

Reflections & Insight

QUARTER TWO 2019



“Blessed are the young, for they will inherit the national debt.” *Herbert Hoover*

After a dismal end to 2018, the New Year began on a pessimistic note. Too pessimistic, as it turned out, with markets posting very healthy gains right from the off and delivering a handsome outturn for the first quarter.

What changed? At the end of last year, it seemed to be clear that the path of interest rates in the US would continue upwards despite expectations that economic activity would be a bit lacklustre. All the talk was of quantitative tightening as the mood music for the year ahead, and equity markets in particular were unimpressed. It became clear in January, though, that a slew of weaker economic data persuaded the monetary authorities in the US that they had been wrong and that a more dovish stance was required. Having guided investors to expect a ‘normalization’ of interest rates, we were instead, and rather suddenly, facing the prospect of no further rises, weaker economic activity and subdued inflation. Déjà vu all over again, as the Americans say.

Notwithstanding hints of political interference in the affairs of the Fed, this was enough to trigger a strong equity market rally, with most of the fourth quarter losses being recovered. While data in the US were a bit flat, confused by a Government shutdown associated with Trumpian posturing over the border wall, elsewhere, things were worse. In the Eurozone, the German economy sputtered, while the Italian economy entered a technical recession. Germany and its satellites were affected by weakness in China lowering demand for exports, and in these circumstances, a tighter monetary policy around the world was bound to be unhelpful to risk assets. Relief all round, therefore, that instead of applying the brake more firmly, a light touch on the accelerator was deemed the most appropriate way of navigating the course.

In the UK, of course, we continued to wrestle with our own demons, and at the time of writing, we still do not know what the future relationship with the EU will look like. What we do know is that the uncertainty has probably cost the economy more than 2% since the referendum in 2016.

That was then. It seems like another era, but at the end of 2018, markets were worried about rate increases and the implications of that as the profits boost from tax cuts began to fade and kick the prop from under earnings growth. This is now. In the new environment, it was not only equity markets which rallied strongly, but bond markets as well.

This caused some Government bond yield curves to invert. This is another piece of financial market jargon which means that yields with longer maturities trade at lower yields than those with short maturities. This is often seen as indicating trouble ahead for the economy. The reason is that you would normally expect to be paid a premium for taking on the additional risk of lending money for a longer period. When that changes, it can be a sign that financial intermediaries (like banks), who borrow at the short end of the curve and lend long, suffer a margin squeeze (they are having to pay more for their short-term funding and receiving less interest on what they lend) and that influences the flow of credit, making it less readily available. In turn, this starts to choke the economic plumbing and in due course has a negative effect on economic growth.

The equity markets have approached the inversion (in some cases near inversion) of yield curves with some caution, while looking for plausible reasons why this time round things might be different. In fact, there are a couple of reasons to suggest that the normal dynamic may not be in play. The first is that interest rates are so low that investors are prepared to pay a premium to hold longer dated assets – giving them a lower income but with security; the second is that central bank behaviour has distorted the shape of the yield curve – they have been artificially suppressing long-term rates through the various forms of QE.

Of course, investors like simple indicators which give clear messages. In the past, the inversion of the yield curve has been a reliable indicator of worsening conditions 18-24 months out. It is usually associated with other economic excesses, which typify a late cycle boom. These are not much present at the moment, but the amount of ink spilled worrying about this issue is a measure of the underlying worry still plaguing markets.

We do know that economies are cyclical animals and that therefore a recession lurks in the undergrowth, but the balance of probabilities suggests that the change in monetary stance at the beginning of this year has kicked the can a bit further down the road. This is of course to some extent a measure of the concern Central Banks feel about the ability of the global economy to weather a significant slowdown and the implications for financial stability. In other words, it is not entirely reassuring that policy has changed as it has.

One concern which weighed heavily on markets last year was a significant slowdown in the Chinese economy. In these reviews we have noted the intention of the authorities there to balance the economy more towards consumption and away from growth led by capital investment and exports. At the best of times, this is a tricky act to pull off, and when you throw into the mix a trade spat, the outcome becomes even less predictable. To address both the uncertainty and a deceleration of the growth rate, there have been more than seventy measures introduced to add stimulus to the economy in the direction desired by policy. Investors have a touching faith in the ability of the Chinese government with its technocratic approach to achieve the most finely balanced outcomes. The reality is that if you end up somewhere on the target, you will have done well, and there is little doubt that statistics are manipulated to make things look closer to the 'plan'.

