WATTERSON
FINANCIAL PLANNING

Market Update

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SQUARE MILE
INVESTMENT SERVICES

"Britain can be cancelled, top EU lawyer says" - so blundered a headline writer on CNN's website. However, it sometimes feels like it. A divided nation, a crippled Government and a Leader of the Opposition who transparently covets investors' hard earned savings. It is perhaps not a surprise therefore that this has been the worst year for UK financial markets since the Great Recession in 2008 and the FTSE 100 is back down to a level first seen in 1999. Over the quarter the FTSE All Share index slumped by 10%. Thankfully we have positioned portfolios cautiously with less exposure to equities and more in cash than we might normally hold, and this has helped protect your portfolio from the worst of the falls. Nevertheless, this was an unpleasant quarter and it has left the portfolio in negative territory over the year. Very few investors made money over 2018 from financial markets.

Perversely, the principal cause of the markets' woes were not UK related but more global in nature, and in particular, American. Stock markets began the quarter on a weak footing as they digested the implications of rising US interest rates, only for the falls to intensify towards the end of the quarter as concerns emerged about the sustainability of economic growth. In fact, Wall Street suffered its weakest Christmas trading period on record and the world index suffered similar losses to the FTSE All Share index. Profits growth over 2018 has been exceptionally strong and investors had been counting on the trend continuing through 2019. As the pace of economic growth falters, these projections are being reassessed.

Cheaper equity market valuations may lead to opportunities

We have been concerned for some time about the threats facing the economy ranging from high debt levels, the structural issues faced in Europe and Trump's 'unconventional' Presidential approach. This has made us feel uncomfortable paying the expensive prices at which financial assets were trading and we have held higher levels of cash than normal. The current market turmoil has left equity prices at more interesting levels if the current level of corporate profitability can be sustained. Investors have been much more circumspect about UK shares, understandably so given Brexit and the shadow cast by Corbyn in the background. The UK stockmarket has fallen at the same pace as global markets this quarter and UK shares are now trading at below average prices, both relative to other markets and to their own history. This potentially leaves them attractive.

There have been few places to hide outside of cash during this market turmoil. Fortunately we have managed to avoid the worst parts of the markets and the areas which we have favoured, such as emerging market equities, actually held up relatively well over the quarter. At the beginning of 2018, we switched a significant proportion of our UK equity exposure into a tracker fund and this proved helpful over the year since it outperformed over 70% of the actively run UK funds. Even more pleasing, was that the two UK active funds that we retained, LF Lindsell Train UK Equity and Jupiter UK Special Situations did even better, outperforming the market index by 8% and 2% respectively. This has all helped us to limit the losses in what has been a difficult period.

We have been right to be cautious over the last year at a time when others have been more optimistic. Now that others are becoming more cautious, should we be becoming more optimistic? It is becoming much harder to justify a cautious portfolio position based on the current valuations. However crucial to this question is whether we believe that economies are entering a recession. If growth turns negative, profits will be shattered. Thankfully we see little evidence to support this notion, although we cannot ignore the possibility entirely. However, our experience tells us that a sudden change in expectations such as we have just experienced, tends to have a fairly immediate short term impact on profits. This won't help what are already frayed investor nerves and our instincts warn us that markets may still weaken further from here. If they do, we will see this as an opportunity and we are preparing to drip feed cash into the equity market at what will hopefully transpire to be attractive valuations.

This does not mean that risks have gone away. Brexit remains an unknowable, the trade war needs to be kept under control and the interest rate outlook is uncertain. An emerging issue is the US budget deficit. The recent massive tax cuts have not been matched by spending cuts and the shortfall is being made up by ever more borrowing. However, the recent market falls combined with the strong profits growth seen over 2018 have left stockmarkets much more attractively valued than has been the case recently. The risks for investors have not gone away, they never do. However the fall in valuations has made the potential long term returns more attractive and this is encouraging if we can look through the uncomfortable short term market noise.

Important Information