ALBERT E SHARP

INVESTMENT MANAGEMENT & STOCKBROKING

MARKET COMMENTARY

October 2018

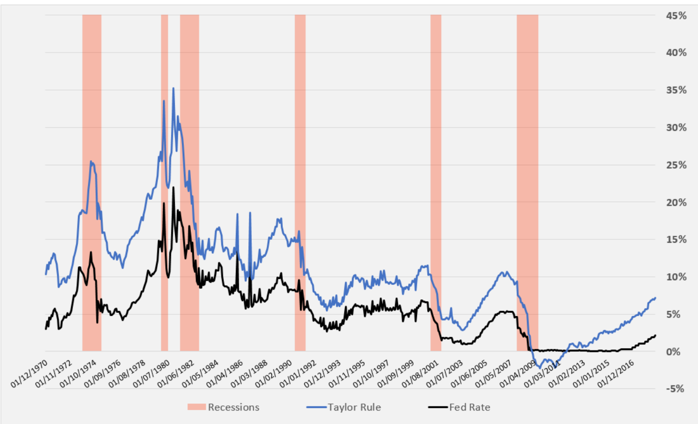
Playing By The Rules

It was a mixed bag for equities in September with the UK and Europe broadly flat and the US marginally ahead. This despite a lowering of GDP estimates by the ECB and tech taking a knock following reports of lower semiconductor demand. The bright spot was Japan, up 5.5% (+20% in sterling terms for the year) following the re-election of President Abe. Asia was generally firmer despite the ongoing worries of trade wars although India was sharply lower on concerns regarding upcoming elections and the impact of higher oil prices.

Bonds were under pressure with US 10-year treasuries falling almost 2% in value, breaking back beyond the 3% yield level. A similar move in May proved to be short-lived, but this time it strengthened, breaching 3.2%, before falling back. Gilts and UK corporate bonds also fell in value by an unusually large amount. More on this below. Elsewhere, gold slid lower again, down over 12% from its January high whilst oil pushed $75 a barrel for the first time in three years.

However, September's events were a sideshow for what occurred in the first few days of October. By the 11th most stock markets had fallen by more than 5% and Asia was off more than 10%. Forget Brexit, look through Trump, these are red herrings. The driver for this sell-off was concern over the path of US interest rates.

It all stemmed from comments made by the relatively new Fed Chairman, Jerome Powell. After hiking interest rates to 2.25% on September 25th he removed a vital line from their usual commentary that the bank would stay 'accommodative'. This single word is critical and should be read to mean 'expansionary' or 'supportive' so surely any help that the Fed was giving to the economy was being removed. Or did it? He argued that this move provided greater freedom for policy decisions, but did not signal a more aggressive tightening policy. However, at best the markets seemed to disagree and at worst were confused. Several economists picked up on other comments that he made suggesting that it was facts such as inflation, or unemployment that should provide an indicator as to where interest rates were headed, supporting previous comments that he is a believer in the Taylor Rule. In simple terms this is an equation that takes into account inflation and GDP growth and provides an output of where interest rates should be. Over the years actual rates and Taylor rates



Source: Bloomberg®, Albert E Sharp

The conclusion that many have drawn is that the black line (actual rate) should be much closer to the blue line, in which case the 3% neutral rate referred to by the Fed at various points recently seems too low; 5% would be more realistic and would not be out of keeping with historic norms. There seems to be a case to be made that if rates rise quickly and start to converge with the Taylor rate, it can trigger a recession. Furthermore inflation is already on the rise and if fuelled further by newly-imposed tariffs, rates will have to go up as a result. The chart below shows how markets react to recessions.

Source: Bloomberg®, Albert E Sharp

Using the S&P-500 as the basis for analysis, we have highlighted periods when the index has either risen or fallen *by more than* 5%. Investors are understandably twitchy that recessions coincide with meaningful falls.

These charts are undeniably appealing and seemingly supported by logic. The difficulty is in predicting (a) when the next one arrives (b) how serious those red bars drop when it does and (c) in the meantime how high the green mountains are. Concluding that the next recession is just around the corner could lead to a huge opportunity cost of being out of the market.

