Lacomp plc

# Quarterly Newsletter / Autumn 2018

**Lacomp plc is an independent investment management company providing portfolio management services to private investors worldwide.**

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## Markets

It is quite common when compiling these commentaries to find a familiar range of issues impacting on the day-to-day market conditions. We have talked before about the perennial problems in the Middle East and Korea, the tribulations within the periphery of the Eurozone and, ad nauseam, the negotiations over Brexit. In the last Newsletter we added a further ingredient, the advent of a trade dispute between the US and China (and, seemingly, anybody else who is deemed by the President to have treated the US unfairly).

Markets have increasingly paid greater attention to the latter as the year has progressed, as evidenced by greater volatility in both upward and downward moves. The VIX 'fear index', a fairly reliable indicator of such phenomena, has steadily moved upwards and is just below its long-term average of 18.5. However, it is still way below the 37.5 reached in February, in spite of the market turbulence of the past few days. This current market move needs to be taken in context – yes, markets have been more volatile, but the underlying economic fundamentals that underpin share prices have remained sound, particularly in the US. As always, there are winners and losers during such times, so it is perhaps worth looking at the run-up to the current position.

The first break from the complacent market conditions of 2017 came during February when the Dow Jones Industrial Average (Dow) fell by 7% over a few days in response to an *improved* US jobs report which many took to imply that interest rates would rise faster than previously thought because of rising inflation. We took this downturn as being indicative of increasing market nervousness – surely rising rates would hardly come as a surprise – and have continued with a steady repositioning of portfolios in order to avoid the worst impact of any sudden slump in sentiment triggered by any (or all) of the above concerns.

Following the February falls, markets generally rose again and, by the end of the third quarter, the Dow was up 8% from February's low and up 7% for the year to date. This during a period when the aforementioned trade disputes were gathering momentum, triggering periodic selloffs, especially in the Emerging Markets where we saw a steady performance gap opening vis-a-vis the US.

'Emerging Markets' is an unhelpful catch-all description of those markets that are not regarded as 'developed' and can include very diverse economies ranging from South Korea to 'frontier' regions in Africa or Eastern Europe. It used to be a truism that these areas 'caught a cold' if America 'sneezed' and, to a degree, this still holds true but it is important to appreciate the changing composition of the asset class – those countries which suffered badly during the crisis of the late Nineties are largely absent from a list of those currently most vulnerable to a strong dollar or disruption of global trade. Broadly speaking, Asia has shed its old vulnerabilities and is seeing rapid economic development even though its stock markets are still termed underdeveloped. It therefore is no coincidence that the main target of the aggressive US trade policy is its biggest potential rival, China.

Europe and the UK have, as we know, their own particular issues to fuel market volatility and, generally speaking, did not withstand these as well as the US so that, by the end of the third quarter, these markets were down by approximately 3% on the year. Political travails aside, the outperformance of the US is partly a reflection of the rather narrow recovery which has seen the US indices driven higher by rapid expansion of technology firms, of which the UK and Europe has relatively few listed. Here, we are particularly talking about the so-called 'FAANG' stocks (Facebook, Amazon, Apple, Netflix and Google). We have sought to avoid funds which heavily overweight these types of stock because of an increasing wariness over valuations, and this has inevitably dampened portfolio performance during the summer.

The end of a quarter is a somewhat arbitrary cut-off and, as is frequently the case, the days following often exhibit a break from the narrative to date. In the days since the end of September, the spectre of rising US interest rates has again come to influence events. Once more, it was *positive* comments from the Federal Reserve about the prospects for sustained US growth on the back of strong corporate earnings and the impetus created by the recent tax cut (US corporate tax rates were cut from 35% to 21%). The Federal Reserve Chairman, Jerome Powell, stated that there is "no reason to think this cycle can't continue for quite some time, effectively indefinitely."

Hmm, that seemed a bit over the top, and his unbridled optimism did cause panic. Investors worried that interest rates could rise further and faster than the market had anticipated. As a consequence, US Treasury yields moved to a ten-year high (causing a fall in bond prices) and the very drivers of the equity rally through the summer were suddenly faced with difficulty in justifying their high valuations.

Technology stocks led the ensuing equity selloff which has hit both aggressive growth funds and passive index trackers alike.

With both bonds and equities falling, our defensive approach has proved a helpful shelter from the worst of the immediate fallout and we are continuing a policy of de-risking portfolios as events unfold. In fact, we had already started to further reduce our equity exposure before the latest upheavals. Still, it remains to be seen whether markets fall further or whether the upturn which followed the February selloff is repeated. Either way, we prefer to err on the side of caution.

We have to briefly touch on the ongoing Brexit negotiations. We say 'briefly' because you must be getting sick and tired of the daily feed on this subject. Switch on a TV or listen to a radio station, and it almost impossible to avoid being bombarded with yet more opinions and views, whether they come from our wonderful politicians (current and ex, some nearly and hopefully soon totally forgotten!), commentators, business spokespeople, observers, civil servants and various types of armchair experts. It is difficult to go into a pub for a quiet drink or attend a dinner party without yet more of the same.

Exactly a year ago, we recommended that you might read the book "Adults in the Room" by the ex-Greek Finance Minister Yanis Varoufakis. We even suggested it should be compulsory reading for our politicians. The book describes how the EU 'negotiated' with Greece over their debt crisis. If you have read it, you will have experienced a sense of déjà vu when observing what is happening – or not happening, as they case may be – in the UK-EU negotiations.

The EU has other problems. Whilst the blunt refusal by Hungary to follow the EU diktat on allowing immigrants and migrants into their country might only be seen as a minor irritation, the Italian coalition government's controversial budget sparked fury in Brussels. Italy is already heavily indebted (over 130% of GDP) and its economy – despite its size – far from impressive. The proposal of a 2.4% of GDP deficit *for the next three years* is three times the size of the previous administration's target. The new coalition government between the right-wing League and the anti-establishment Five Star Movement, both populist forces, has got some pretty outlandish ideas. The League wants tax cuts, and the Five Star Movement wants to provide the poor with a minimum 'citizen's income' as well as lower the retirement age. So, you have headstrong populists in Rome and a stubborn EU in Brussels. Headbutting with the EU has not done any damage to the coalition in the poll ratings.

However, the Italian debt dwarfs that of Greece a few years ago, and there simply is not enough money in either the European Stability Mechanism or the European Central Bank to bail out Italy if it all ends in tears – even if those institutions had the political will to do so. European Commission President Jean-Claude Juncker warned Italy that they risked a Greek-style depression, and he even said that Italy could put the eurozone (meaning the euro) in jeopardy. We don't know at what time of the day he made those statements, but he has been a little unsteady on his feet on occasions…

Regular readers of our Newsletter know that we have always considered the euro a failed construction. For a single currency in a heterogeneous collection of countries that make up Europe to work, you first need to have fiscal and political integration in place. The EU decided to do it the other way around.

Ah well, we will have to tolerate more 'developments' in the EU as well as their negotiations with the UK, probably beyond 2020 and possibly even longer. We hope you are strong enough!

## Housekeeping

Being aware of the damage of plastic in the environment and particularly in the oceans and other waterways, we have decided to dispense with the plastic wallets in your valuation pack. We hope you don't mind and approve.

Bagshot 18th October 2018

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