

Reflections & Insight

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“You can’t take it with you, and even if you did, it would probably melt.” Dorothy Parker on money

The combination of rises in US interest rates, less robust economic news around the world and the stepping back of quantitative easing (QE) were enough to deliver a poor fourth quarter in capital markets. Indeed, the absence of the usual ‘Santa’ year-end rally led to this December being the worst for US equity markets since 1931.

Investors have been wondering for a while what would happen if interest rates started to normalise at a time when the punchbowl was being removed, and now we know. Markets go down and volatility goes up. Perhaps the most surprising thing about this is that it is surprising. The good times have been rolling for so long now that there are not many participants in the investment world who have any experience of a more conventional economic cycle, and what we are seeing now is precisely normal in the context of history.

It is so easy to get lost in the arcane world of central banking that confusion between QE, its evil twin QT (quantitative tightening) and its irritating cousin the ‘taper’ is understandable. Easier to see and to understand is what is happening to interest rates, and they have been going up (in the US particularly) – not a surprise as there has been a big long standing headline from the Fed telling us that was what they were going to do. In such circumstances, it would be reasonable to suppose that these rate rises were factored into prices. Maybe they were, but the weight of other news was clearly not.

Starting with QE, the Fed has been clear that it intended to start shrinking its balance sheet and indeed began to do so in the autumn. This may sound technical but it starts to reverse one of the most important props of the bull market. The effect of the change in policy is that it removes a source of liquidity from the markets. Liquidity is investment jargon shorthand for the money sloshing around the system which is available to buy assets (and so support prices). Liquidity comes from all sorts of places (profits, excess savings, tax cuts etc.) but a large lake of it was provided by central banks globally to help the

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world recover from the 2008 financial crisis. It may surprise many to know that the measures introduced then are still in play around the world, to a greater or lesser extent. This reflects the unfortunate reality that the global economy is still somewhat fragile and nobody really knows how it would cope with a significant slowdown. The reason that the Fed began to remove QE is that it judges the US financial system (and especially its banking system) to be robust enough to take some strain and buy the authorities some headroom for when the economy does turn down. It would be normal for interest rates to fall in the event of an economic downturn, but with levels already low, room is limited, especially in Europe, and given very loose fiscal policy (tax cuts), especially in the US, there isn't much room for that type of stimulus either.

In essence though, the markets are disturbed by the conflict between a tighter monetary policy and some weakness in the real economy. This can be seen in the fact that forward markets are pricing in a decline in the rate of inflation and a standstill in rate rises (or even a cut), while the rhetoric of central banks continues to point in the other direction. This contradiction between market perception and central bank policy is quite unusual.

Nor is QT the only thing out there. We also have a slew of geopolitical worry (often rehearsed in these reviews) and less than robust economies in the Eurozone and most recently in China. The importance of this last cannot be overstated as China is now the world's largest economy (depending on how you measure it) and relevant to everyone's wellbeing. While growth there remains high by global standards, it has been slipping - the leading economic indicators have turned down while debt is very high and heavily directed by the state. Exports have softened in the face of tariffs and the country's strategic and economic ambitions are subject to a much higher level of scrutiny than hitherto. The effects of this are visible in Apple's recent problems. The response has been for the system to strengthen its control, not only of sectors where it is the major actor, but in the private sector as well. These changes will have consequences, but are likely to act as something of a brake on growth rates, even

though some measures to stimulate the economy are in train.

To add to this already heady brew, Trump mused about sacking Powell, the Chairman of the Fed, and it is hard to imagine a scenario more likely to frighten the horses; US politics looks ever more poisonous and partisan; and energy prices have collapsed. Bond spreads have widened and the yield curve has flattened, both indicators of heightened risk. On the other side of the Atlantic (groan) we still don't know what Brexit means.

It isn't unusual for there to be a vast number of forces weighing on asset prices, and it is always hard to identify the straw which breaks the camel's back. The point about the straw, of course, is that it doesn't need to be anything weighty. Markets are dynamic and chaotic systems and the belief they can be understood and captured is arrogant in the extreme.

There are two further questions to consider. The first is to do with the extent of the setback; the second with whether it has any predictive content.

Turning to the decline, which measured 13% USD in the fourth quarter as measured by the Global index, markets turned very quickly from nonchalant optimism to visceral fear. The reaction may tell us something about what are known in the jargon as 'crowded trades'. These are portfolio positions where almost all market participants have 'skin in the game'. When something shifts, they all head for the exit at the same time and the car crash that results is pretty much what we had in December. The most 'crowded trade' of last year was the technology sector (known these days by its acronym - the FAANG's). Investors in these stocks often didn't own the stocks themselves, but held ETF's or other forms of (sometimes) leveraged derivatives. When prices break, some of the selling is forced by margin calls, some is driven by redemption and some is sheer panic. You might think that there would be investors looking to snap up a bargain at much lower valuations, and while there are a few, they are outnumbered by the herd.

Looking at the long term, declines like this are far from unusual. There have been seven occasions since the Second World War when the market fell

between 20 and 30 percent without the added impetus of a recession. When a recession has been involved, the decline has more typically been higher, averaging in the 30's. More recently, of course, significant declines have been thin on the ground. Between April and October 2011, the US market fell by 19%, but recovered pretty sharply in an environment of plentiful liquidity.

This brings us to the second question. Stock markets are supposed to be engines of prediction, although they are famously said to have predicted nine out of the last five recessions. What about this time? The current economic expansion is now 120 months old, and if it survives another year, it will be the longest on the historic record. Most of the leading indicators of a recession are not in worrying territory in the US, but are more mixed when looking at the global picture. Earnings for the year just closed will be robust across the world and while forecasts are slipping for the current year, they still posit decent growth, underpinned by a respectable outturn for GDP. In November, markets expected two interest rate increases in the US in 2019 and have now changed their mind, expecting no further increases instead. This tells us that the market is beginning to think that 2019 will see the economic picture deteriorate from its current consensus and that a recession may be lurking out there somewhere.

As we know, predicting the future is a mug's game. We do know that at some point, there will be a recession, but the most likely outcome is that we won't know we are in one until sometime after it has started. We also know that the global economy is still somewhat fragile, that debt levels remain elevated but that policymakers have some tools to deal with a slowdown even when interest rate are near zero. All of this suggests that the current

market setback, whatever its cause, is a fairly major attack of the collywobbles and not necessarily a harbinger of doom. It is quite possible that it has reset expectations at too pessimistic a level. Nevertheless, the data will need to be watched closely as the cycle matures.

One concern which has marked reviews in the past has been valuation. This is no longer much of a problem anywhere, unless you wish to make it so – there are always cyclically adjusted measures which make things look expensive. As has been said before, valuation on its own is never a reason to buy or to sell, but it does contain information about the level of return you can expect from an investment over the long run. Other things being equal, buying something at a low valuation embeds a higher potential return than buying the same asset at a high valuation. Where we are today is, therefore, a cause for cheer. In order to maximise that cheer, and given the maturity of the current cycle, it is important to emphasise quality and growth in portfolios – quality because it builds in some shelter and growth because it will be harder to come by.

A Cook's tour of the world will throw up some anomalies, particularly in emerging markets, but we should note that global markets are quite tightly correlated, reflecting tighter integration of global businesses. That does not mean that in smaller companies, for example, there are not opportunities exposed to a particular domestic economy, and these have a role in portfolios in all regions. Lastly this remains a time to search for assets which are uncorrelated. Traditionally, bond markets have been the first port of call for these, but nowadays, they often trade directionally with equity markets, so it is important to cast the net widely.

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