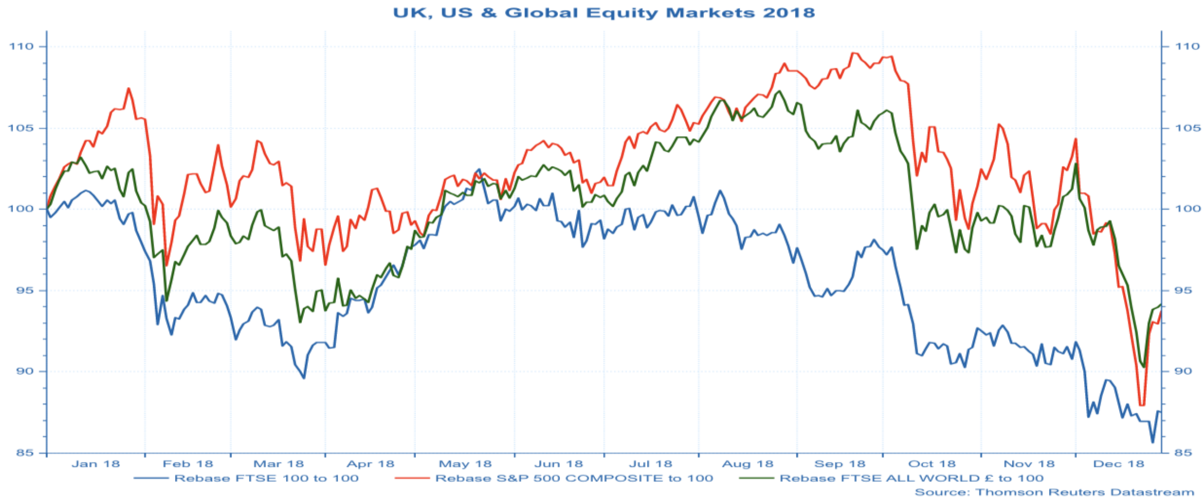
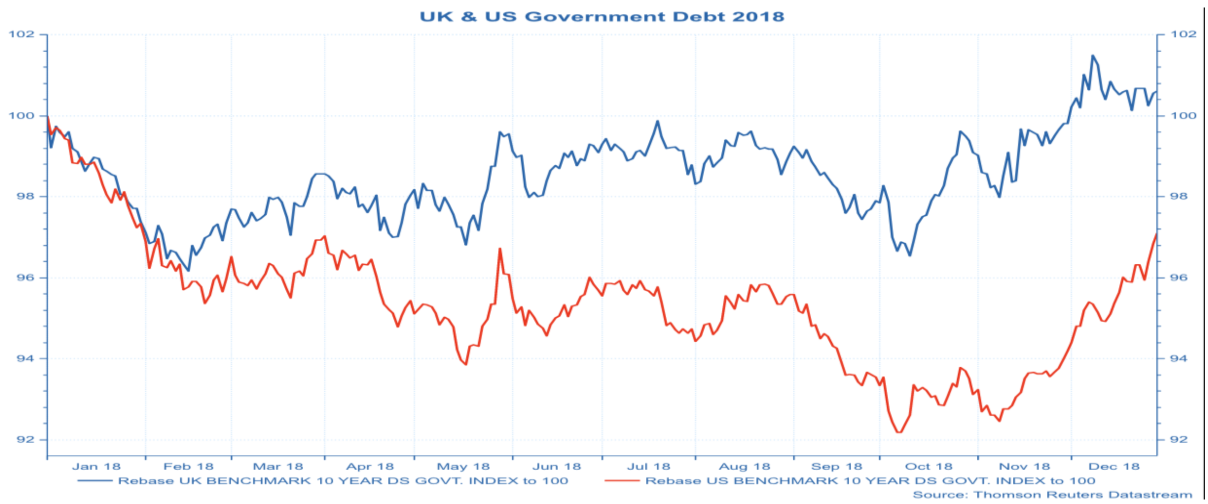
2018 & Beyond

What Just Happened?

Looking back at 2018 everything seemed to be going along quite nicely; by May the UK, US and World Equities were up almost 2.5%; with the latter two hitting over 8% by September. However, by the end of the year all three were "under water" by double digits.



The safe havens of UK and US Government Debt (Gilts and Treasuries) did little better only recovering towards the year end as investor preferences changed and their appetite for lower risk assets such as these rose as equities fell.



