



Investment Letter – Q3 2019

“Be sure you put your feet in the right place, then stand firm.” Abraham Lincoln

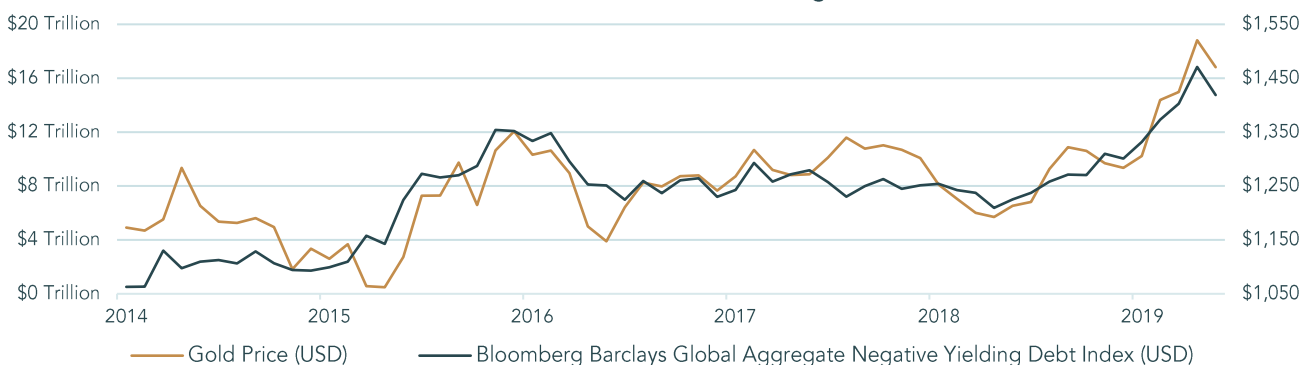
Summer is reputedly a quiet period for markets, but not so this year, with sharp and frequent changes in sentiment and material shifts in the political and financial landscape. The final numbers suggest that the quarter has been relatively benign, but within the period we have seen large swings. The political environment in the UK has altered, with Boris Johnson taking control of the Conservative Party and moving to a more confrontational Brexit strategy. In the US, the central bank cut rates for the first time in over 10 years. This move, whilst expected and well flagged, had significant implications for the bond market, where conventional fixed income instruments rallied. In equities, the MSCI World and the FTSE 100 indices fell peak to trough 6% and 8%, respectively, but by the end of the quarter equities had made a good recovery. Two common indicators of investor risk appetite are the price of gold and long dated treasury yields. Over the quarter the gold price rallied and the 10-year US treasury yield dropped from 2.0% to 1.7%; both moves highlighting a more cautious tone across markets.

At the end of 2018, the consensus was that the US would have 2 interest rate rises in 2019, however we have now seen the exact opposite. The US Federal Reserve Chairman, Jerome Powell, downplayed the July 0.25% rate cut as “a mid-cycle adjustment to policy”. He then seemingly succumbed to presidential and bond market demands by trimming rates by a further 0.25% in September. The market is pricing in one more rate cut this year, which appears to be inconsistent with improving consumer spending and housing market data, both of which imply reasonable strength in the underlying economy. With fixed income yields falling, and the price of bonds rising dramatically, owning these assets would have helped short-term performance. However, we have regularly spoken about why we do not favour conventional fixed income in portfolios, based on our belief that the bond market is extremely over-priced. We perceive the margin of safety in these investments as too small, and with wealth preservation in mind, we have not been inclined to chase the rally.

In Europe, outgoing ECB President Mario Draghi gave bond investors a parting gift with a further 0.10% cut to the core interest rate and a €20bn bond-buying stimulus package. In our Q1 letter, we wrote about the \$10 trillion global mountain of negative yielding debt, which had by mid-August peaked at an astounding \$17 trillion. At the peak, 30% of all investment grade bonds had a negative yield, meaning that buying and holding these bonds until maturity guaranteed a capital loss. It is with this backdrop that Christine Lagarde will take over the ECB Presidency on 1st November. Whilst not a dramatic change in isolation, investors will listen with care as Lagarde provides details of her approach to monetary policy in the wake of a supportive 8 years under Draghi's stewardship.

With many other notionally ‘safe’ assets like government bonds paying a negative yield, we continue to see a compelling case for owning gold as a hedge. Gold offers a proven means of preserving capital and has the further benefit of rallying during periods of political tension, of which there have been plenty in the last three months. The chart below highlights the relationship between the total amount of negative yielding bonds and gold. Normally, owning gold means missing out on earning interest on other assets such as bonds and equities - the opportunity cost. However, as a zero-yielding asset, gold currently looks more attractive versus an asset that is guaranteed to lose money. As the total amount of negative yielding bonds has increased over the last 12 months, our holding in gold has been a helpful contributor in portfolios.

Gold versus Total Amount of Debt Yielding Less Than Zero



Source: Bloomberg, 2019



Lincoln Private
Investment Office
London

30 September 2019

Gold demonstrated its safe haven qualities when the price rallied particularly strongly on the 1st August, as the US President announced a fresh round of tariffs on \$300bn of Chinese imports, effective from September. In retaliation, China allowed its currency to weaken below the significant level of 7 Renminbi per Dollar for the first time in over a decade. A weaker currency gives China a competitive trading advantage since its exports become cheaper, creating additional demand and potentially mitigating the effect of tariffs. Despite the lingering tariff tensions, we remain positive on Asian equities. Our managers covering the region have a focus on companies that have strong demand from both the domestic market and that of neighbouring countries, rather than being US-reliant exporters.

We spoke last quarter about our views on value versus growth stocks. The start of September saw a modest rally in unloved value names, accompanied by a sell-off in popular, momentum equities, which had helped lead the S&P 500 higher this year. This nascent trend was most visible in the US market where the banking, energy and retail sectors bounced 6-9% and momentum names, particularly consumer staples and real estate investment trusts, were sold. In Europe, car manufacturers have been the most representative of value investments this year; we consider the 7% rally in European autos and auto-parts as evidence that the value outperformance was not confined to the US. We also saw strong performance in our Japanese equity funds, which hold high-quality cyclical businesses that have been temporarily out of favour. Whilst it is too early to predict that value equities will outperform going forward, their recent recovery is pleasing given our current bias to that investment style in developed markets.

As expected, Brexit negotiations have come down to the wire. The question over the next few weeks is whether or not Boris Johnson can strike a deal that is acceptable in the limited available time. We feel that domestic markets have become increasingly numb to political noise, perhaps one oblique benefit of Donald Trump's tweets? We remain optimistic for the UK currency and equity market, once uncertainty has been reduced and capital starts to flow.

We enter the final quarter of the year with pivotal matters yet to be resolved: Brexit, trade wars, and Trump's impeachment, to name a few. On a micro level, we continue to see examples of what we consider to be a decoupling between valuations and fundamentals. Recent examples are the eye watering values attached to the so-called tech unicorns, WeWork and Peloton. We consider these valuations to be unsustainable and in contrast, with a focus on protecting capital, our equity positions are based on underlying fundamentals. As we navigate the current climate, we echo the mantra of President Lincoln; planting our feet and standing firm by our convictions.

Fred Hervey
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