Over the last five years following similar sell-offs, as prior commentaries show, we consistently regarded them as buying opportunities. As time goes on, it is difficult to argue the point with the same level of conviction, but several factors lead us to conclude that putting cash under the mattress is not the answer.

Click on blue links for more information online

Firstly, US interest rates are still set to stay very low by any historic standards. True, investors are finding it hard to adjust, particularly in the emerging markets, but even at 3% this is should not be seen as an emergency brake on global growth. Secondly, the trajectory of global economic recovery post the events of 2008 has been incredibly shallow on every metric, be it GDP growth, wage inflation, corporate earnings or stock market returns. The FTSE-100 for example is today at the same level as it was in 1999! Thirdly, and maybe more subjectively and at the risk of appearing glib, we see the 'big issues' of Brexit and Trump as transient issues, distractions from the fundamentals that drive the global economy. So again, we say buy on the dip.

For what it's worth, plenty of others share our view on this. David Norris from TwentyFour Asset Management says in a recent article *Call That a Correction* that the current earnings season in the US "could serve as a timely reminder that this aging cycle remains intact". Jeremy Podger at Fidelity in an article where he advises staying calm, remarks that following the recent drop "in relation to prevailing company profits US equities - and all other markets for that matter - are significantly cheaper today than they were a year ago." Luca Paolini, Chief Strategist at Pictet in his note *Looking Past The Gloom* says, "compared with January 2018, when markets were last threatening to enter a protracted nosedive, the fundamental and technical indicators we monitor are more positive now than they were then. Growth may be easing, but economic conditions remain healthy."

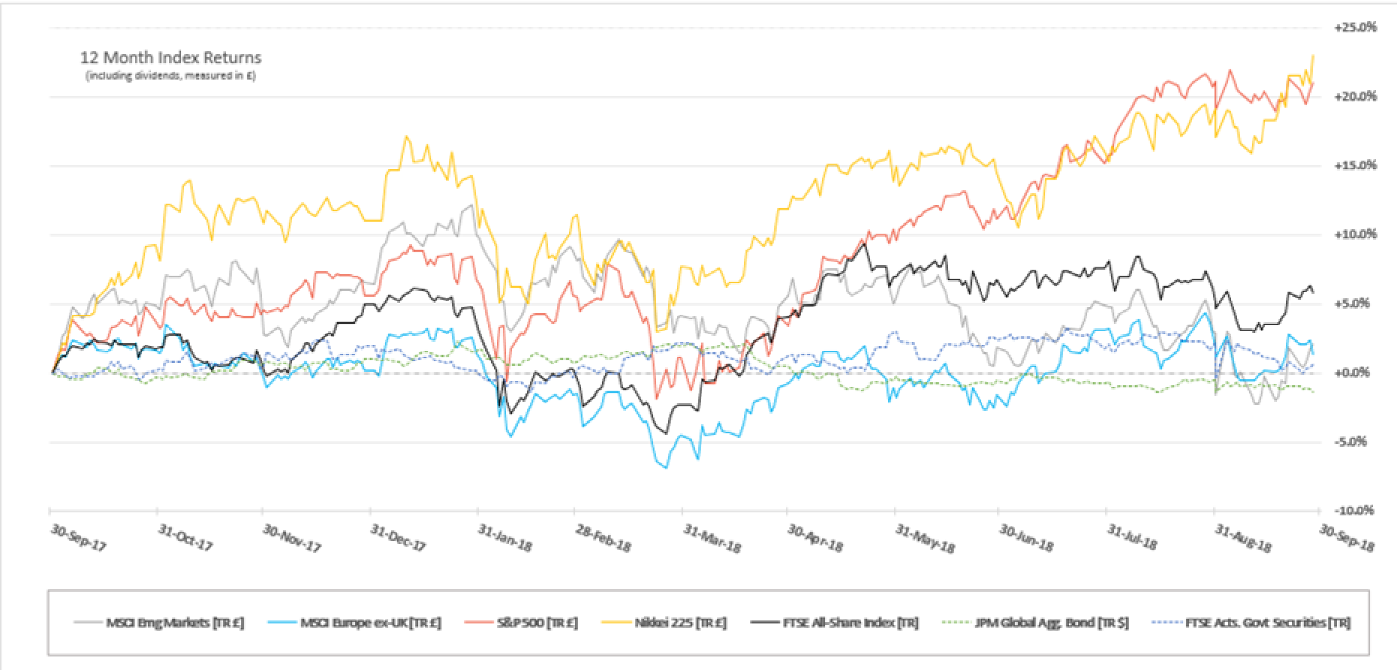
This commentary has focused on equities and it does feel amiss not to mention fixed income because this asset class is so inextricably linked to interest rates. Suffice to say that it even after the falls, we do not see a case for most developed market government bonds. However corporate debt selectively across the globe has pockets of value and specialist categories such as floating rate notes have attractions. Consequently we prefer funds with flexibility, an ability to move across geographies, up and down the maturity range and between investment grades. Returns here may not be huge, but should be well ahead of bank deposit rates after accounting for inflation.

