one's view of the merits or otherwise of leaving the EU, it is difficult to argue with the notion that the malaise which Parliament has been in over the last three years has not been helpful for the UK economy. Some commentators had posited that a large majority might mean the possibility of a softer Brexit, but Johnson's decision to put a hard deadline on the date of leaving might indicate otherwise. Much has been made of the normal timescales for a trade negotiation, but what is at stake, and indeed the starting position, mean that this negotiation is far from normal.

Although uncertainty remains over the direction of Brexit, our Investment Committee decided that the definitive outcome of the election is likely to spur greater investment, making UK equities a more attractive proposition at current valuations. As such we have initiated a position in UK small-cap equities, moving marginally overweight equities as a whole, reducing cash and gold where we have been overweight. The decision was also taken to switch from index-linked gilts, which have performed extremely strongly in recent years, and instead purchase conventional gilts.

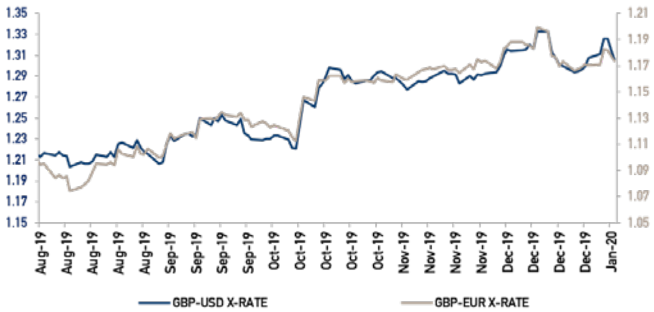
I hope you find this newsletter interesting and relevant to you, and I would very much welcome any feedback you may have. Please do feel free to get in touch with your thoughts either by phone on 020 7063 4259, or by email on david.baker@mazars.co.uk.

MAZARS

Economies and markets in brief

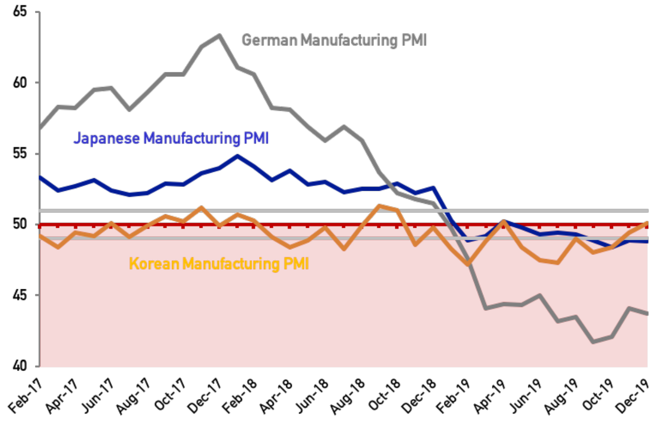
Sterling Post Election

The Pound rallied significantly on the announcement of the exit poll, which proved to be essentially correct, reaching $1.33 and €1.20, the highest since immediately following the referendum in 2016. However in the week following the election Boris Johnson announced plans to enshrine the ending of the transition agreement by the close of 2020 in law. This creates another cliff edge moment, dashing market hopes that Boris Johnson would use his significant majority to engineer a smooth Brexit. The Pound has fallen back closer to pre-election levels at $1.30 and €1.17, with progress on the trade deal, which needs to be completed by the end of 2020 in order to avoid the erection of barriers to trade with Europe, expected to be the prime driver of Sterling performance over the next year.



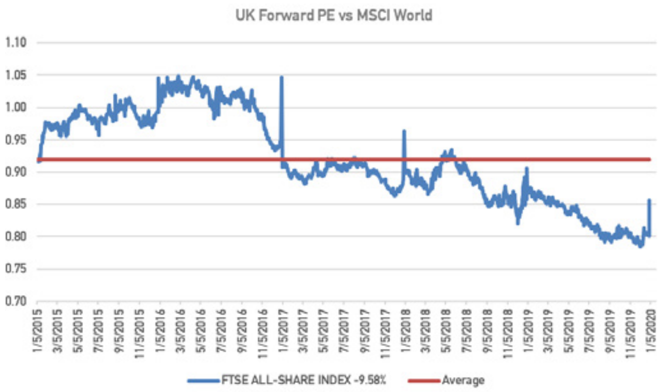
Trump Trade War Focus now on Europe?

There is no certainty that a trade deal will be completed between the US and China, however there are signs that something concrete will be signed off relatively soon (although some of the figures on increased imports that China is apparently agreeing to may never actually be met). Assuming this deal is done and dusted, Europe is likely to come into President Trump's crosshairs. He has long complained that Germany in particular has benefitted from a weak currency. However given the EU trades as a block, any ramping up of tariffs, which he used as part of his campaign against China, would be placed on the EU as a whole. Tariffs are likely to be chosen to hurt specific countries disproportionately, however it is easy to imagine a tariff on goods such as cars, designed to target Germany, causing problems for other car producers such as Italy. Yet in reality we may not see such escalation for some time, depending on whether Trump feels it is politically helpful to initiate a battle on trade in an election year.