It was a similar story for Gold Bullion and Oil. The higher volatility and declines have probably started to make investors think that the 1.5%-2% available on cash deposits is now looking pretty attractive!

There are lots of factors at play here that could have caused these declines as we saw an increase in: -

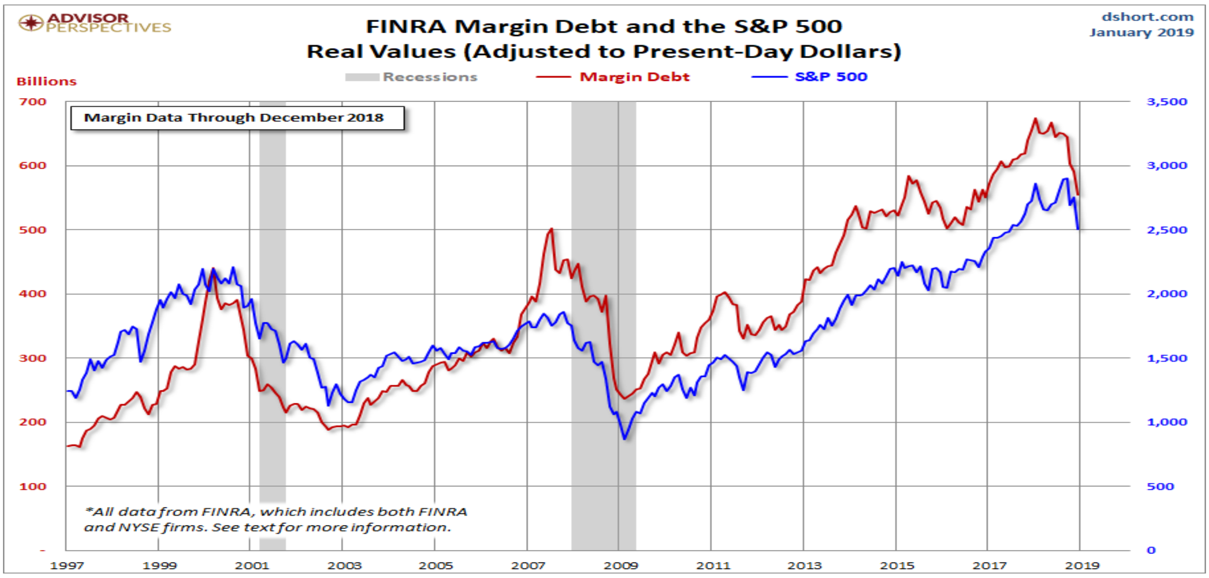
- Geopolitical risks
- Trade wars and tariffs between the US and China
- Britain's protracted exit from the EU
- Populist Governments and Political movements

Any of these could have been, or will be, the trigger for changing investor sentiment and risk aversion; however, they are not the actual problem. The underlying issue is that we are still dealing with a debt hangover from the Financial Crisis.

The Effect of Debt & Future Risks

The level of debt globally for Governments, Financial Institutions, Companies and Households is huge and ultimately some form of deleveraging (debt reduction) needs to happen.

