Psigma
Investment Management

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View from Psigma
VALUATION COMMENTARY

Tom Becket
Chief Investment Officer

The first quarter of 2019 brought a major recovery in asset markets, which served as a welcome tonic for nervous investors following the challenges of the final quarter of 2018 and the poor performance of many asset classes last year.

All markets around the world rallied in an extraordinary period of synchronised gains, with equities enjoying their best start to the year since 1987. Whilst equity markets snatched the "yellow jersey" we witnessed a complete reversal of the widespread losses of 2018, with all the major asset markets across the risk spectrum posting positive gains.

The Economic Engine Splutters

In direct contrast to the pervasive strength in asset markets, the global economy suffered a period of sluggish growth, with a slowdown most obviously taking place in all of the export-focused economies of Asia and Europe. As yet there has been no clear sign of recovery appearing in the mercantilist economies and the most recent data points suggest that the slowdown has become more entrenched than anyone was expecting. Even the previously strong US economy saw growth ratchet down to a slower rate over the last few months, as the global economy slumped down through the gears, thereby affecting the US at a time when the positive effects of the Trump administration's fiscal push from last year started to wane.

Growth Peaked in 2018

Our view from the start of this year was that 2018 saw the peak of growth for this economic cycle and we fully expected the slowdown that we are now experiencing. Our view was also that the global economy would see its growth rate fall back towards "trend" levels of growth from the overachieving levels of the last eighteen months. However, we believe medium-term trend growth of the global economy is below consensus and that sustainable growth from the global economy is around 2.5% real GDP growth; previously the trend growth rate of the world was more like 3.5%.

Balancing the Short and the Long Term

Our expectations for lower economic growth are built around the poor demographics that we are seeing across the developed world, high levels of outstanding debt that exist and lower levels of productivity. There is a chance that these negative factors improve but it would have to be an historic effort, and the trends of the last few decades would have to be reversed. That being said, short term growth could reach a trough in the coming months. There has been a combination of monetary stimulus and fiscal support that could support growth and prevent a major economic downturn, with this improvement already priced into risky asset markets. If there is disappointment in the coming months and momentum does not start to improve, then we would expect asset markets to stall after the recent gains.

"Trade Wars" Evolve into a "New Cold War"

The ongoing "trade wars" between the US and China have also been an impediment to recent growth rates. Global trade grew impressively in 2017, but with the opening salvo of a mutually-impairing trade war between the US and China, obstacles to free trade have been raised and this is undoubtedly a situation we need to monitor as 2019 progresses. It could well be that a deal emerges between the US and China, but we are sceptical that it will be particularly impressive over the long run, not least because the spat that started over trade has morphed into matters of national security, thereby opening a "Pandora's box" of long term political, technological and military concerns. Predicting a smooth outcome from this developing relationship is very hard and is perhaps the key issue for us to monitor over the next few decades.

The Federal Reserve to the Rescue

The US Federal Reserve (Fed) buckled in the face of weakening asset markets and carried out a major volte-face with regards to their likely future monetary policy over the last few months. As recently as December 2018, the expectation was for further rate hikes in 2019 and a continued shrinking of the Federal Reserve's "balance sheet", which had built up over the post-financial crisis years' quantitative easing policies. Now in one of the biggest switches in financial market history, the next move from the Fed is expected to be a rate cut and they have decided to stop their quantitative tightening process. This has been the major driver behind positive asset market returns in the last few months, as the yields on offer in government bonds have fallen aggressively, thereby making other assets (particularly equities) comparatively attractive. The question we need to ask ourselves is whether the fact that the Fed can't raise interest rates due to a slowdown in the US economy should weigh on asset prices rather than boost them, as has been the case so far this year. We also need to evaluate what might happen if today's lower rates of inflation across the world should start to rise once again, as it will be hard for central bankers to justify keeping interest rates quite as low as they are now.

Europe Stuck in Secular Stagnation

At least the Federal Reserve was afforded the chance to raise interest rates in the last decade; so weak is the European economy that the European Central Bank (ECB) might not ever do so again. Indeed, having only recently reverted their monetary policy measures of the last decade, the ECB have been forced to change tack and loosen policy once again. This is reflective of the fact that the European economy is suffering from a combination of bad political decisions, a lack of vital structural reform, the constraints of the single currency, low levels of economic growth and persistently low levels of confidence. Monetary policy is not going to be enough to change those dynamics, leaving Europe looking like the sick man of the global economy to us.

To Leave or not to Leave; the UK Languishes

The UK economy continues to stagnate under the fog created by the never-ending process of leaving the European Union. Economic growth has dwindled, in line with the global economy, with a number of businesses understandably putting off investment decisions until the UK's political path becomes clearer. We expect a further delay in the process to be followed by a deal, which will hopefully lead to more certainty and an improvement in growth. In the environment we see ahead, we see no rush for the Bank of England to raise interest rates.

As Goes China, Goes the World

China continues to be the pre-eminent driver behind the global economic cycle, a fact that is missed by many commentators. Certainly, the fiscal and monetary support applied by the Chinese authorities in 2015 and 2016 was the biggest impulse behind the strong growth enjoyed by the global economy in 2017 and early 2018. As that impulse began to fade, the global economy stuttered and growth rates declined to the point where we are now. Therefore, the fact that the Chinese are now starting to be more active with their policies could be a positive dynamic for global growth as the year progresses. Two caveats should be noted; firstly the Chinese are not being as aggressive as they were in 2015 and secondly there will be some longer-term negative implications of this further addition to China's debt pile.

Current Positioning

Our portfolios are positioned with a "neutral with a hint of caution" stance, with high levels of diversification and a moderate cash buffer. This helped to partially protect against the volatility of all major asset markets last year. In recent months we have been tactically moderating our risk allocations and have temporarily had more of a "risk on" approach as we started 2019; we have subsequently reduced risk as markets have risen. We are continuing to operate with a flexible mind-set as to our next strategy moves, as we head deeper into this unpredictable year.

Conclusion

We continue to be constructive on the outlook for certain equity markets and a range of fixed interest investments around the world, despite the fact that valuations have become more expensive after the recent rise across markets. In addition, it has been a rewarding start to the year for our more "niche" investments in emerging market debt, gold equities and infrastructure assets and we have confidence that such investments should continue to do well. Our core view is that there is a "new regime" for the global economy and financial markets from that which we experienced between 2009 and 2018 and we need to be respectful of growing volatility and rising risks, whilst remaining alert to any opportunities that come our way.

Tom Becket
Chief Investment Officer

Psigma
Investment Management

client.services@psigma.com
businessdevelopment@psigma.com
www.psigma.com

@PsigmaIM

company/psigma-investment-management

London

11 Strand,
London,
WC2N 5HR

+44 (0)20 3327 5450

Birmingham

1 Colmore Row,
Birmingham,
B3 2BJ

+44 (0)121 230 1937

Edinburgh

The Capital Building,
12/13 St Andrew Square,
Edinburgh, EH2 2AF

+44 (0)330 094 0090

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