Lincoln Private
Investment Office
London

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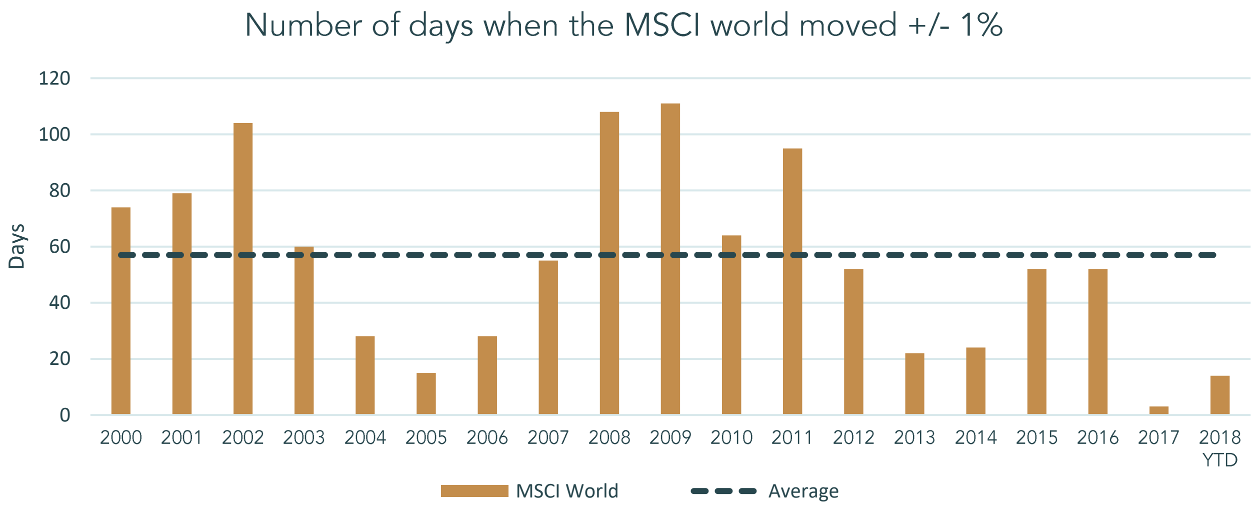
Investment Letter – Q1 2018

We have regularly written about our scepticism of asset valuation levels and our concern over taking excessive risk in a low volatility world. After a euphoric start to the year, volatility returned. On January 26th markets sold off, seemingly reacting to stronger than expected inflation data; the S&P 500 fell 10% peak to trough, the FTSE 100 fell 11%, MSCI World was off 9% and the Global Bond Index slipped by 1.6%. Markets then remained unsettled until the end of the quarter. As risks increased there were few places to hide in conventional portfolios as both equity and fixed income markets came under pressure, with the traditional negative correlation between these asset classes not holding true. In contrast, our unconventional fixed income, absolute return and more value-focused equity approach held up well in comparison to the wider market. As a result, our Core portfolio ended the quarter down 0.9% versus the FTSE 100 that finished down 8.2%.

The recent lack of volatility in markets has been a concern to us. The chart below shows that over the last 18 years the average number of days that the MSCI World equity index moved more than 1% up or down each year was 57. During 2017 this occurred on only 3 days – incredibly few by historic standards. In the first 3 months of 2018 it returned to more normal levels, with 14 days having a +/-1% move. Low volatility brought more and more money into strategies and products that were reliant on this calm market environment continuing. When volatility spiked in January, many of these products were severely impacted and some went into liquidation having fallen 100% in a matter of days.