Nevertheless, it does look as if the stimulus measures are beginning to gain traction. Higher and better balanced growth in China, possibly combined with some face-saving compromise on trade, will improve sentiment sharply. It will also take pressure off Germany and, by extension, other Eurozone countries and be a significant positive across Asia.

Putting all this together, it looks as if the slowdown which was gathering steam in the second half of 2018 has come to a halt, and the outlook for the balance of 2019 and 2020 is somewhat more positive. Furthermore, in that environment, investors would have been expecting a less generous monetary policy, which is instead now supporting risk asset prices. This is a setting

which is broadly positive for equity markets, and less encouraging for bond markets.

Typically, the end of long expansionary cycles of the sort investors have been in since 2009, are accompanied by wild excesses. Valuations are often sky high; there is a boom in some fashionable stock market area; housing markets are overheating; and inflation is picking up. How do we stack up today against these yardsticks?

Valuations are high, but arguably not excessively so when adjusted for the level of interest rates. Technology has been the boom area, but here, the risk of regulation looms and disruption creates as many losers as winners. As an aside, it is worth noting that the major gains in the technology sector are mostly captured by investors who are involved before a new 'unicorn' comes to market. Returns are not 'democratically' available. Housing markets are patchy around the world and certainly not redolent of a boom. Inflation is absent. Indeed, the failure of current policies to achieve inflation targets is a surprise given the strength of labour markets. There are a number of theories as to why this is happening, from increasing labour force participation (i.e. a bigger percentage of the population in work) to a productivity improvement driven by a new capital spending cycle (especially in the US).

In any event, there appears to be some slack in the economy and markets are cautiously optimistic rather than wildly bullish. These are not the factors which characterize market tops.

The investment background is thus somewhat more positive than was the case three months ago, but it is not a time for screaming bullishness. We must remember that this economic expansion is long in the tooth and that profits will struggle to grow at historic rates. Valuations don't offer much upside but are not flashing red. Geographically, a balanced global approach is warranted. US markets have led the world throughout this cycle, and it is there that the weight of excellent businesses is heaviest. At the same time, the economic momentum is likely to be stronger in Europe and Asia as these regions benefit more directly from a Chinese recovery. Anomalies exist in two areas. First, Emerging Markets are cheap by historic standards and are likely to benefit from greater economic momentum around the world. This looks like a good time to gain exposure there. Second, the UK is cheap, reflecting the political shambles and the twin risks of BREXIT and a Corbyn government. It is nevertheless dangerous to base an investment policy on a positive solution to that conundrum.

This document includes information concerning financial markets that was developed at a particular point in time. This information is subject to change at any time, without notice, and without update. This commentary may also include forward looking statements concerning anticipated results, circumstances, and expectations regarding future events. Forward-looking statements require assumptions to be made and are, therefore, subject to inherent risks and uncertainties. There is significant risk that predictions and other forward looking statements will not prove to be accurate. Investing involves risk. Equity markets are volatile and will increase and decrease in response to economic, political, regulatory and other developments. The risks and potential rewards are usually greater for small companies and companies located in emerging markets. Bond markets and fixed-income securities are sensitive to interest rate movements. Inflation, credit and default risks are all associated with fixed income securities. Diversification may not protect against market risk and loss of principal may result. Certain information contained in this document has been obtained from external parties which we believe to be reliable, however we cannot guarantee its accuracy. This presentation is for general purposes only and does not constitute investment, legal, accounting, tax advice or a recommendation to buy, sell or hold a security. It is only intended for the audience to whom it has been distributed and may not be reproduced or redistributed without the consent of Guardian Capital LP or GuardCap Asset Management Limited. GuardCap Asset Management Limited is a wholly-owned subsidiary of Guardian Capital Group Limited which is a publicly traded firm listed on the Toronto Stock Exchange. For further information on Guardian Capital LP or GuardCap Asset Management Limited, please visit www.guardiancapitallp.com or www.guardcap.co.uk.