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MARKET COMMENTARY

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Phew! What a Scorcher!

Helped by a final flurry in June, 2019 was the best first half for equities in over twenty years across Europe and the US. Boosted by the technology sector, the S&P-500 led the way closing up 21.4% in local currency terms (including dividends) - the strongest return since 1997. Europe wasn't far behind, up 19.3%, helped by a particularly strong French market. The UK lagged, but still up 13.4%, the last time we saw better returns was in 1998. One must remember that this follows a sharp sell-off in Q4 2018, especially December, but now all markets are in positive territory year-on-year. This seemed unthinkable back in January and the reason for the change in mood is very simply the huge shift in stance at the US Federal Reserve, where instead of raising interest rates in 2019, they now look set to be cut. More on this below.

Government bonds also continued their ascent last month. Index-linked gilts are now up 7.9% year-to-date, with conventional gilts up 4.7% - this after more than 18 months of sideways movement. Again, the Fed is behind this. Elsewhere, commodities were mixed with agricultural markets broadly flat, whereas oil edged higher on tensions in the Gulf. Metals generally had a very strong month with nickel up over 19% on higher anticipated levels of electric vehicle production. Palladium was up 15% also due to industrial demand and gold rallied 8% reportedly due to investor nervousness. Up nearly 10% so far this year, gold had spent most of the previous five years going nowhere.

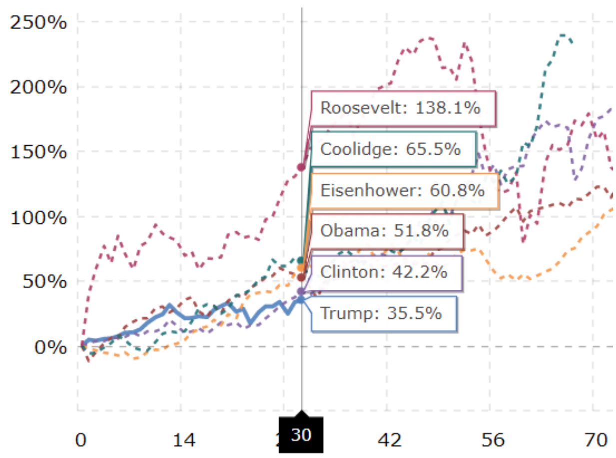
It may seem paradoxical that the price of gold is rallying because investors are looking for safe havens, whilst at the same time the US stock markets are hitting all-time highs. Bonds, too, are at their peak, with the recent move looking unusually acute. Are these really signs of investor nerves? The rationale is that Trump's rhetoric and the ratcheting up of Chinese tariffs, or at least the threat of doing so, is putting a brake on global growth. There are clear signs of slowing, with Germany now on the brink of recession and this can't be good news for France, Spain or Italy. Geopolitical tensions, especially in Iran, could escalate quickly and one consequence might be an oil price spike which would damage corporate profitability. Nerves or not, we suspect the explanation at least in part could lie in the fact that with most financial markets rallying hard, some investors are simply finding it marginally more appealing now to buy gold.

What is undeniably true, however, is that the stock market is a barometer of investor confidence. If investors are nervous, they sell and this isn't happening. In which case the real paradox is that with the S&P-500 at a new high, why are US interest rates coming down? Pundits highlight unemployment data that does seem to be softening, with announced lay-offs up for 11 straight months, but the number remains at an historically very low level. Some economists cite that with inflation set to stay close to 1.8%, there is room to cut without worrying that it will suddenly fuel widespread price rises, but is that relevant?

Trump has publicly criticised Fed governor Jay Powell and the argument that he has influenced decision-making is looking increasingly persuasive. This is not good. The financial markets value stable central banks and clear communication is key. If there is no rate cut on July 31st, there will be uproar not because investors want to see lower interest rates but because they want to see consistency. It is ironic that cutting rates could prove to be a major policy mistake, but not cutting could create utter turmoil. In which case it is maybe understandable that some investors conclude that gold is the answer.

Trying to second guess what will happen is an interesting pursuit, but from an investment perspective, a fruitless one. What we do know is that valuations in some areas look attractive (quality smaller companies in Europe) and stretched in others (government bonds). To conclude that share prices are set to plunge because we are on the brink of a global recession risks missing out on a Trump-induced 'melt-up'. One thing is for sure, he knows that a collapsing stock market will do his re-election push no good and that so far he is not quite as successful as he claims. As the chart below shows, at this stage, 30 months into his presidency, the Dow Jones Industrial Average Index is up 35.5%, trailing Obama on 51.8% and Clinton on 42.2% at the same stage. Record highs means votes and Trump needs to do whatever is possible to keep this party going.

