Psigma
Investment Management

View from Psigma
VALUATION COMMENTARY

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2018 has been an extraordinary year for the global economy, the political world and for financial markets. There are some important changes taking place in the global financial system and some major fiscal and monetary actions being undertaken that will have consequences for us all in the coming decades. From a political standpoint we appear to be witnessing the very fabric of the accepted political order of the post-World War II era being ripped up and replaced by a new world dynamic. In financial markets the action has been no less "exciting", even if the healthy returns and low volatility environment that we enjoyed through the second half of 2016 and 2017 now appears to be over. In addition, great divergences have arisen across financial markets that should create opportunities for investors in the long term, even if our core view is that risks have risen in financial markets over the last six months and we are now less comfortable taking risk than we have been for some time.

"Solid but Unspectacular" Economic Growth (Again)

From an economic perspective, 2018 has been another year of generally "solid, but unspectacular" growth. The US has been the developed world's best performing economy, driven in no small part by the fiscal stimulus provided by the Trump administration, while the output of Europe, Japan and the UK has grown at a slower, but satisfactory rate. While this economic cycle appears to be maturing, there is not yet sufficient evidence to call an end to the positive growth pattern of the last 10 years. The emerging world has seen a mixed period of growth, with India growing well, China slowing and parts of the developing world suffering economic turmoil, with Turkey, Argentina, Brazil and South Africa all problem areas. The question we need to ask ourselves is whether a combination of divergent economic fortunes, assorted political threats, rising interest rates and growing inflationary pressures could bring this period of economic expansion to an end, 10 years after the end of the financial crisis.

Domestic Politics & UK Investment Exposure

As much as we try not to give too much of a political view, we have to recognise that politics have become increasingly important for financial markets. Hopefully you will have read our recent update on the UK's ongoing divorce from the European Union, but our conclusion was that this situation is a significant risk for both the UK economy and domestic asset markets in the short term. Longer term it is harder to have a clear view, not least because so many possible scenarios remain open, but the threat of major economic disruption and a significant change of policy under a future government has led us to scrutinise all positions that we have in UK assets and ensure that we fully understand the potential risks and rewards that each individual position presents.

The US Steps Back and China Steps Forward

From a global perspective, politics has rarely been more interesting. The sweeping changes that are taking place also offer a growing risk to global financial markets. The biggest development is undoubtedly in the US, where a toxic relationship between both sides of the political divide and the Trump administration's determination to put "America First" is unravelling the accepted understanding of the US being the world's political leader and policeman. For the first time in seven decades this is changing. This creates an additional level of unpredictability on top of the already impactful domestic policies put in place by the Trump administration. It is also leading to China and Russia moving into the power vacuum created by the US's isolationist policies and allowing them to grow their sphere of influence in parts of the world near and far. This was always going to be the case with a maturing China, but we would suggest that not even the Chinese could have guessed that their passage to becoming the global political and economic leader would have been taking place so fast. As we have written before, how the US and China ultimately split up the world from a political, financial and economic perspective will set the scene for all of us as global citizens in the next few decades and it will also be key for financial markets.

Populism is Here to Stay

We can also now answer the question of whether "populism" peaked with the election of Donald Trump in late 2016. The answer is a resounding "no". Recent elections in Italy, Germany and Sweden show that large parts of the population all around the world have had enough of their governments' policies over the previous decade. In the case of Europe, it is immigration that has caused much of the swing to "alternative" parties, but the obvious undertone of much of the rise of populism is the understandable bitterness over the contradictory fortunes of the rich and everybody else in the recovery that has taken place after the Great Financial Crisis. In simple terms, if you have owned assets you have done well over the last ten years, as the actions of central banks have supported and driven up the prices of basically everything. However, if you rely on a salary or welfare payments then you have struggled, as they have barely risen and, in many cases have fallen in real terms. Until the gap between the wealthy and other parts of society shrinks then populism will be fuelled by discontent and that is one of the reasons that the threat of a significant change of economic direction in the UK is real under a new government.

Politicians Love Debt; Markets Less So

There is a clear linkage between populism and the greatest financial threat to the world; the extremely large and growing debt pile of governments. The Trump administration, in particular, is pursuing an unbelievably large fiscal stimulus in the US economy, at a time when economic growth is positive and inflation is rising. The expansion of the US deficit, at a time when outstanding US government debt is already $21.5trn, is undoubtedly a concern and explains in part, the global rise in borrowing costs. However, while the US is the debtor-in-chief it is not alone in its fiscal imprudence, as all around the world, most governments are still spending more than they earn and debt levels are rising. This massive debt creation was not much of a problem when central banks set their printing presses to full speed and bought as many bonds as they could as part of their quantitative easing programmes, but with the central bank purchases about to stop in most places and some about to go into reverse, we are undoubtedly worried about what the effects of all this issuance of debt might be on borrowing costs and the price of existing debt issues. We must also remember that it is the price of bonds that set most other asset valuations and the threat of further rises in market interest rates adds to our caution.

Bond Markets Come Under Pressure

Bond markets have struggled in 2018 as there has been a great deal of new debt issuance and official interest rates in the US have been rising. The US Federal Reserve has become sufficiently confident to raise rates, because economic growth has been positive and inflationary trends are clearly moving higher, and other major central banks seem set to follow suit in the relatively near future. This has naturally led to a rise in bond yields, or borrowing costs. At the same time, we have seen major selling of US government bonds by certain governments around the world, who either have less money to invest in the US government's debt or want to reduce their dependency on the US dollar (or both). Increasing US government yields set the benchmark for all global bond prices, which have therefore performed negatively so far this year. Our positioning has been to greatly reduce our sensitivity to rising yields, but making positive returns in bond markets has been a major challenge this year. Pleasingly some of our specific credit investments have performed well and we feel confident that they can continue to do so. However, this is a very different investment environment to that of the last decade, where most fixed interest investments went up year after year.

Fortunes Mixed in Global Equity Markets

One of the more difficult situations to navigate in 2018 has been the varied performance of regional equity markets. As we entered 2018, US equities stood out as being expensive but with positive corporate growth prospects; the significant outperformance of US companies' share prices this year show that investors have focussed on the growth dynamic rather than their expensive relative valuations. Outside of the juggernaut US market it has been really hard to make positive returns in other parts of the world, with most markets suffering from volatility and ultimately going nowhere. We are therefore enthused by some great contrarian opportunities that have been created and we are re-evaluating our overall positioning and specific opportunities in some markets where there has been disappointment in recent months.

Conclusion

With so many significant political events creating uncertainty at a time when economic and market risks have risen, we have actively reduced risk across our investment strategies over the last year. At the same time we have been very selective about our chosen investments, both in the UK and overseas. As we wrote in our first View of 2018, the time to be become very defensive in our investment strategies for the first time in 10 years is coming. Whilst we do not believe that we are at that inflection point yet and, to be clear, we are not suggesting that great investment opportunities do not exist, we are respectful of the changes taking place and the fact that political, economic and financial market risks have risen; this is reflected in our ongoing diversified and flexible investment approach.

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