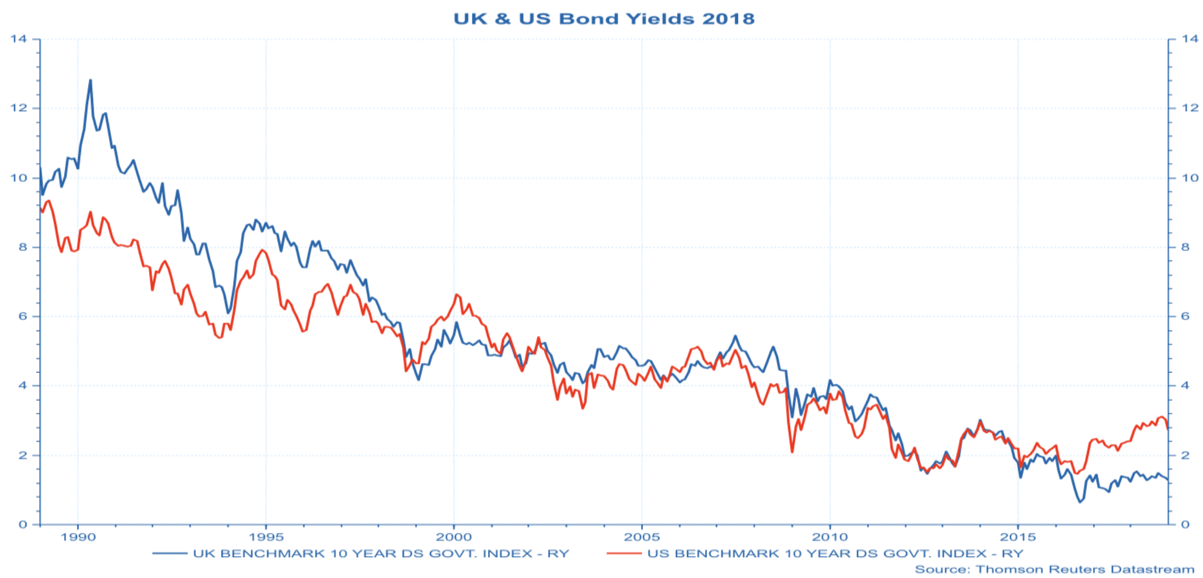
Debt is everywhere; a good example is Margin Debt in the US – margin debt is how much borrowing investors take on to fund their investments.



Quantitative Easing (QE) was intended to stimulate the Economy by encouraging Financial Institutions to lend but this has served only to stimulate financial markets. As a result, we are probably now at the stage known as "pushing on a string" where despite near zero interest rates and huge QE programmes we see low growth, low returns on assets and a failure to increase spending that would stimulate the economy.

A number of indicators also suggest that the US and other Countries are headed toward recession as Central Banks try to unwind their QE programmes tighten their belts. Societe Generale strategist Albert Edwards cited in January that ten of the last thirteen US Federal Reserve Tightening Cycles have ended in recession.[1]

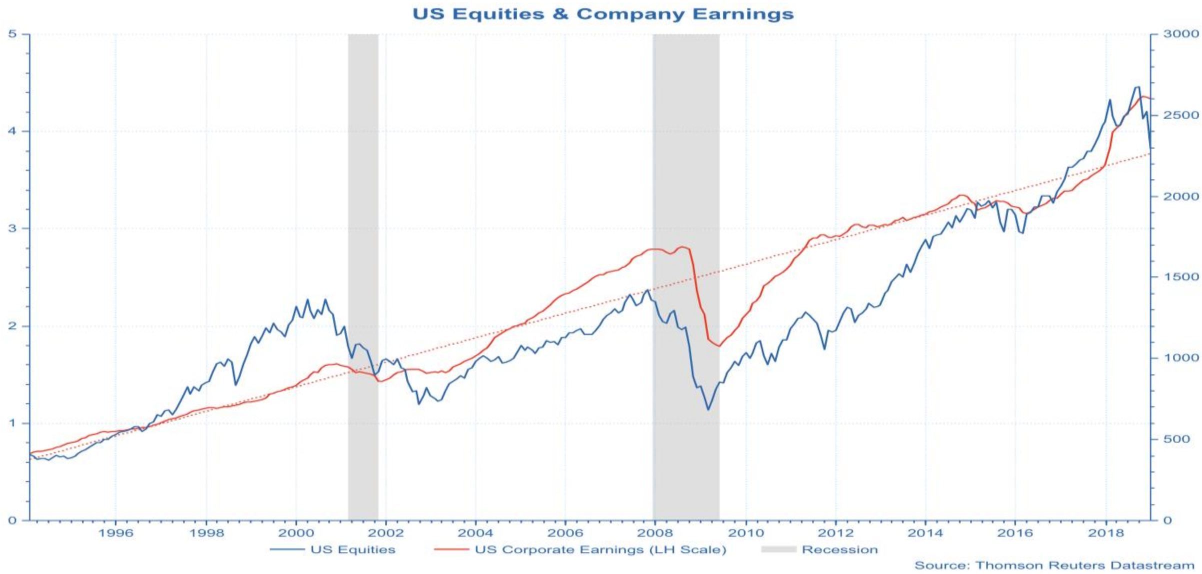
If this is the case and a slowdown occurs, we should in the first case expect a deflationary environment where Government Debt outperforms the stock market. Even though Government Bond Yields are near all-time lows (which means high prices) they could go even lower.



