VERMEER NEWSLETTER

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THOUGHTS ON 2019

A Year in Review

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2019 saw markets recover from the sharp falls experienced over the fourth quarter of 2018 with most global stock markets finishing the year close to or at their all-time highs. Global equities rose by 22% (in sterling terms), bond yields continued to fall while both the gold price and the oil price rallied. The US dollar remained strong while the second half of the year saw sterling recover from oversold levels. Unemployment around the developed world remained low and inflation muted.

The primary reason for this return to a more positive frame of mind was a sharp change in direction by the US Federal Reserve. Having closed out 2018 by raising interest rates for the fourth time and signalling further hikes in 2019, policy makers in the US embarked on a sudden change of heart in early 2019 and by July had initiated the first of three rate cuts. With interest rates in the world's largest economy now set lower than GDP growth and inflation, bond yields fell sharply and the US stock market rallied to close the year at an all-time high. Other stock markets around the world followed pace, although the UK market was a relative laggard with only Hong Kong – held back by pro-democracy protests - performing worse among the developed world economies. Once again, an international focus proved beneficial to UK investors.

What triggered the Federal Reserve's sudden policy U-turn? It had become clear that around the summer of 2018 the global economy entered a sharp industrial slowdown resulting in a big shift in the central bank's views about the health of the US economy and its ability to shield itself from outside risks. Not helped by President Trump's trade war with China, manufacturing activity slowed, capital spending by businesses dried up and factory output fell. However, manufacturing remains a relatively small part of the global economy and around the world unemployment is low and consumer confidence high: in the US, the best labour market in decades has made Americans feel secure in their jobs and confident enough to keep spending. The pace of layoffs and unemployment are both near half-century lows and wages are rising.

If the economy continues at this pace the prospect of a second term in office is President Trump's to lose. Markets appear to have taken his impeachment in their stride. In fact the biggest market movements in 2019 centred around announcements by this highly unconventional President - mainly through his Twitter account - on the ongoing China/US trade war. The world's two largest economies battle it out imposing tariffs on each other's imports and whenever negotiations looked like ending the impasse, renewed tensions have followed.

Closer to home, as the country looked set to go back to the polls for the third time in under five years, UK centric stocks and the value of the pound started to rise in expectation of a modest Tory victory. A general election was called for December 12th and the Tories secured an overwhelming majority consigning Jeremy Corbyn's Labour party to its worst defeat since 1935. Boris Johnson achieved the seemingly impossible by winning Northern working-class seats that had not returned a Tory candidate in generations. What is more, the removal for the foreseeable future of the threat of a radical economic programme of nationalisations and tax rises lent considerable support to domestic UK businesses, many of which have underperformed in recent years. The UK's mid and small cap indices rose sharply post the election. The UK stock market finished the year up 14% although still lower than it was at the start of 2018. But mid cap stocks, which have a higher sensitivity to the domestic UK economy, fared better returning 24%.

Nonetheless, despite renewed Brexit optimism and a resurgent Boris Johnson led Tory party, the focus now shifts from "no deal" to "no trade deal" as Johnson may struggle to fulfil his pledge to finalise a new trading relationship with the EU by year's end. There are still considerable uncertainties surrounding the UK's position outside the EU and - ever mindful of this - sterling finished the year marginally lower against the US dollar than where it had been on the eve of the general election result.

In the Eurozone while stock markets benefitted from the strong global recovery, it has become clear that monetary policy alone cannot stimulate major European economies. Germany narrowly escaped a recession and the Eurozone's real GDP for the year was projected by the IMF to grow at its lowest rate since 2013.

The corporate governance reforms in Japan continue apace and proof that fundamental and attractive change is occurring in Japan continued to be evidenced by the fact that the number of foreign investors in Japan continued to grow over 2019. Meanwhile Prime Minister Shinzo Abe's 13 trillion yen fiscal package relieved the Bank of Japan from having to delve deeper into its already depleted ammunition. Japanese equities returned 15% in sterling terms over the year.

Political unrest and rioting in Hong Kong placed a dampener on Asian stock markets while Emerging Markets generally continue to grapple with a resurgent dollar. India's stock market benefited from a surprise cut in corporation tax rates designed

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to spur investment and boost growth in the country's faltering economy.

At the individual stock level, once again it was technology companies that topped the leader boards with both Apple and Microsoft producing strong returns. Credit card companies, particularly Visa, continued to shine. Meanwhile, “old industry” sectors such as automobiles and oil & gas stocks suffered. In the UK, house builders such as Persimmon performed strongly after the election and infrastructure funds including HICL and INPP benefitted from Jeremy Corbyn’s electoral defeat.

Later in the year, we started to see a recovery in traditional “value” sectors, which had remained out of favour for so long. With bond yields reaching record low levels in the summer - at the peak in late August $17 trillion of debt was trading with a negative yield - investors begun to question whether the economic backdrop was really so bad to justify locking in permanent losses on many government bonds. The first few days of September saw a sharp reversal in the value versus growth trade where low bond yields and low inflation had driven cyclical, growth stocks ever higher.

2019 saw some of the froth come out of the hitherto buoyant IPO market with WeWork delivering the year’s most high-profile slip-up when it scrapped plans for a floatation amid concerns over poor governance and a sky-high valuation. Other highly valued growth stocks, such as new issues Uber and Lyft, saw their share prices fall sharply after listing. While more mature technology businesses such as Alphabet and Amazon continue to offer compelling investment opportunities, we feel that investors are becoming more discerning over the valuations placed on many internet start-ups. This could start to negatively impact funds with a high growth bias.

2019 will also go down as the year when investors started to appreciate the risk presented by large open-ended funds investing in illiquid assets, as exemplified by the spectacular fall from grace of one-time star stock picker Neil Woodford. We would remind readers that this is a risk not just contained to small-cap equities but also credit markets which can be notoriously hard to trade, hence the failure of H2O Asset Management whose funds were revealed to have large holdings of illiquid corporate bonds, which could not be sold when investors rushed to the exit.

The end of the year also, of course, marks the end of a decade, and it is worth reminding ourselves that following the great financial crisis of the late 2000’s the last ten years has seen a rising economic tide and global stock markets have more than doubled. Living standards continue to improve with the rate of extreme poverty around the world cut in half (15.7% in 2010 to 7.7% now), and all but eradicated in China. The global financial crisis officially ended in 2009 and the world economy has not stopped growing since, expanding through the Eurozone crisis, US rate rises, concerns over China’s economic growth and the manufacturing downturn of 2016. The current economic expansion is now the longest in modern history, extending for 10 and a half years and counting. Corporate profits just keep climbing and American businesses are sitting on a $2 trillion pile of cash. Investors should enter the 2020’s in a positive frame of mind.

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