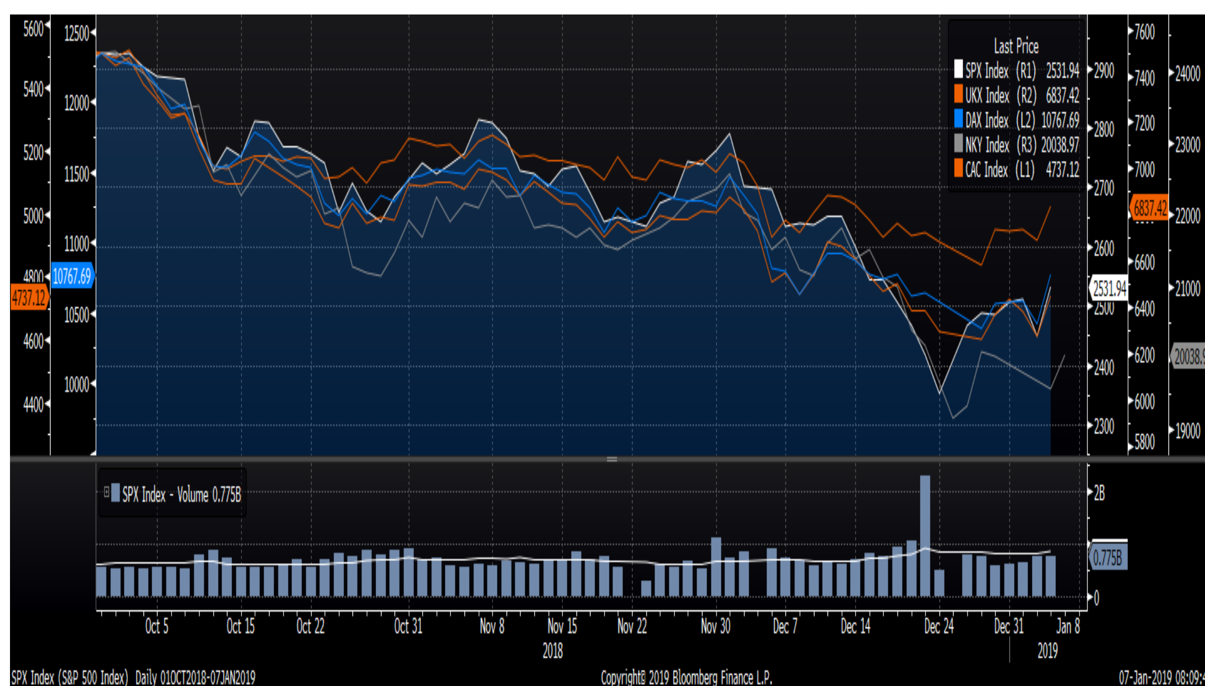
Market Review (30.04.19)

Last quarter, the actions (or inaction) of the US Federal Reserve, the European Central Bank (ECB) and the UK Parliament, prompted the MPL Investment Team to delay making the adjustments to client portfolios discussed in our last letter to you.

In the US the Federal Reserve paused plans to keep on raising interest rates, the ECB extended their current monetary policy quantitative easing by a further year, and here in the UK, the 29th of March, D-Day for the UK's exit from the European Union came and went, with everybody concerned none-the-wiser as to what this exit will look like and indeed when it will happen.

Due to the fluid nature of global financial markets in the short term, the above factors have been viewed by market participants as accommodative, with markets in these regions and indeed globally, moving higher accordingly.

US S&P 500 Index vs. FTSE 100; the DAX 30 (Germany); Nikkei 225 (Japan); and CAC 40 (France) January 2019 to Present



Source: Bloomberg

The pause in the US interest rate cycle and indications from the Fed that it will hold US interest rates steady at 2.25 per cent to 2.5 per cent through this year following four rises in 2018, has led to increased market expectations of a rate cut by the end of this year. This is accommodative not only to companies who would have lower debt interest obligations and hence higher earnings in the event of a rate cut, but also overseas companies who are reliant upon the US dollar to trade. Such companies will benefit financially from the resulting lower cost of these dollars, again a factor which will enhance their earnings and indeed their market valuations.

US financial markets across the board have benefited in the short term from this communication, as well as overseas companies in Asia and Emerging markets.

The ECB extension of their quantitative easing program (TARP) has benefited European companies for whom earnings may have been squeezed in the event of the imposition of tighter monetary conditions this year by the ECB.

The impact of the UK's ongoing battle regarding Brexit has recently led to some market debate as to whether UK equity markets are now traded at circa 20-30% below where they should be. If we have some certainty on the future of UK Plc, this discount should close.

Ongoing delays to our exit from the EU (TBA) have increased the chances of a "soft" Brexit (TBC), hence UK markets have rallied as the estimated earnings outlook for UK companies have been revised upwards (in the ultra-short term) resulting in this recent rally in UK markets.

Fear is still with us, however.

Whilst the above factors have been accommodative for global financial markets in the short term, in the US the pause in the Fed's monetary policy, has left some investors questioning whether the Fed's actions are now telling us something about the health of the US economy.

This has been played out in the US bond markets which at present show the 10 year and 2-year yield curve spread 6 basis points away from inversion. An inversion here would indicate that the US business cycle is near its peak. From history this signal has given an 18-month warning of an impending recession in the US.

We highlighted in our last letter that US economic indicators were still indicating expanding economic growth albeit at a slower rate, rather than a significant recessionary slowdown. This has been supported by a strong jobs figure last week which came in at 186,000.

However, forward earnings estimates are diminishing as a result of cuts to profit margin estimates. The boost from the Trump tax cuts now wearing off and any potential trade deal between the US and China is largely priced into markets, and some company valuations are now starting to look fully valued on 2019 earnings expectations.

The length of any delay to Article 50 in the Brexit negotiations with the EU, or indeed the shape of any deal struck with the EU, will have an impact upon the forward earnings estimates for UK companies, and the current rally could be halted in the event that any of these factors are viewed negatively.

As we approach the summer months, the MPL Investment Team will initiate the actions discussed in our last letter, reducing the sensitivity to US equity markets in the face of these headwinds.

Portfolio Allocation

Holdings in areas such as Information Technology, US Mid and Large cap, and Japanese equities, will be reduced or sold due to earnings expectations for the year ended 2019 in these areas, being largely priced into current valuations, which means that downside risk is now higher than upside risks here.

Underperforming areas such as the F&C Commercial Property Trust will also be sold. There were two company voluntary arrangements (CVA's) in the retail area of the F&C Commercial property trust portfolio, which suggests a deterioration in the quality of tenant composition in the portfolio of which retail forms 36%.

Holdings in the healthcare sector (AXA Framlington Biotech and the iShares Nasdaq biotechnology index ETF), will be increased as there is still some upside to valuations in this more defensive area, when considering full year earnings expectations for 2019.

Value also remains in Asian and Emerging Market equities, which are cheaper than US equity markets at present. Companies in these regions have benefitted from the accommodative environment discussed above and have to potential to outperform if the US interest rate cycle has peaked, as this will result in a cheaper US Dollar which is beneficial to companies in this region as it is used as a reserve currency.