Best Dow Jones Performance By President



Source: Macrotrends.net

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On an unrelated note, we need to comment on the Woodford saga that has raised countless questions over the last few weeks. For those unacquainted, Neil Woodford, is one of the City's best-known fund managers, initially gaining recognition at Invesco Perpetual where for 25 years he ran funds that focused on UK equities. In 2014 he went out alone with much early success, attracting more than £10 billion from investors including the general public, local authorities and pension funds. The flagship UK Equity Income fund had many similarities to his previous vehicle at Invesco Perpetual and with near universal support from the media, the venture looked set for success. What many people didn't realise is that as well as holding shares in companies such as Lloyds Bank, AstraZeneca and Barratt Developments he also held US shares, smaller company shares (that are sometimes difficult to sell, i.e. illiquid) and unlisted shares (those with no secondary market i.e. very illiquid).


"Liquidity is when you wake up one day to see your pension pot has vanished, then you wet yourself."
CartoonStock.com

Early last month it was announced that the UK Equity Income fund was suspended, after breaching the rules. Due to faltering performance following some high-profile stock blow-ups, investors had been losing faith and pulling their money out. These redemptions needed to be paid somehow from the portfolio and the easiest, indeed only, way was to sell down the liquid positions. As a result however, the unlisted and illiquid holdings grew in proportion and sooner or later, regulatory limits were going to be broken. When they finally did there was no choice but to temporarily close the fund. This measure is in place so that the manager has time to sell what he can in an orderly manner, reducing the scope of being forced to jettison holdings quickly at fire-sale prices. Although the unitholders want their money back, most will understand that trying to recover it in haste could reduce the proceeds. This might take weeks or months and although investors will not have lost everything, many are angry that the Woodford proposition was much riskier than they were led to believe.

On that point we would defend Woodford, because, as far as we are aware, as much was disclosed as was required, in which case this should not have come as a shock to those monitoring the situation; the risk of suspension had been building for months.

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Savvy investors pulled out in time – the more savvy investors didn't invest in the first place. We would say that of course, because we never bought either the Woodford UK Income Fund or his prior fund at Invesco Perpetual and it is easy to explain why.

Our starting point is always in trying to identify what exactly we are looking for, what is required. Once we have established this, a detailed brief is drawn up. We then go through a series of strict criteria, filter out funds that do not fit and this produces a shortlist. We then try and meet the managers to gain more colour and eventually conclude on one or two funds with a couple in reserve. This all works within a portfolio construction process that aims to avoid funds with overlapping mandates. By isolating manager responsibilities, the scope for doubling up on holdings is cut which also makes risk measurement much easier.

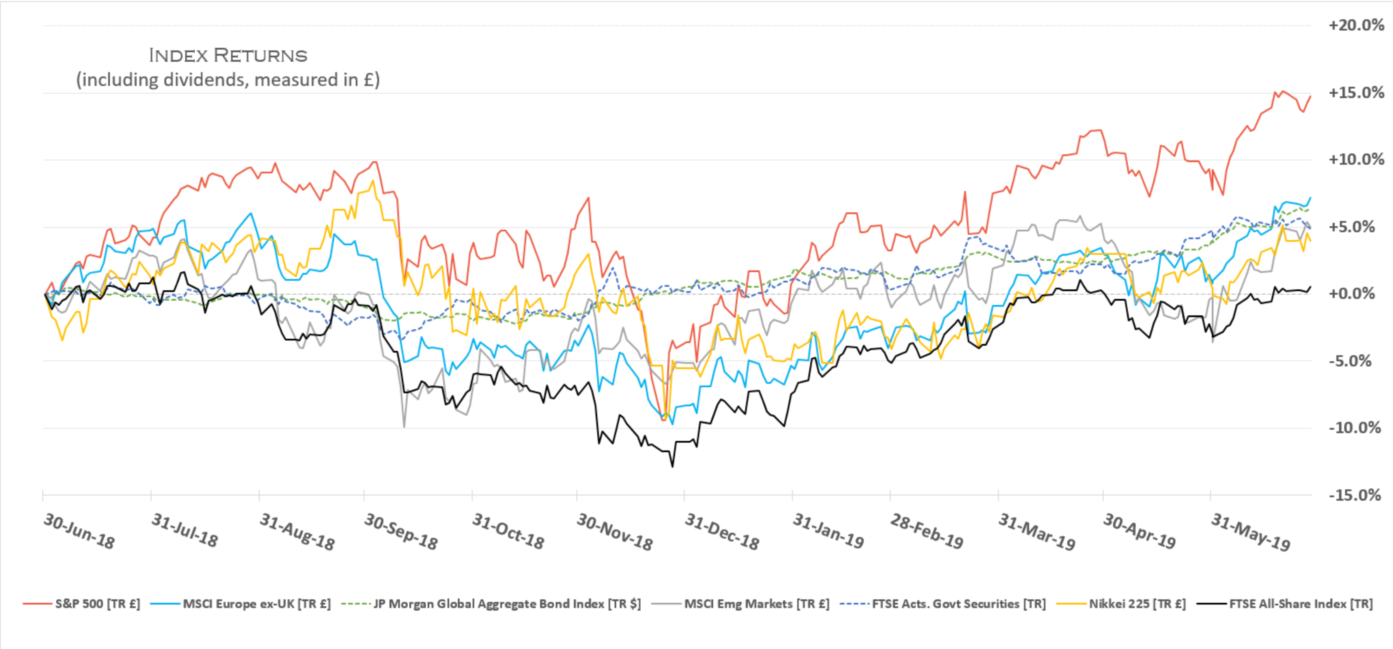
What would be very unlikely is a brief that read, 'look for a single fund that simultaneously has several very focused bets on UK equities that could either rocket or go bust; has exposure to the US; has unlisted securities especially in the healthcare/biotech industry'. There is nothing wrong with these three approaches in principle, but why do it all at the same time under one single umbrella? Straying at the margins might be fine but we prefer our managers to stick to their knitting.

