Lincoln Private Investment Office
London

31 December 2019

Investment Letter – Q4 2019

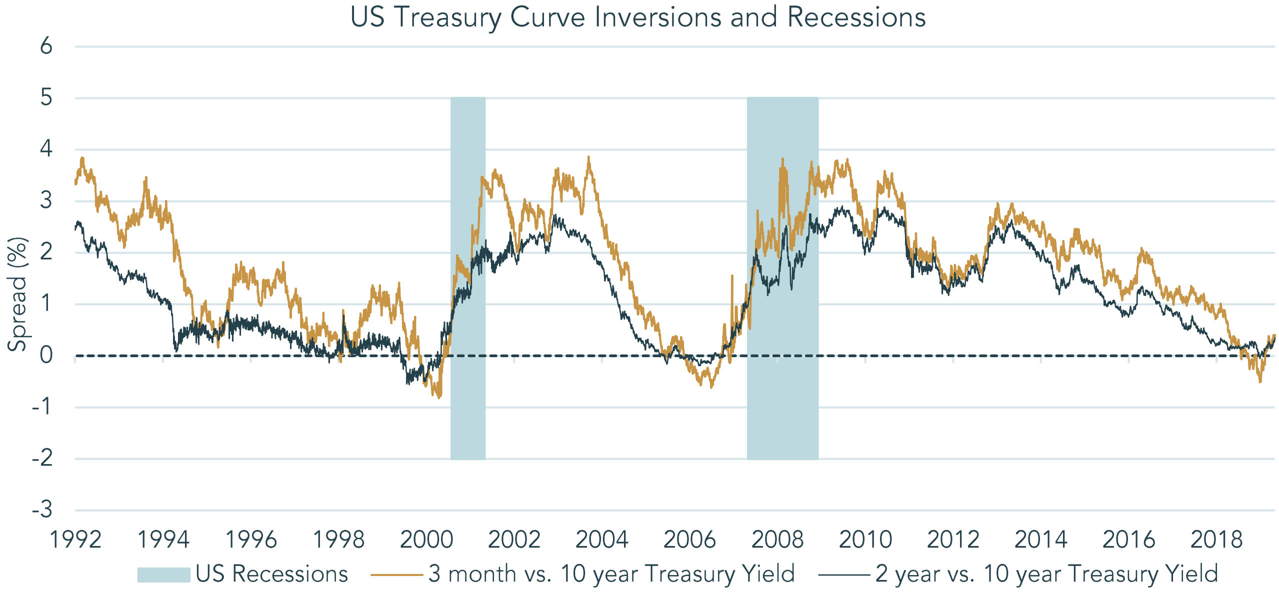
"When you see only problems, you're not seeing clearly." Phil Knight, founder of Nike

December's election result is likely to mean that international investors will look at the UK as an investable destination once again. By winning an 80-seat majority, Boris Johnson will negotiate the UK's future relationship with the European Union on a much stronger parliamentary footing. Whilst these negotiations will no doubt present challenges, markets should be reassured that they will be delivered without reliance on the support of divergent groups in Westminster. The extent of the boost to the UK economy depends on whether the Conservatives feel empowered to deliver a fiscal stimulus, alongside their commitments to Brexit. We believe that the electoral outcome will allow them to do both.

Immediately after the result, Sterling appreciated materially against major currencies. Although these levels were only sustained briefly, our view is that with increased certainty in the UK, Sterling will continue to gradually strengthen against major currencies in 2020. Within UK equities, we are currently positioned with a bias towards UK domestic businesses via a smaller companies fund, a FTSE 250 index tracker and a UK value manager. These positions should benefit from a strong pound compared with large companies that typically make more revenue overseas.

One of 2019's talking points was the inversion of the US Treasury yield curve, historically a leading indicator of an impending recession. The yield curve is a visual representation of the yield you can earn by owning US government bonds over different timescales. In a conventional environment, investors lending the US government money for a longer period of time demand more in return, so yields on longer dated bonds will typically be higher than those for shorter dated bonds. However, when investors are worried about the outlook for the economy, this relationship breaks down. Investors seek to reduce risk by buying the perceived safe haven of long-dated US government bonds, pushing up the price and reducing the yield. At its extreme, this can cause an inversion where longer-term government bonds have lower yields than shorter-term equivalents. We saw this inversion at various points in 2019 as trade war fears caused investors to flock to the safety of 10 year US government bonds.

