MARKET COMMENTARY - FEBRUARY 2019

QUILTER CHEVIOT

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Past performance is no guarantee of future returns.

Risk assets recovered strongly in January and – although not recouping all their fourth quarter losses – recorded positive returns. With global economic growth continuing to slow, markets were reassured by the Federal Reserve's signal that US interest rate rises were effectively on hold and the possibility of a face-saving resolution to the US/China trade talks. However, sentiment indicators remained relatively depressed, suggesting a degree of scepticism about the sustainability of the rally.

US equities led the rebound with the S&P 500 up 197 at 2,704 – 15% above its Christmas Eve low. Gains elsewhere were less spectacular with Asia, emerging markets, Europe (FTSE EuroFirst up 80 at 1,411) and Japan (Nikkei 225 up 759 at 20,773) closing around 8% above their respective lows. The UK lagged at 6% with the FTSE 100 rising 241 to 6,968 while the more cyclically orientated FTSE 250 was up 1,210 at 18,711. Having fallen steadily during the fourth quarter and into early January, 10 year bond yields recovered to end little changed at 2.6% on US Treasuries and 1.2% on UK gilts. Corporate bonds rebounded with the equity rally. The likelihood of a delayed Brexit boosted sterling around 3% to $1.32 and €1.15. Oil rallied 15% to $62 a barrel after OPEC and its non-cartel allies – notably Russia – recommitted to limiting output.

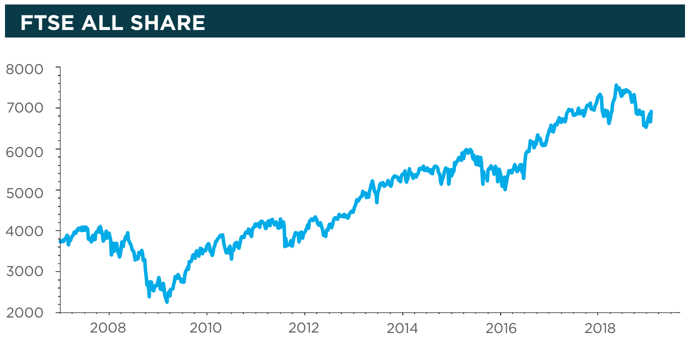
Assuming no further deterioration in trade conditions in 2019, we anticipate a modest fall in global GDP growth from 3.2% to 3%. Most regions will slow apart from the UK and Japan – both of which are starting from a low base. Shipment data and business surveys suggest the manufacturing slowdown has further to go but some of this represents inventory normalisation after 'frontloading' ahead of higher US tariffs. Strong labour markets and rising wages mean consumer spending is well supported even if confidence has waned. Financial conditions will continue to tighten although real interest rates and credit availability remain accommodative with targeted fiscal policy being used when necessary. Trade tensions on agriculture and autos could widen to Japan and the eurozone once a preliminary US/China deal is reached.

We expect that US growth is more robust than estimates suggest, but the government shutdown and lack of official economic data mean this may not be apparent for some time. Q1 GDP is likely to fall from 2.8% in Q4 to 2.1% before accelerating in Q2. Although markets were caught off-guard by the sharp downturn in December's ISM manufacturing new orders component, the forward-looking Philly Fed survey was more encouraging. While the weaker oil price indicates a slowdown in investment and industrial production, consumption remains robust and is being supported by tax cuts, lower gasoline prices, new job creation and wage increases running at 3.1% year-on-year. The latter could well provide the trigger for the Federal Reserve to take a more aggressive approach on monetary policy mid-year.

Q4 GDP in China expanded 6.6% – the slowest rate since 1990. Exports continued to grow for much of 2018 as US companies built up inventories ahead of higher tariffs. However, this trend reversed sharply in December and is likely to continue in Q1. There is also evidence of other pressures including a fall in commitments to outward investment. The pace of policy easing is intensifying and focused on maintaining job creation which should support growth from Q2.