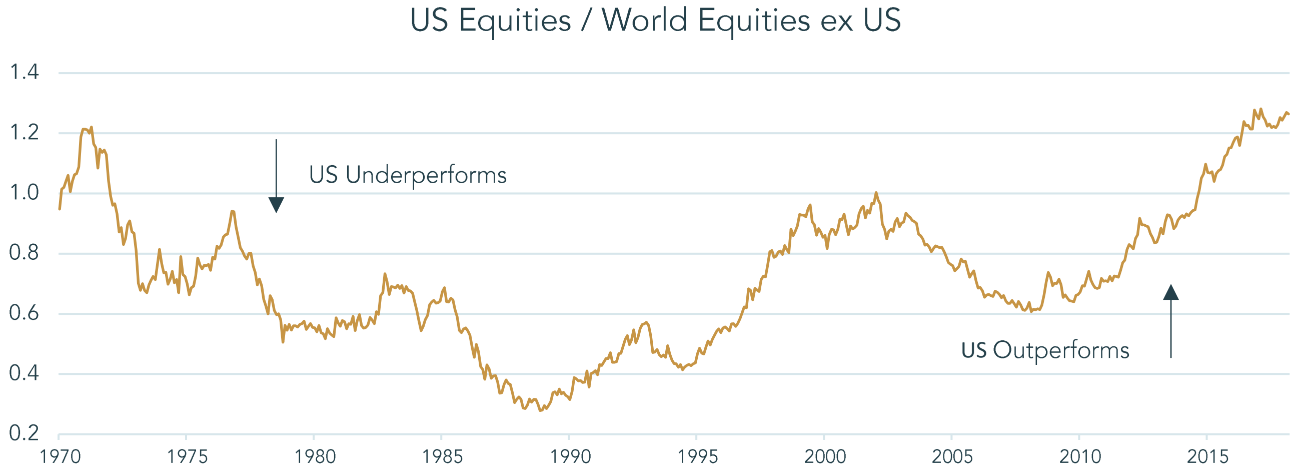
Source: Bloomberg, 2018

In March, despite market moves, US consumer sentiment jumped to a 14 year high. This optimism was driven by tax cuts and the response of large corporations that followed. Walmart, who employ a staggering 1% of the United States workforce alone, announced a 22% increase in their starting wage, as well as giving one-off bonuses. The total tax cut effect could add a further 0.8% to US GDP. This is in an economy that is already running very low unemployment levels of 4.1% leading to concerns that these effects will begin to fuel inflation.

Inflation is also at risk of being driven upwards by protectionist strategies. After some initial tweeting from Donald Trump about trade and putting America first, there have now been moves towards what could turn into a trade war between the US and China. According to a basic premise of economics, increasing trade raises the productivity and wealth of the world economy through comparative advantage, division of labour and economies of scale. Ultimately, nobody wins in a trade war, because it leads to higher pricing, reduced market efficiency and crucially the start of a cycle of ‘tit-for-tat’ responses between countries. Any escalation into a serious trade war could bring large economic consequences. The hope is that this move is merely an initial tactic to strengthen the US negotiating position and encourage China to come to the table.

Trade also remained a priority in Brexit negotiations; recent data showed that only 8% of all EU exports headed to the UK, whereas 43% of UK exports went the other way. Ensuring this trade flow is not disrupted is crucial for the UK's trade outlook. European politics made headlines again during the quarter. In February, Angela Merkel finally managed to form a coalition government, but the Italian election delivered further evidence of the rise in anti-establishment views in the region, with the Five Star Movement receiving the most votes. Large support came from southern Italy, where there is significant unemployment and where GDP per capita is substantially less than that of the North. Despite the political uncertainties, European economic data is generally still positive, albeit with sentiment indicators falling slightly.

In terms of our current tactical asset allocation, one of the highest conviction positions that we have in client portfolios is an underweight to US Equities. The extent to how expensive the US market has become is evident by the fact that in January 2018 the S&P 500 had nearly doubled since 2007, whereas over the same period, global equities excluding the US were down 10%. The graph below shows the recent outperformance of the US market in comparison to the rest of the world since the 1990s. When the graph is downward sloping the US is underperforming the rest of the world, and vice versa. The more recent period of US outperformance since 2009 is particularly marked, driven by a small number of stocks dominating the indices; more specifically the strength of key technology stocks, the FAANGs (Facebook, Apple, Amazon, Netflix, and Alphabet's Google), which are up 25 times from 2009. We have been very mindful of how expensive this concentrated area of the US market has become and in March we saw an abrupt reversal as Facebook was the subject of numerous negative headlines and Trump turned his Twitter account against Amazon. The last few years have seen extreme outperformance of these FAANG stocks and the rise of certain Asian technology stocks, the BATs (Baidu, Alibaba and Tencent). Yet with the threat of tighter regulation and inevitably more negative headlines about data protection, the recent quarter has shown that the FAANGs and BATs do have the ability to bite.



Source: MSCI US Index, MSCI World ex US Index; Bloomberg, 2018

We remain positive on the long-term outlook for Japan, an area of the world that we believe continues to undergo positive systematic change. Historically, Japan was very cyclical in nature as investors would enter and leave the market. Abenomics started the process of structural and cultural reform which has helped the economy, particularly in the areas of employment and tourism. At the corporate level there has been a move away from the 'job for life' mentality and increased attention on shareholder return, with management focused on delivering higher and sustainable dividends.

Our core investment thesis remains little changed. We continue to be positioned for higher volatility and believe that equities in some developed markets are overvalued and more interesting opportunities can be found in the Asia-Pacific region and Emerging Markets. As we enter a period of monetary tightening there will be less stimulus for equity and fixed income markets. We therefore look for strategies that will improve diversification by targeting returns that are not correlated to these markets and have a focus on capital protection. We remain unafraid to be contrarian in our stance and will not be distracted by the noise of daily headlines.

Fred Hervey
Chief Investment Officer