Financial risks therefore come in several guises and this isn't always well understood by the man on the street. Most will be familiar with market risk, the consequence of shifting conditions that might impact profit margins for example, which in turn will affect prices of shares, bonds, etc. This is usually measured by volatility. The Woodford case is a good example of liquidity risk, something that clearly didn't even occur to a lot of people. Credit risk and the inability of companies or nations to pay their debts speaks for itself and was at the root of the 2008 crash. Operational risks refer to the consequences of single events, often unforeseen by badly-managed organisations – the fall of Barings jumps to mind. Warren Buffett puts it more simply; "Risk comes from not knowing what you're doing."

We think that using volatility to measure market risk can be misleading and since it is backward-looking, it is of little help in anticipating things that might go wrong in the future. We find that a focus on sources of 'permanent capital loss' is far more useful and when using this lens, the pitfalls suddenly become much easier to spot. Avoiding the losers is just as important as finding the winners and a 100% loss is risk at its most extreme. After all, you can't grow your money back if you've lost it.

Index Returns

Index	Region/Asset Class	30 Jun 2019	1 Month Change	1 Year Change	2 Year Change
UK 100	UK	7,425.6	+3.7%	-2.8%	+1.5%
UK Mid Cap	UK	537.3	+4.0%	-6.8%	-1.6%
UK Small Cap	UK	5,570.1	+0.3%	-5.2%	-0.3%
Dow Jones Ind Avg	USA	26,600.0	+7.2%	+9.6%	+24.6%
S&P 500 Index	USA	2,941.8	+6.9%	+8.2%	+21.4%
NASDAQ Comp.	USA	8,006.2	+7.4%	+6.6%	+30.4%
Nikkei 225	Japan	21,275.9	+3.3%	-4.6%	+6.2%
Euro Stoxx 50	Europe	3,473.7	+5.9%	+2.3%	+0.9%
CAC 40 Index	France	5,539.0	+6.4%	+4.0%	+8.2%
DAX Index	Germany	12,398.8	+5.7%	+0.8%	+0.6%
Milan Index	Italy	21,234.8	+7.2%	-1.8%	+3.2%
MSCI Emg Mkts (£)	Emg Mkts	578.2	+5.2%	+5.0%	+11.8%
IBOVESPA Index	Brazil	100,967.2	+4.1%	+38.8%	+60.5%
IMOEX Index	Russia	2,765.9	+3.8%	+20.5%	+47.2%
S&P BSE SENSEX	India	39,394.6	-0.8%	+11.2%	+27.4%
Shanghai SE Comp.	China	2,978.9	+2.8%	+4.6%	-6.7%
Hang Seng	Hong Kong	28,542.6	+6.1%	-1.4%	+10.8%
UK All Property	UK Property	132.9	-0.3%	-0.6%	+6.3%
UK Conv Gilts	UK Gilts	3,780.6	+0.2%	+4.9%	+6.9%
UK Index linked Gilts	UK IL Gilts	5,281.5	-0.8%	+8.6%	+10.6%
JPM Glob Agg. Bond ($)	Global Bonds	597.2	+2.2%	+6.4%	+7.7%
iBoxx Non-Gilt	UK Corp Bonds	355.8	+1.1%	+5.9%	+6.5%
WTI Crude ($/barrel)	Oil	58.5	+9.3%	-21.1%	+27.0%
LMEX	Base Metals	2,818.6	+2.0%	-12.0%	-1.2%
Gold Spot ($/oz)	Commodities	1,409.45	+8.0%	+12.5%	+13.5%
S&P Agri & Livestock	Agriculture	697.11	-0.5%	-3.9%	-15.0%
£1 = US$	Currencies	1.27	+0.5%	-3.9%	-2.5%
£1 = €	Currencies	1.12	-1.3%	-1.2%	-2.0%
£1 = Yen	Currencies	136.92	+0.1%	-6.4%	-6.5%



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