Lincoln Private
Investment Office
London

31 December 2018

Investment Letter – Q4 2018

"There is no risk-free path for monetary policy". Jerome Powell, Chair of the Federal Reserve

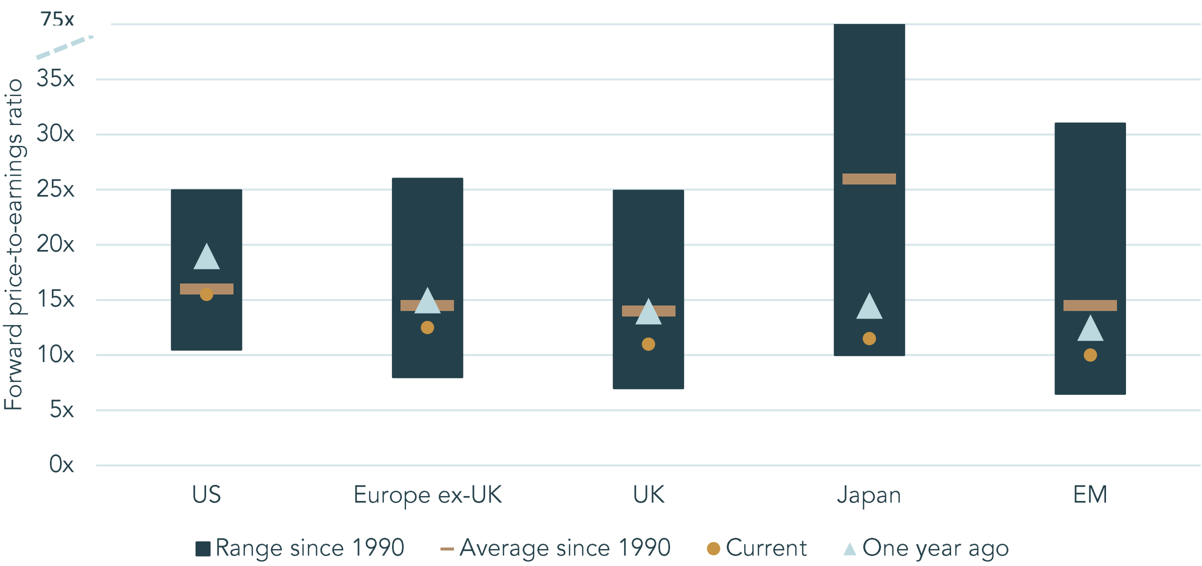
At the beginning of 2018, the talk in markets was of synchronised global growth, as all areas of the world were seeing strong economic performance. Investors were more concerned about missing out on the 'melt up' than worrying about any potential melt down. This view reversed sharply at the end of January with the realisation that low interest rates were not permanent, leading to a sell-off in the first quarter. Q2 and Q3 saw some stability and growth return to markets before the most recent quarter wiped away any gains made, with all major equity indices showing negative performance for the year. Volatility had well and truly returned. If we look at the US market, the last 6 years have seen only 8 days when the S&P 500 has had daily declines of more than 3%; with 5 of those in 2018. Q4 has been the most painful for investment performance. Since markets peaked on the 20th September, the major equity indices have dropped by 9% in the UK, 14% in the US, 12% in Europe, 16% in Japan, 10% in China and 7% in Emerging Markets, making it the worst year for investing since 2008.

It is extremely rare to find economic growth coupled with a significant fall in markets, but that's what we saw in 2018. In the US, GDP growth has been especially strong, yet the S&P fell 19.8% peak to trough (near the bear market definition of 20%). This scenario has only been seen once since World War II, when in 1987 the S&P fell 33%, whilst GDP and earnings recorded new highs over the next 6 quarters.

It has been a year of elevated political risks, with Brexit at the forefront of UK investors' minds, and China/US tensions influencing the level of daily volatility in markets. The real driver, however, has been central banks, and in particular the US Federal Reserve (Fed). In the last 3 years, interest rates have been raised 9 times in the US, compared to twice in the UK and no raises at all in Europe or Japan. The fear that the Fed was raising interest rates too quickly, along with concern about trade wars and slowing growth, caused all equity indices to sell-off materially in Q4. Parts of the equity market that looked relatively expensive a year ago have seen a material repricing. The declines have been dramatic; one trading day in October saw Google and Amazon lose $100 billion in market capitalisation, equivalent to 5x the size of Rolls-Royce.

We have been cautious in our investment selection in developed markets for a while as we felt the high valuations seen in some areas of the equity market were not justified. The chart below demonstrates this and shows forward price-to-earnings ratios for major markets now versus one year ago, and then compared to their long-term average. Following this sell-off, we are starting to see more attractive levels with all markets, aside from the US, now below their long-term average.