The idea that shares will underperform seems even more likely when we consider the relationship between earnings and share prices; earnings are the profits that Company's achieve, if we see a recession these earnings could decline, a decline in earnings means investors are unwilling to pay as much for the Company shares so the price declines.

1 Source Adviser Perspectives 21st Jan 2019

Earnings long term trend has been upwards, but there are cycles, and we certainly appear to now be at a peak in the US where earnings have been significantly above trend. The previous peaks in 2000 and 2007 saw earnings decline, a recession and a savage sell off for equities (this may well have already started again).



A deflationary environment would prove very unpleasant, but what comes after that is probably even more worrying. If Central Banks feel QE is failing but they want to continue their commitment to stimulus programmes to try and support growth, then what are the next steps?

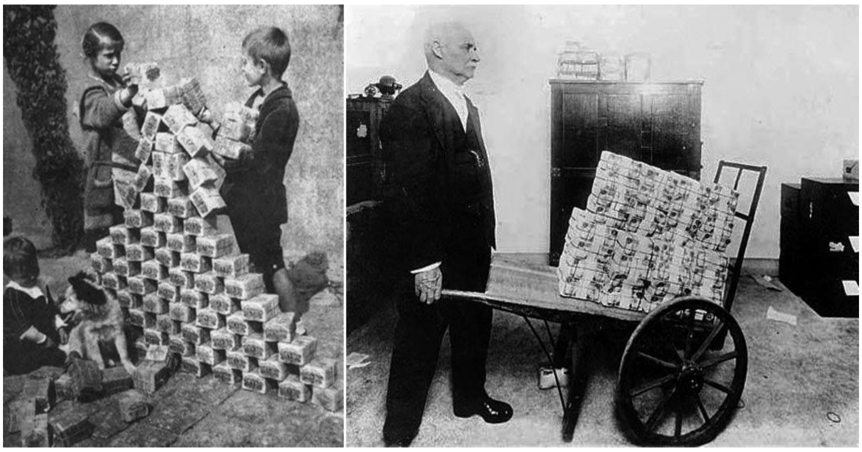
There is the possibility of "Helicopter Money" which is an unorthodox tool that bypasses the Financial Institutions and puts money in the hands of the consumer to spend.

This is a complex area with a lot of unknowns; currency devaluation is probable with deflationary and then inflationary outcomes both a possibility – probably in that order.

There is also the risk that the heavily indebted consumer doesn't spend the helicopter money but instead decides to be sensible and pays down the huge levels of debt they have racked up. The results could leave us with a real dilemma…

Prepare for deflationary Ice Age?

Prepare for Weimar Republic Inflation?



Whilst the risk of either will rise if we see Helicopter Money the probability of deflation and then inflation seem likely; there is also the possibility of something in between! As you can see, the investment decisions we face are not only difficult but extremely complex and littered with Donald Rumsfeld's "unknown unknowns"! [2]

[2] In February 2002, Donald Rumsfeld, the then US Secretary of State for Defence, stated at a Defence Department briefing: 'There are known knowns. There are things we know that we know. There are known unknowns. That is to say, there are things that we now know we don't know. But there are also unknown unknowns. There are things we do not know we don't know.

How Can We Prepare?

It would be unrealistic of us to suggest that this is a great time to be an investor – it's not – but that doesn't mean we should give up and hide the money under the mattress. The good news is that there are strategies we can follow now and strategies that we will follow when conditions become more favourable. However, in the current climate we must accept the likelihood of lower returns and higher risk; we therefore need to be patient and wait for conditions that will generate stronger long term returns with less risk.

Stage One – Protection

This is our current position and we feel that holding a more conservative combination of assets will allow a reasonable rate of return without excessive risk. At the same time, we can also be prepared for opportunities that arise. Depending on attitude to risk we would expect portfolios[3] to be allocated as follows: -

Asset	Defensive Portfolio	Balanced Portfolio
Cash	35%	25%
Emerging Market Equities	0%	9%
Far East Equities	0%	3%
Gold	4%	4%
Global Equities	11%	16%
Hedge Funds	6%	9%
Japanese Equities	3%	3%
Multi Asset Funds	18%	12%
Private Equity	3%	3%
UK Index Linked Gilts	4%	3%
UK Equities	4%	4%
US Treasuries	4%	3%
US Treasury Inflation Protected Securities	8%	6%

Both have similar characteristics; the Defensive Portfolio is representative of an investor more focused on capital preservation, perhaps with an investment term of five years. In contrast the Balanced Portfolio would suit an investor more willing to accept a higher level of volatility who would be thinking of investing over ten years or more.

