VERMEER NEWSLETTER

January 2019

THOUGHTS ON 2019

No Time for Heroics

By Simon King
Chief Investment Officer
T: +44 (0)20 7123 5200
E simon.king@vermeerllp.com

The turn of the year is the time when it is traditional for stock market commentators and pundits to expound on grand theories and strategies and proffer numerous stock tips and ideas. This is a thankless task at the best of times, but as we edge cautiously into 2019 it is perhaps even more difficult than normal. We are faced with a plethora of challenges which unusually have mainly binary outcomes. These outcomes could lead us down several different paths with the eventual end point being anywhere on a wide spectrum of scenarios.

Perversely forecasting the actual economic numbers and statistics we all see in the news is less of a problem. The issue will be predicting on which flight path we exit 2019. Although there are the usual dizzying range of forecasts available the majority are within a reasonably tight consensus. The global economy is likely to grow this year, probably in the 2%-3% range, with the risk being it could be slightly slower for reasons dealt with below. Growth will be stronger in emerging markets than developed ones.

Interest rates will continue to edge upwards, but only slightly, with perhaps 0.5% on rates in the US and little if anything in other developed markets. Brexit will determine UK interest rate movements in the short term, but even the long-term is unclear. Rate rises are a flimsy stick to wave at inflation, being imported due to an even weaker pound. Inflation will be more varied across countries and dependent on currency movements and commodity prices, but it is unlikely to explode. Indeed, more downbeat investors are worried about the return of deflation, when prices go down and markets and economies generally underperform.

The major change in markets this year is likely to be a sustained pick up in levels of volatility. Put simply prices will move around more often and to a greater degree. This is not unusual, and volatility will likely only be increasing to normal levels. This is worthy of comment because this is in stark contrast to the previous ten years where we have enjoyed relatively benign conditions in global stock markets with consistently rising prices and low levels of volatility. One of the major themes from now on will be that this period is now over, as witnessed by events in the final quarter of 2018. All investors will have to adjust their expectations on returns overall and the short term swings they will endure within their portfolios.

The real challenges facing us in 2019 seem almost too numerous to list. In the UK we are understandably obsessed with Brexit. Although the current state of paralysis and inaction is strangling the UK economy, there will be an outcome. However unpalatable that may be, companies will be able to begin to adjust and react which is what the good ones do best. Nonetheless the various possible outcomes will have different implications and could have severe unknown consequences well into 2020. Our property market faces stretched affordability and perverse tax structures but is chronically undersupplied.

The US remains the great conundrum. Outwardly it appears to be performing well and will remain the power house of developed world growth. Scratch a little under the surface and the cracks start to appear. Tax cuts and loose monetary policy have driven the markets but cannot continue and the dollar cannot rise forever. Regardless of one's views on the current administration it is clear it will continue to face acute challenges, surprise markets and generally cause uncertainty. Trump's tenure could be anywhere from five minutes to five years.

An unfortunate side product of the Trump desire to disrupt has been the escalation in the Trade War with China. It is not that the imbalances that infuriate the US do not need addressing, rather that although the new aggressive stance will work in the short term, it provides no basis for effective management of trade disputes in the future. Again, this could go either way: either a compromise is reached, or we are faced with a full-scale trade war which would probably tip China into recession. That would blow an icy economic wind across the globe. Even putting this to one side China faces a whole host of domestic challenges which are likely to weigh on its economic performance in 2019.
Europe is also at a major junction. It must deal with the fallout from Brexit and do so as many of its members question the way forward for the EU. It must also contend with a host of country specific issues in all its major territories both, economic and political. Germany faces its first change in leadership for 15 years, France continues to wrestle with its many structural issues and social unrest, Greece and Italy limp on. A number of the leaders of Europe's major institutions are also due to change.

Japan remains the most stable economy with low growth, low interest rates, low inflation and low stock market valuations.

The main plank of the huge rescue programme undertaken post the 2008 financial crisis was a series of indicatives broadly known as Quantitative Easing (QE). Put simply this is the introduction of new money into the system, usually by the central bank of the respective regions. Regardless of opinion of its merits and demerits it is pretty clear that it has generally inflated virtually all asset prices in the last ten years. At the stocks and shares level the easy availability of money has meant economies have grown, as intended, and companies have increased borrowings, not really intended. This has allowed them to double their profit margins and generate large amounts of cash. Unfortunately,

THOUGHTS ON 2019

No Time for Heroics

By Simon King
Chief Investment Officer
T: +44 (0)20 7123 5200
E simon.king@vermeerllp.com

instead of applying this cash flow to investment and capital expenditure, they have tended to increase dividends and share buybacks thereby further increasing share price and perpetuating the 'virtuous circle'. All good news for shareholders until it stops.

We are not wise or brave enough to know when QE will disappear, but it appears to have stopped increasing and is beginning to unwind. The problem for all investors is there is no guidebook to how things will react since we have never been here before. Obviously, the plan was to unwind it into a naturally buoyant economy. We seem a long way from this. We suspect QE will be around for longer than most anticipate, but investors need to become familiar with the concept of Quantitative Tightening (QT) where money is sucked out of the economy. This absence of a guidebook is not restricted to QE. We have never entered a downturn after a period of strong performance across all asset classes. As such some of the traditional places of safe haven, such as fixed income, are not overly attractive. Governments are highly indebted and have few policy levers to pull to combat more difficult conditions.

So where does this leave us with regards to navigating a path through the challenges of 2019? As we suggest in the title to this piece it is no time for heroics. Investors are unlikely to be rewarded for taking on excess risks. There will still be numerous success stories but for everyone there will be many more tales of woe. To minimise the downside from the inevitable failures a diversified portfolio will experience, it is necessary to have a sound understanding of how an investment will react to changing circumstances. This is very difficult at a macroeconomic level but more manageable when analysing individual companies. Portfolios need to be tightly managed with no room for passengers or hunches. As active managers we have the ability to manage downside risk and we will use it.

We will continue to seek out companies with sound market positions, ability to capture growth as it occurs, strong balance sheets and the capacity to generate enough cash to meet their own growth requirements and provide an attractive return to shareholders in the form of dividends. Some of these opportunities may lie in the more esoteric corners of the market but the same disciplines must be applied. Despite recent tensions the markets will continue to operate on a global basis and it is important that we are able identify opportunities in all parts of the globe. In the more volatile conditions we have outlined it will be important to recognise change and react quickly and confidently. Market conditions are changing, but change creates opportunity.

Vermeer Partners is a trading name of Vermeer Investment Management Ltd which is registered in England & Wales (Company Number 09081916).
Registered office address 130 Jermyn Street, London SW1Y 4UR. Authorised and regulated by the Financial Conduct Authority (FRN: 710280).