Global forward price-to-earnings ratios



Source: JPMorgan, 2018

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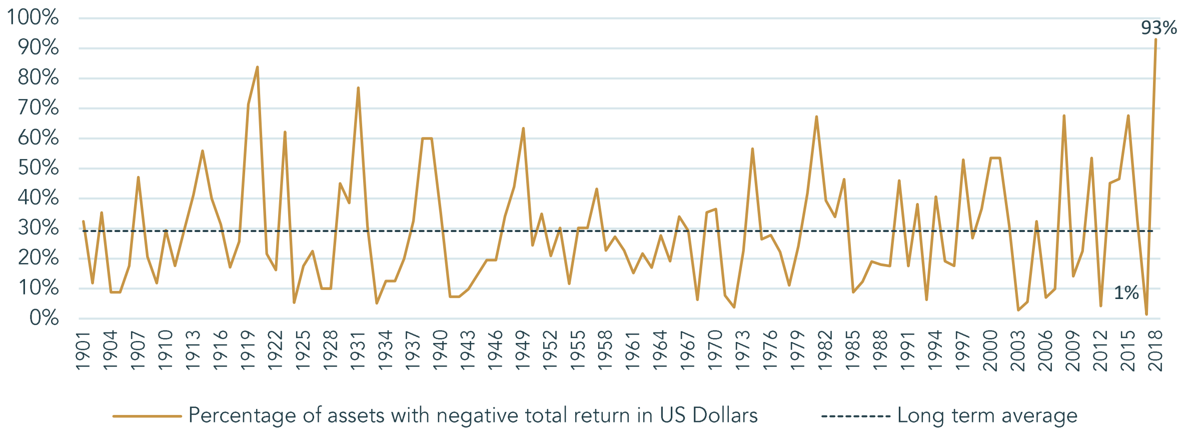
Throughout 2018, we reduced risk from portfolios, whilst remaining tactically overweight in Emerging Market and Asian equities. In developed markets, where we are underweight, we continue to have a value bias, following years of underperformance of value companies in comparison to growth. Although we have not been able to shelter portfolios from this year's equity market volatility as much as we would have hoped, it has been encouraging to see the recent relative outperformance of Emerging Market and Asian equities over those of the US, and the extremely high valued US technology companies experience some normalisation.

It has been an unusually tough year for all parts of the market. The graph below shows the percentage of assets with a negative total return measured in US Dollars each year. 2018 has been the worst year of this measure since the Great Depression with a staggering 93% of assets delivering a negative return. This is in stark contrast to 2017 where, on the same measure, only 1% of assets recorded a negative return. This swing has been particularly dramatic as developed market central banks have only just started to reduce liquidity from the market, with the beginning of the end of Quantitative Easing.

Percentage of assets with a negative total return in US Dollars



Source: Deutsche Bank & Bloomberg Finance LP, 2018

We maintain an unconventional approach in fixed income, specifically in government and investment grade corporate bonds, as prices are so high that risks to capital are notably skewed to the downside. We remain concerned generally about the health of the bond market, the level of issuance and the deterioration of quality. Today over 50% of the bonds in the investment grade bond index are rated BBB (the last rating above 'junk' level), whilst in 2008 this figure was 30%. Any material downgrades for bonds from investment grade to junk will leave an enormous funding gap for these types of companies with a glut of sellers and very limited demand. In fixed income, we prefer to be exposed to areas where you get rewarded for the risk you are taking. For example, one of the funds in our High Yield Bond asset class currently receives a yield of 7.3% and our Emerging Market Bond fund yields 6.4%.

Whilst there is no shortage of risks as we enter 2019, and we continue to be positioned accordingly, it is times like this when market fear creates anomalies that investors can take advantage of. Whilst the UK remains bogged down in no man's land over Brexit, with little sign of a straightforward conclusion, there appears to be willingness from both China and the US to reach an agreement on trade. This may be helped by the shift in US politics as a result of the Democrats taking control of the House of Representatives, and elections on the horizon in 2020; we may see more conciliatory noises from the White House, soothing rather than fuelling market concerns. We are confident of our positions in Asian and Emerging Market Equities, with attractive valuations in many regions and the financial influence of the positive demographic change likely to prove rewarding over time. The most recent period, where sentiment has been more important than valuations, was not a pleasant time to be an investor, however for those with longer-term time horizons we also know these moments give rise to opportunities, which we continue to look for and take advantage of where we can.

Fred Hervey
Chief Investment Officer