The first inversion to grab headlines was in March when the yield on the 10 year US government bond fell below that of the 3 month equivalent. In late August, recessionary fears grew further as the 'more reliable' 2 year versus 10 year yield curve inverted, however it lasted for just seven days during a turbulent month for both bond and equity markets. The chart below shows historic inversions of these two indicators, and the subsequent timings of US recessions. The inversions are shown when the lines fall below zero, meaning that the difference between the two yields (the spread) has turned negative.



Source: Bloomberg, 2019

31 December 2019

Whilst we are mindful of these yield curve inversions and recognise that the developed world is late in the economic cycle, we have seen in the past that the time lag between a yield curve inversion and an economic downturn can vary hugely from 6 months to 2 years. More importantly, the distortion that quantitative easing has created in bond markets makes any attempt to pinpoint the moment we will enter any future recession even more futile. Inevitably there will be a recession at some stage, but due to supportive monetary policy a continuation of this unnaturally long business cycle is possible. Ahead of prior recessions, which have been forecast by the described yield curve inversions, inflation was rising and US employment was falling. Neither of these two important factors have occurred, giving us some confidence that a US recession is not imminent.

With low growth and low inflation in the developed world, we choose instead to make significant portfolio allocations to Asian and Emerging Market equities. This is by no means the consensus view, with many investors continuing to chase the high-profile US technology behemoths that have driven the US market for the last decade. We prefer to invest in more structural growth themes that are especially prevalent in Asia and Emerging Markets, which performed strongly in Q4.

We particularly like the various consumer stories emerging across Asia, with slightly different trends in each country depending on its level of GDP per capita. In China, surveys have indicated that Chinese consumers desire two things above all others: property ownership and travel. Given that 80% of Chinese citizens now own property, the tourism industry is expected to be a significant beneficiary of the incremental wealth amassed by China's rapidly expanding middle class. With just 15% of Chinese citizens in possession of a passport, we see plenty of runway for this story. In India, where GDP per capita is lower, opportunities lie in earlier stage consumer behaviour such as buying a first car or opening a bank account.

We continue to feel positive on Japan, where equity market strength seemed to coincide with last year's hugely successful Rugby World Cup. Unlike the tournament, which was fleeting and euphoric, we argue that the story in Japanese equities will be one of gradual, steady improvement. We wrote in detail about corporate Japan in May, citing robust balance sheets and attractive valuations among listed companies, with rising dividend payments. Indeed, investors have seen tangible evidence of this change, with the value of share buybacks by Japanese corporates up 136% in the first three quarters of 2019, another record year. Dividends have also seen healthy growth through the year, although with 57% of listed Japanese companies in a net cash position compared to just 20% in the S&P 500, we see plenty more pay-outs to come.

In the wider Japanese economy, 2019 saw the introduction of a sales tax hike on retailers, which was blamed for the 14% fall in October retail sales. Whilst certainly a setback, we note the timing of Typhoon Hagibis in the same month and wait for subsequent data to reveal more about the hike's impact. Later in the year, Prime Minister Abe announced a ¥13.2tn fiscal stimulus package which will be delivered over the remainder of the 2019 fiscal year (to March 2020), with further spending lasting until 2021. Whilst the proposed investments into infrastructure and technology are potentially good news for the economy, our thesis in Japan is less contingent on the economy and more a view on its undervalued listed companies.

We enter 2020 with a number of key themes running through the portfolios. We feel that developed market bonds are overpriced and we expect yields to increase over the coming year, meaning that we continue not to own conventional government and corporate bonds. On the equity side, we look forward to seeing global investors re-allocate to the UK, supporting both domestic companies and the currency. We see attractive value opportunities in Europe and Japan, and exciting growth opportunities in Asia and Emerging Markets. As we embark on a new decade, we see much to be confident about.

Fred Hervey

Fred Hervey
Chief Investment Officer