MARKET COMMENTARY - JANUARY 2019

QUILTER CHEVIOT

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2018 was unexpectedly challenging for financial markets, despite a backdrop of above-trend growth and below target inflation. It began with markets in euphoric mood as leading indicators suggested growth momentum would lead to another year of double-digit corporate profit increases. However, following a strong rally in January, concerns about accelerating US wages sparked the first of three corrections during a year of tightening financial conditions, heightened volatility, and losses across most major equity markets. After some relief mid-year, confidence was shaken when the Chairman of the Federal Reserve said US interest rates were still some way below neutral, tension over US/China trade tariffs escalated, a 'no deal' Brexit became a distinct possibility, and budget proposals from new 'populist' Italian government breached EU limits.

Although emerging markets peaked in January and the eurozone in May, the US and Japan did not falter until late September/early October. During Q4, major equity markets fell more than 10%, hitting 2018 lows before Christmas when President Trump tweeted criticism of the Federal Reserve for overly aggressive rate increases and Congress' failure to agree a budget that included funding for a border wall with Mexico resulted in a partial federal government shutdown. Over the quarter, the S&P 500 declined 407 to 2,506, the FTSE Eurofirst300 172 to 1,331, the FTSE100 782 to 6,728 and the Nikkei 225 4,105 to 20,014. Volatility also impacted global bond markets with US yields – particularly at the short end as the curve flattened – rising across the maturity spectrum for most of 2018. In the final weeks, 10 year yields fell sharply from 3.2% to 2.7% leaving them up 25bp over the year. UK gilt yields peaked at 1.3% and also fell during Q4 to close near their 2018 low but, unlike the US, there was little change to the inverted yield curve. Interest rate and growth differentials boosted the dollar against major currencies: over the year it gained 4% against the euro (€1.15) and 5%

against sterling ($1.28). OPEC production constraints helped the price of Brent crude rise to $86 in October before ending the year down 18% at $54 reflecting the waiving of sanctions on Iran and over-supply by Saudi, Russia and the US.

Capital investment by a wide range of companies and stable consumption helped global GDP grow 3.2% in 2018 – similar to 2017 and above the 2.7% long-term average. The gap between industrialised economies (GDP 2.3%) and emerging economies (4.6%) narrowed marginally as the US (2.9%) surprised on the upside boosted by a combination of corporate and personal tax cuts, rising employment, deregulation and repatriation of overseas cash. Growth in Japan (0.8%) and the eurozone (1.9%) was below expectations with both impacted by slowing global trade. Spain, the Netherlands and Ireland were the strongest EU economies but Brexit uncertainty hit UK business investment – and latterly consumer spending – with 1.2% growth the lowest in Europe bar Italy.

The 4.6% recorded by emerging economies – which now account for 60% of global GDP on a purchasing power parity basis – was similar to 2017 with China (6.5%) and India (7.3%) once again well above average. However, although growth was stable in China, the slower expansion of money supply to curb property speculation, rising oil prices in H1 and dollar strength contributed to significantly tighter financial conditions for emerging economies. Fearful of a liquidity crisis, external investors retreated and widening credit spreads and falling equity markets compounded the tightening process. While many emerging economies remain highly sensitive to global trade, external debt levels — apart from notable exceptions such as Argentina, Turkey and South Africa – are less challenging than during previous crises.

Central banks have made no secret of their intention to 'normalise' monetary policy and 2018 saw further progress towards this target. The Federal Reserve started three years ago and has steadily raised interest rates – most recently to 2.5% in December, the fourth increase for the year. It has also been shrinking its balance sheet as a percentage of GDP through quantitative tightening. While there is a disparity between the Fed's 'dot plot' guidance of a 3% neutral rate and market pricing, policy overall is not yet restrictive. As the European Central Bank and Bank of Japan have been slower to follow suit, monetary policy for the G10 economies has remained highly accommodative and helped to sustain a longer than average, albeit sub-par, economic expansion. Low global inflation has been a contributory factor and, despite increased employment, remains within most central bank targets.

