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Market and Portfolio Update

It is fair to say that it has been a strange summer. The Brexit proceedings have transcended farce. The Greek government is borrowing at cheaper rates than the US. Sterling strengthened on the hopes of a Corbyn government. President Trump labelled his own central banker as an enemy. The British government would collapse, if only the opposition would allow it. Investors have decided that it is a sound idea to pay for the privilege of loaning money in vast swathes of the global government bond market. If you find all this a bit baffling, join the club.

Most of the portfolios that we manage made modest gains over the quarter, even though the UK stockmarket returned 1%. The gains came in large part from a strengthening bond market and the continued weakening in the value of sterling versus the dollar. These have added to the strong returns which investors enjoyed in the first half of the year. Unfortunately, these gains have not come about from hopes of better things to come. Instead, growth expectations are being crimped and the value of existing income streams are being bid higher as a result. This is diminishing expectations of future returns.

Growth in the global economy is slowing. At the beginning of the year, central banks abandoned their efforts to lift interest rates to more normal levels and over the summer months, they have resorted to cutting rates. Both the US Federal Reserve and the European Central Bank (ECB) reduced their key base rates in an attempt to buoy flagging growth. This pessimism has driven bond prices higher and yields have been pushed back towards the all-time lows set in 2016. On that occasion we felt that bond markets had become overextended and we exited positions in longer maturity issues for our clients. Today, judging from some supporting economic indicators, we believe that bond markets are signing a continued slowdown in growth, which in places may glide to a halt. With interest rates in Europe already in negative territory, it may be difficult to restore economic growth using monetary policy and the departing President of the ECB has suggested that politicians may need to consider fiscal tools such as additional government spending.

The global economy continues to slow down

We believe the odds of a recession developing in economies such as the US and UK are shortening. Nations with high manufacturing output such as Germany may already be in recession. However, we do not think the economic decline will be anything like the acute hit which occurred in 2008. Instead we expect the slowdown to be gradual, rather like a sailboat slowly grounding itself on a sandbank. If this happens, a modest decline in share prices seems on the cards. However, over the long-term, shares are the only game in town. For example, European investors today can either invest in German government bonds at -0.2% p.a. return over the next 30 years or buy European equities on a dividend yield of 3.8%. That is a sizeable difference and even with some deeply pessimistic assumptions an additional 1% or so return from dividend growth seems reasonable.

So rather than reducing equity positions in the portfolio, we have been considering action that will act as cheap insurance to protect the portfolio if a recession develops. As such, we have taken a position in US government bonds. The US is the only major government bond market that offers a material yield, at around 1.75%. If a recession hits, these yields should fall below 1% and could approach 0%. In such an event, holders would enjoy a useful capital gain. We are buying a currency hedged fund, which removes the foreign exchange risk from the position. If yields were to move the other way, we expect that the cause of it would be a brighter economic outlook. In that event, other elements in the portfolio would perform well.

We are also switching some of the portfolio's equity exposure into more defensive equities. The Legg Mason IF RARE Global Infrastructure Income fund provides an attractive and stable equity yield through investments into businesses operating in areas such as electricity, water, airports and toll roads. If recession strikes, the share prices of these businesses will suffer, but less so than the funds that we are selling to finance this investment. If recession is avoided, this fund will continue to deliver a useful yield.

We are in a tricky period for the global economy and this raises challenges for investors. We are far from despondent about the outlook though the cautionary action we are taking should help to protect the portfolio in any market decline, which we expect in any event to be short lived. Over the longer term we think the portfolio will continue to compound steady long-term returns, ahead of the returns offered by cash.

Over the long term, equities are the only game in town

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