UK Stocks at a Discount

The UK stock market has always been somewhat quirky, given the dominance of financials, given the dominance of financials, oil majors, and miners. The lack of industries such as tech, which can trade on higher multiples of earnings due to capital light balance sheets, means that it has always traded at a discount to the US. However the uncertainty around Brexit has meant that since June 2016 UK stock have traded at a discount to global equities as a whole. Currently UK large-caps trade at 13.5x earnings vs 17.3x for global equities, 15.4x for European equities and 18.6x for US equities. There is still a lot of uncertainty given the deadline Boris Johnson is insisting on for an EU trade deal, but at these valuations UK equities offer good value, and even if they don't see a revaluation will likely continue to be ripe takeover targets for foreign companies.



TWEET IN 280 CHARACTERS (OR SO!)

With a majority of 80, Boris Johnson now has the ability to shape the direction of the UK for the next generation.

JARGON BUSTER

JARGON BUSTER – VALUE vs GROWTH

Some equities are considered to 'value stocks' with others considered 'growth stocks'. Value stocks typically have a market capitalisation (the number of shares outstanding x share price) at a low multiple of the firm's annual earnings. Growth stocks in contrast typically have a market capitalisation at a high multiple of the firm's annual earnings, however have greater growth prospects. Long term returns suggest that stocks with value characteristics tend to outperform, however during the current economic cycle since 2008 growth stocks have performed significantly better.

2020 key events for UK investors

As this year concludes we find ourselves asking what key events in 2020 are likely to be material for financial markets. Below we explore three events whose outcomes have the capacity to change the underlying investment landscape from the perspective of a UK based investor.

UK-EU trade deal deadline

The next step in the Brexit timeline is the EU-UK trade deal negotiations. The UK and the EU have until the end of 2020 to agree on the terms and conditions for the UK's continued trading with the bloc, and with Boris Johnson's hard stance on Brexit, by no means is a deal or an extension guaranteed. Trade negotiations will be particularly thorny on issues such as business subsidies, tax and environmental protection. Another factor is that Donald Trump has vetoed appointments to the WTO, so that the arbitration court is no longer functioning. If either side were to behave in bad faith, there is currently no legal remedy. The reality is that as the UK is the smaller market, it would be more prone to the larger EU misbehaving. The UK is likely to push for a fast deal that ensures tariff-free, duty-free trade in goods. However the EU has indicated that a "bare-bones" or "skinny" free trade agreement, which focuses on bare essentials and core demands while ensuring a "level playing field" of environmental, social and state-aid rules, might be the most that is achievable.

US presidential election

Whether we see a second Trump term is hard to predict, with the results highly contingent on who the Democrats ultimately nominate. With Joe Biden the current favourite it is likely to be a close contest. However, historically three-quarters of presidents have been re-elected, looking at data going back to 1932. Furthermore, an incumbent president never failed to win re-election unless a recession occurred during their time in office. So far the US economy has held up well, driven by strong consumption, however, the impeachment case and recent Iran conflict do introduce more wildcard factors into this November's election.

US-China trade war resolution

Over the past 40 years, China's economic growth has been nothing short of remarkable. Over this period China established a large trade deficit with the US, and now Xi Jinping's China is rivalling the United States as the leading economic powerhouse. Trump decided he would not let this continue, and has imposed tariffs on Chinese goods and is seeking a trade deal that among many other things, reduces intellectual property theft and tackles Chinese subsidies. A phase one mini-deal has been reached, but the long term negotiations are far from complete. A resolution on this front could see a revival in global trade volumes and remove some of the political uncertainty; an event financial markets would welcome with open arms.

UK Small-Cap Equities - in focus

What are UK Small funds?

These are funds that typically invest a large proportion of their assets in UK based smaller companies, those outside the FTSE 100. Focus is on stocks in the lower half of the FTSE 250, the FTSE Small-Cap and AIM indices.

Why do we use them?

Small companies are typically more volatile than larger companies. These sectors often have high growth potential and historically grow at a faster rate than larger companies, rewarding the greater risk taken. We would expect that the smaller the average size of the investment the greater the share of both the upside and the downside of market returns will be captured. Almost £15 billion has left UK funds since the EU referendum in 2016. There is some evidence that this has left the market undervalued.

The UK remains cheap relative to both foreign markets and its own historical average. The FTSE 250 trades at a Price-to-Earnings ratio discount of 17.50% relative to its long-term average. UK assets have been shown by Goldman Sachs to outperform as 'no deal' risks fade, while the new government has pledged £100 billion on public infrastructure over the next five years. This should help support small-to-medium sized businesses in the UK.

Our approach

Our UK small-cap exposure will be achieved through the Fidelity UK Smaller Companies fund. Managed by Jonathan Winton since 2013, this fund looks to take a contrarian stance in undervalued companies with the opportunity for positive change, giving the fund a slight value bias. The fund has managed to keep pace with the performance of smaller companies in general, despite its value style having been out of favour over most of the period.

A – Fidelity – UK Smaller Companies W Acc in GB [26.33%]
B – IA UK Smaller Companies GTR in GB [25.34%]
C – Numis Smaller Companies Excluding Investment Companies TR in GB [25.17%]

31/12/2018 - 31/12/2019 Data from FE fundinfo 2020

MAZARS