The lessons of every sell-off since 2008 has been to buy on the dips and the case for doing so again looks intact. With Q4 typically the strongest quarter of the year we wouldn't rule out fresh highs being achieved before Christmas. So once again, keep calm and carry on.

Click on blue links for more information online

Index Returns

Index	Region/Asset Class	30 Sep 2018	1 Month Change	1 Year Change	2 Year Change
UK 100	UK	7,510.2	+1.0%	+1.9%	+8.9%
UK Mid Cap	UK	558.2	-1.2%	+0.6%	+7.1%
UK Small Cap	UK	5,822.0	-0.3%	+1.9%	+17.0%
Dow Jones Ind Avg	USA	26,458.3	+1.9%	+18.1%	+44.5%
S&P 500 Index	USA	2,914.0	+0.4%	+15.7%	+34.4%
NASDAQ Comp.	USA	8,046.4	-0.8%	+23.9%	+51.5%
Nikkei 225	Japan	24,120.0	+5.5%	+18.5%	+46.6%
Euro Stoxx 50	Europe	3,399.2	+0.2%	-5.4%	+13.2%
CAC 40 Index	France	5,493.5	+1.6%	+3.1%	+23.5%
DAX Index	Germany	12,246.7	-0.9%	-4.5%	+16.5%
Milan Index	Italy	20,711.7	+2.2%	-8.7%	+26.3%
MSCI Emg Mkts (£)	Emg Mkts	551.5	-0.9%	+2.0%	+21.0%
IBOVESPA Index	Brazil	79,342.4	+3.5%	+6.8%	+35.9%
IMOEX Index	Russia	2,475.4	+5.5%	+19.2%	+25.1%
S&P BSE SENSEX	India	36,227.1	-6.3%	+15.8%	+30.0%
Shanghai SE Comp.	China	2,821.4	+3.5%	-15.8%	-6.1%
Hang Seng	Hong Kong	27,788.5	-0.4%	+0.9%	+19.3%
UK All Property	UK Property	135.0	+0.3%	+5.9%	+13.3%
UK Conv Gilts	UK Gilts	3,541.6	-1.5%	+0.6%	-3.0%
UK Index linked Gilts	UK IL Gilts	4,805.6	-1.0%	+1.3%	-2.5%
JPM Glob Agg. Bond ($)	Global Bonds	556.5	-0.8%	-1.3%	-2.3%
iBoxx Non-Gilt	UK Corp Bonds	334.8	-0.9%	+0.2%	-0.1%
WTI Crude ($/barrel)	Oil	73.3	+4.9%	+41.8%	+51.8%
LMEX	Base Metals	2,994.8	+2.3%	-4.2%	+21.1%
Gold Spot ($/oz)	Commodities	1,192.50	-0.7%	-6.8%	-9.4%
S&P Agri & Livestock	Agriculture	703.78	-0.4%	-7.4%	-10.3%
£1 = US$	Currencies	1.30	+0.5%	-2.7%	+0.5%
£1 = €	Currencies	1.12	+0.5%	-1.0%	-2.7%
£1 = Yen	Currencies	148.16	+2.9%	-1.7%	+12.7%



ALBERT E SHARP
INVESTMENT MANAGEMENT & STOCKBROKING

WWW.ALBERTESHARP.COM

7 Elm Court
Arden Street
Stratford Upon Avon
Warwickshire
CV37 7LN
☎ 01789 404000