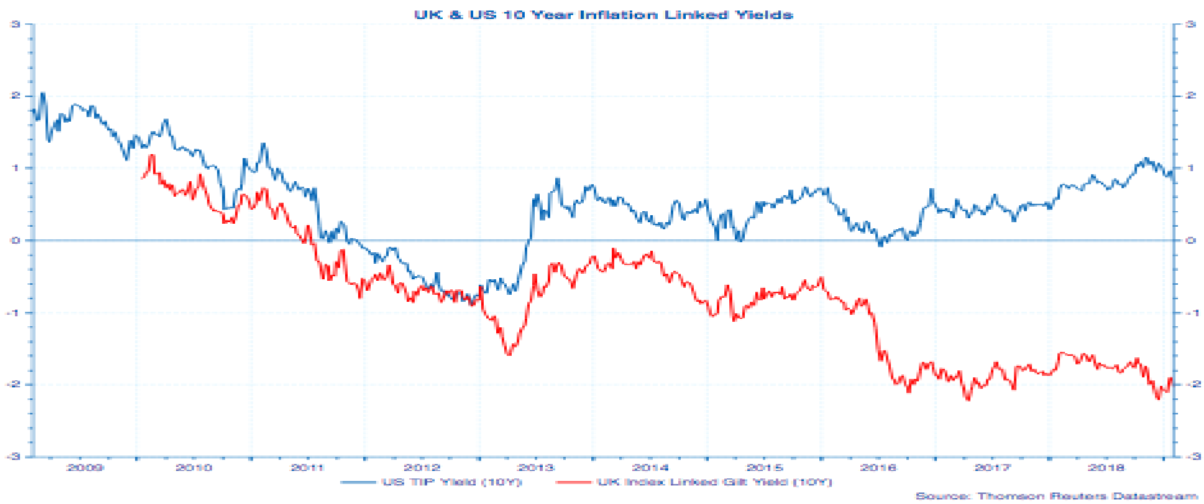
[3] Model Portfolio allocations are based on our current views and recent Investment Committee discussions in January 2019 – these are not fixed and will change over time

The following provides a short summary of our thinking behind some of the key components and why they may be suitable stage one.

Cash – this provides protection from market volatility as capital values remain intact; it also offers liquidity that can be invested as opportunities arise.

Gold – this can be quite a divisive holding with critics citing its lack of income and "goldbugs" it's worth as a store of value dating back to Roman times. Our view is that it could provide protection against inflation or deflation. Whilst it is not perfect by any stretch of the imagination, its value as a "safe haven" asset makes it an essential part of our plans. If we see inflation investors worried about maintaining purchasing power look to Gold; if we see deflation characterised by poor investor sentiment, a weak economy and a decline in the value of currencies, again investors will turn to Gold. The real prospect of Helicopter Money that would almost definitely devalue currencies making Gold an attractive option.

Index Linked Gilts & US Treasury Inflation Protected Securities – both of these offer us not only protection against rising inflation as their capital and income rises with RPI in the UK and CPI in the US, but they can also perform well in a deflationary environment. The reason for this is that at maturity there will be a return of capital the par value. We favour the US equivalent TIPS as they have a positive yield – if a bond has a negative yield if you hold it to redemption it will result in a loss of capital. At the same time "breakeven rates" in the US are currently 1.73%; this means that if inflation is above this level over the next 10 years TIPS will outperform conventional bonds. This makes them ideal for now and stage two.



US Treasuries – unlike the rest of the World, yields on US Treasuries are around 3% as a result of the rise in interest rates. If we were to see deflation, we would expect these to perform well as yields could fall to similar levels to their UK and European counter parts that would see capital values rise.

None of the options that we have are prefect and it is increasingly difficult to diversify a portfolio to protect it from declines in a World where we feel most things are overvalued.

However, we hope this approach coupled with some small positions in opportunities that arise will mean that portfolios can generate a reasonable return in stage one whilst avoiding significant declines in value.

Stage Two – Opportunity

Now for the good news! Whilst inflation and deflation are extremely dangerous for equity prices and we would expect them to decline, these events are then likely to create the opportunity that we have been waiting for.

