Psigma
Investment Management

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View from Psigma
VALUATION COMMENTARY

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2018 was a challenging time for all major asset markets, with volatility significantly higher than the relaxed environment we enjoyed in 2017. Positive returns were almost impossible to come by and we believe that the challenges remain as we head deeper into 2019.

Many commentators were surprised by the change in market behaviour, as it came at a time when the global economy was expanding and corporate profits grew at a healthy pace. However, our view was that the global outlook had become more uncertain and when this was combined with high valuations and creeping complacency, it spelt trouble for investors.

- Our early expectations this year are that we expect a year of around trend growth from the global economy, but that the chances are that we have seen the best of the growth for this particular economic cycle and that downside risks certainly exist. We constantly stress that we need to keep an "open-mind" about any economic projections, as there remain a confluence of major factors providing a genuinely uncertain short-term future. However, we now expect a slowdown in global growth in 2019 as this economic cycle comes towards an end, before a possible global recession in 2020.
- Whilst we are starting to think about an end to this business cycle, loose fiscal policies in the US and continued "pent-up" economic demand could potentially lengthen the cycle further. On the negative side, the positive "credit impulse" from China has slowed and liquidity in the global economy is tightening. Any concrete signs of a change in either of those dynamics could be supportive of economic output and market direction, and notably we have seen stimulative actions announced by the Chinese government in recent weeks, which could well spur growth in the short term.
- The key factors behind the recent market oscillations have been concerns over global trade, rising market interest rates and signs of a return of inflation. Global trade grew impressively in 2017, but with the opening salvo of a mutually-impairing trade war between the US and China having been fired, obstacles to free trade have been raised and this is undoubtedly a key concern we need to monitor as 2019

progresses. It could well be that a deal emerges between the US and China at some point in the next few months and markets have started to assume such an outcome, but we are sceptical that any such deal will be a particularly impressive deal over the long run. The developing and deteriorating relationship between China and the US remains one of the most significant factors for investors to assess for the decade ahead.

- The biggest change over the last 18 months has been the change in central bank mind-set from "loosening" to "tightening". The US Federal Reserve (Fed) has been raising interest rates and reducing their balance sheet through quantitative tightening, ensuring a tighter liquidity environment for investors. We identified this at the end of 2017 as an obvious risk for markets and sadly this view was correct in 2018 and a major reason behind the volatility in financial markets. Interestingly, investors have now switched their projections for the Fed raising interest rates further to join us in a view that the Fed will struggle to raise rates this year, due to the slower rate of growth both in the US and the world, as a whole. If the Fed were to confirm an end to their tightening bias then markets could well rejoice in the short term and this has been a major contributory factor to asset markets' short term recovery at the start of 2019.
- Bond yields and borrowing costs were also given added upward pressure last year from the spending intentions of the US government, which has decided to pursue an extremely loose approach to its finances to spur further growth. When combined with the tax cuts afforded to US companies and consumers at the end of 2017, the cost could well be extremely high to the future generations with question marks hanging over the efficiency of the additional spending. It could also lead to a further structural shift lower in the US dollar over the next decade, something which is reflected across our investment strategies.
- Another by-product of the US government's splurge could well be a further inflationary push. Certainly, the days of disinflation and deflationary fears that peaked in 2014 and 2015 now appear to be behind us and inflation uncertainty has risen. Notably nobody else appears to be worried about inflation and this is something that should therefore concern us. Certainly, wage growth seems to have some long overdue upward pressure and this could feed through into inflation rates.
- In the UK, the Monetary Policy Committee (MPC) raised rates in August 2018, although we are not convinced by this decision and recognise that their own forecasting powers are not strong and they are prone to change their minds. We are sceptical about the merits of the MPC's change in policy towards a moderate tightening bias, with the UK economy still lingering under a fog of political and economic uncertainty; the chances are that we might see another UK rate hike later in 2019, depending on how the current economic situation plays out. We are warming to the potential of UK investments, not least as they have fallen into the "unloved" and "contrarian" category, and we continue to view Brexit as just as much as an "opportunity as a risk" for our portfolios. Potentially rewarding investments exist in both domestic equity and bond markets, even if we have to acknowledge that sentiment will remain brittle and volatility high towards UK investments, as our chaotic political situation rumbles on.
- In Europe, there finally seems to be a commitment to bring to an end the insanely loose monetary policy that has been in place for the last few years and notably the European Central Bank stopped further asset purchases at the end of 2018. This is a dynamic that might have major consequences for investors and we may finally start to discover what price certain assets should be without the indiscriminate purchases from central banks distorting financial markets. We are also unsure why the ECB has chosen this time (when European economic data has been so weak and political uncertainty has risen), to curtail their supportive monetary actions. Europe still looks a significant source of concern for the future.

- Our asset class forecasts are predicting that future returns from equity and fixed interest markets will be lower than they have been through history, although after the recent falls across global asset markets we now expect higher returns from developed world equities in the years ahead than we previously expected. Returns will still likely be lower in the future than they have been in the past, but we believe that "realism" is appropriate at a time when asset valuations are not outstandingly cheap and the economic potential of the developed world, in particular, is lower than it has been for the last 50 years. We continue to believe that high debt levels and deteriorating demographic trends will be a hindrance to the mature world's economic potential in the coming years.
- Our portfolios remain positioned with a "neutral with a hint of caution" stance, with high levels of diversification and a cash allocation, which we hope to use on new investment opportunities in the coming months. Our investment stance helped to partially protect against the volatility of all major asset markets last year, particularly in the early and late months of 2018. In recent months we have been moderating our risk allocations tactically and have temporarily had more of a "risk on" approach, although this is more of a short term call to reflect oversold markets. There had been a shift in the underlying components of our portfolios to allow us to benefit from the improvement in market sentiment over the last few weeks. However, we are continuing to operate with a flexible mind-set as to our next strategy moves, as we head deeper into this New Year.
- We are ready to take advantage of selective opportunities as they present themselves with emerging market assets chief amongst the investments that we are reviewing for possible increases. Other investments that have performed badly could also be ripe for an increase, despite our core view that the there is a "new regime" for the global economy and financial markets and we need to be more respectful of growing volatility and rising risks, while remaining alert to any opportunities that come our way.

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