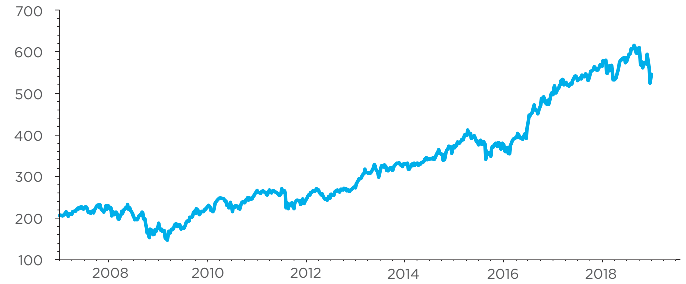
FTSE ALL SHARE

Source: Thomson Reuters Datastream 03/01/2019

FTSE BRIT GOVT ALL STOCK

Source: Thomson Reuters Datastream 03/01/2019

FTSE ALL WORLD £ - TOT Return IND



Source: Thomson Reuters Datastream 03/01/2019

Mrs May's inability to gain widespread support for her Brexit deal caused a political crisis in the UK at the end of Q4. However, as the divisions are not neatly defined along party lines, they are very unlikely to be resolved by a change of leadership or a general election. The parliamentary vote on the deal has been delayed but it could still gain approval given politicians are under extreme pressure to deliver Brexit. The alternative is a 'no deal' exit or to request an extension of EU membership under the terms of Article 50. The latter would probably only be granted if there was another referendum with an option to remain. While the electorate is now rather better informed about the potential economic consequences than in June 2016, the lack of an alternative plan suggests a second referendum is unlikely to produce a decisive result. In the absence of a disruptive 'no deal', there is scope for economic upside as expectations are so low.

2018 was another strong year for corporate profits with global earnings increasing 16%. Although a number of one-off factors helped to boost US earnings (+23%), Europe, the UK and Japan also produced rises of 10% or more while Asia and emerging markets lagged at around 7%. Aside from disproportionate gains as energy companies recovered from the oil price downturn, most sectors generated double-digit increases with materials, technology and financials all close to 20%. By contrast, consumer staples, utilities and real estate only managed small rises. Share price performance did not follow the same pattern in either magnitude or, in some cases, direction as tighter financial conditions prompted investors to start discounting the next recession. This in turn led to a significant valuation de-rating. Across global markets, financials (particularly banks) were the major negative contributors followed by industrials and consumer discretionary. For UK investors, oil and pharma were the largest positive contributors while the usually defensive tobacco sector was a significant laggard on stock specific developments.

2019 begins with markets in an unsettled mood after a period of weaker than expected economic data and uncertainty over central bank liquidity support. We agree with the consensus view that global economic growth is likely to be around 3% but stress that this is not recession territory. The main contributors will, as usual, be the US consumer and China with Japan and Europe likely to lag by a considerable margin. The lingering impact of US tax cuts will help support activity in the first half of the year, as will fiscal stimulus measures in China and, to a lesser extent, Europe where austerity is being eased in France, Italy and the UK. Central banks - including the European Central Bank - will aim to reduce net asset purchases and move towards neutral real interest rates but there is no need for restrictive conditions. Employment and wages have been increasing modestly – which we see as 'good' growth – and lower oil prices will provide short-term relief for headline inflation. Monetary policy moves have been well flagged – albeit they are data dependent – which is more than can be said for geopolitics in the US, Europe and China where policy mistakes threaten to disrupt the global supply chain. Analyst estimates for global earnings growth of 7% (UK 5% ex commodities) in 2019 are predicated on robust consumer demand, above average growth in financials and, outside the US, recovery in industrials/cyclicals. While there may be some downward revisions, valuations of 13 times earnings are at the low end of their long-term range and appear to be discounting an unusually gloomy outlook.

QUILTER CHEVIOT
Head Office
One Kingsway
London WC2B 6AN

Please contact our
Marketing Department
on +44 (0)20 7150 4000 or email
marketing@quiltercheviot.com

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