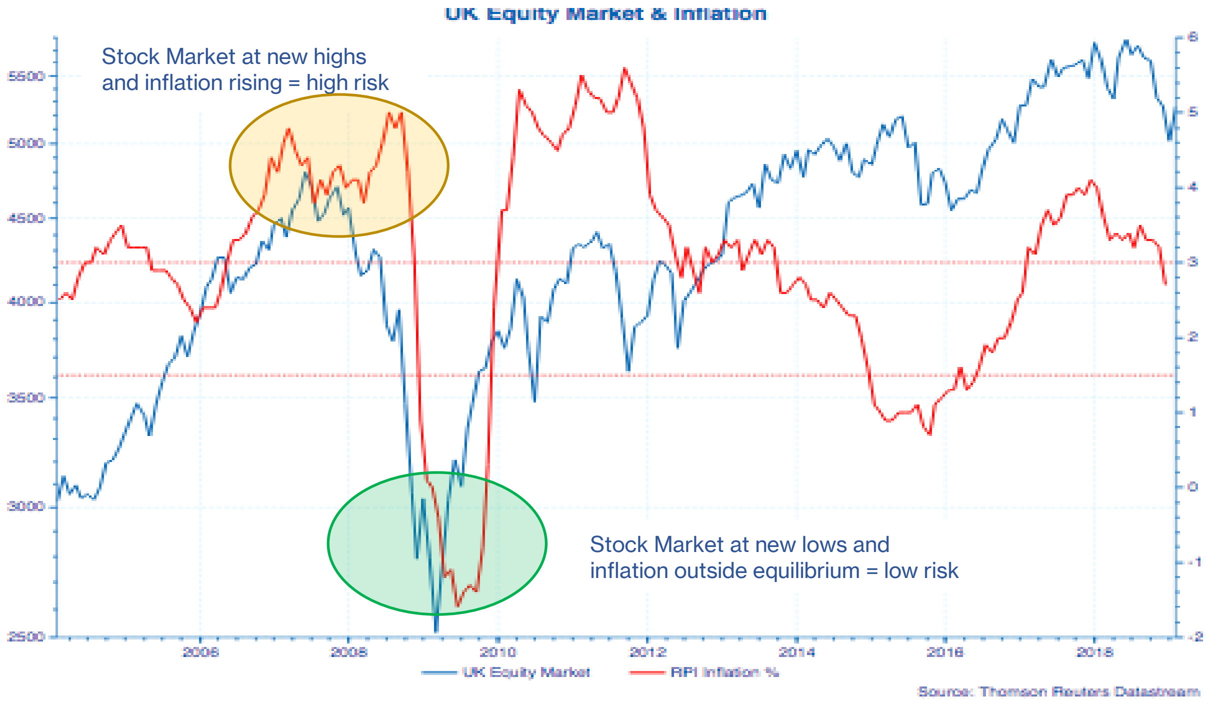
Again, there are numerous factors beyond the scope of this report but if we see inflation move outside of equilibrium as a result of deflation or inflation [4] the stock market is likely to decline.

Once this happens, probably accompanied by a decline in earnings growth, valuations will move lower and investor sentiment become extremely negative. This is the opportunity where we will able to take on risk and recommend investment into equities.

On the next we see a great example; whilst inflation was in equilibrium for the UK at 1.5% to 3% the stock market moved along quite nicely; in 2007-2008 we saw that not only was the Stock Market at new highs but inflation was also outside equilibrium.

The move back down to equilibrium took the Stock Market down to multi-year lows sharply as deflationary conditions took hold and the Financial Crisis accelerated. The result was a great opportunity and the return to equilibrium supported a strong stock market recovery.

[4] Inflation is not our only indicator and a lot of additional analysis takes place behind the scenes.



We saw a repeat of this on a smaller scale in 2014/2015 and may well be seeing the start of something similar now after the new highs in the Stock Market in 2018.

The same is true across most equity markets that we monitor and when we these events occur the asset allocation that we will be recommending is likely to change dramatically; cash and fixed interest holdings will reduce, and the emphasis will shift to equity investment and hopefully the prospect

Hopefully this document provides you with a useful insight into our strategy and thought processes – we hope that we can remain consistent in Stage One and be able to act promptly when Stage Two arrives. We will of course keep you updated!