2019 GDP estimates for the eurozone have been cut to 1.2% following weak business surveys in December. The EU economy is highly sensitive to global trade and Germany, France and Italy are facing political as well as economic challenges. Having benefitted from fiscal and monetary stimulus, Spain is the exception, even though it has an unemployment rate of 15% and a fragile minority government. The European Central Bank is likely to be less aggressive than the Federal Reserve in scaling back quantitative easing and is expected to maintain low interest rates for an extended period. This will put pressure on the euro despite the healthy current account surplus.

The UK is stuck in a similar low growth cycle. Short-term stockpiling by industry has boosted manufacturing activity but business investment is contracting and export growth has not kept pace with imports. Disarray over Brexit has knocked consumer confidence and retail sales even though a record 76% of the working population has a job and year-on-year average earnings rose 3.4% - their fastest rate for a decade. It was therefore no great surprise when the



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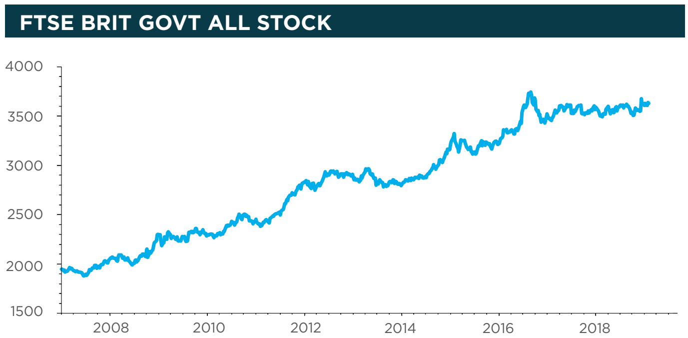

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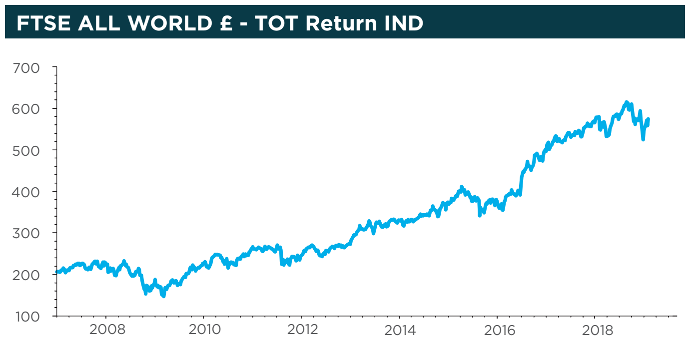

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Bank of England signalled that, if the Brexit transition is relatively smooth, interest rates are likely to rise - possibly in May and November. 2019 GDP estimates of 1.3% are predicated on a 'soft' Brexit - which is far from certain - and the first fiscal boost since the financial crisis.

Progress on the US/China trade talks is key to a sustainable market upturn but, despite both sides now having the motivation to negotiate, the timetable is tight given the 1 March deadline. The economic impact on China has been greater than expected and a confidence boost would improve the effectiveness of its recent policy stimulus. President Trump needs a 'great deal' to deflect attention from the Republican electoral defeat, scrutiny over alleged links to Russia and market weakness that could be correlated with his popularity rating. China has shown a willingness to make concessions on agricultural products but not on industrial policies, the protection of intellectual property or cyber-theft. National security concerns around the technology sector mean uncertainties will continue even though an interim face-saving deal now looks possible.

As the investment cycle matures, central banks tighten monetary policy, and corporate profit growth slows/reverts to normal, financial markets are likely to remain volatile. 1987 and 2018 showed that sizeable equity falls occur without a recession as markets de-rate on fears of slower growth. A rebound usually follows because the cycle does not reverse in the absence of recession – and we see few signs of this. Assuming there is no geopolitical meltdown, our view is that valuations already largely reflect lower GDP and corporate profitability. Since last summer, global earnings per share estimates have fallen from 10% to 6% – one of the steepest declines on record – leaving equities on a forward price earnings multiple of 14x, slightly below the long-term average. We expect markets to continue rewarding 'capex-lite' companies with strong free cash flow (the surplus cash generated net of capital requirements) that will support dividends and/or share buybacks. We have not heard anything during the latest round of corporate results to suggest an imminent or material risk to profits and are therefore maintaining our risk asset exposure.

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