Harwood

Wealth Management Group plc

Quarterly Update

Q1 2020

IMPORTANT INFORMATION

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INTRODUCTION

The purpose of this report is to highlight the economic and political trends that are affecting the world today and to forecast potential outcomes for investments in the current year and beyond. This allows us to make tactical decisions that take account of short to medium term threats and opportunities.

In the final quarter of the year, capital markets were quite volatile. In reality it should not be surprising considering the trade war between the US and China gathered apace, the announcement of and subsequent UK general election and fears of global economic slowdown. Q4 saw the oil price rise significantly (partly as the effects from the September terrorist attack on oil installations in Saudi Arabia were starting to be realised) and a rising oil price should have negative impacts to both economic growth and keeping inflation under control.

By and large, capital markets were positive though for UK investors in the last quarter of the decade. Sterling strengthened against the main currency blocs – registering an almost 7% improvement against the US Dollar and over 4% against its largest trading partner – the Euro. This – obviously – produced negative returns for the major bond markets for Sterling investors, and the UK gilt market also suffered. Although the Conservatives won by a significant majority, the odds are the new government are likely to take their foot off the austerity brake meaning more government debt issuance is likely to be forthcoming.

Europe welcomed Christine Lagarde as the new President of the European Central Bank. She takes over from Mario Draghi and has a lot of work to do to get the union growing. She also inherits a negative interest rate scenario (meaning no quick wins) and the largest economy - Germany - on the precipice of recession. The rest of the continent sees sluggish economic growth numbers. Europe has suffered from the trade war between the US and China as it hasn't pinned its colours to either mast and therefore has been squeezed.

Looking forward we expect interest rates to remain low, inflation to be subdued but volatility to remain high. Last year the "yield curve" in the US inverted (basically meaning it cost more money to borrow in the short-term rather than the long) and this has always been seen as a reliable indicator to the next recession. Equity markets performed really strongly in 2019 and we don't foresee this to be repeated in 2020. Corporate earnings are high, corporate debt is high. Vigilance is key.

Sector Analysis

Top Performing 30/09/2019 - 31/12/2019		Top Performing YTD 2019 (31/12/2019)	
UK Smaller Companies	13.58%	Tech & Telecom	29.94%
UK Equity Income	6.94%	North American Smaller Companies	25.89%
UK All Companies	6.72%	UK Smaller Companies	25.23%
European Smaller Companies	4.96%	North America	24.92%
Tech &Telecom	4.72%	China/Greater China	22.43%
Worst Performing 30/09/2019 - 31/12/2019		**Worst Performing YTD 2019 (31/12/2019)**	
UK Index Linked Gilts	-9.03%	UK Direct Property	0.05%
UK Gilts	-4.20%	Standard Money Market	0.27%
Global Bonds	-2.10%	Short Term Money Market	0.56%
Global Emerging Markets Bond	-1.89%	Targeted Absolute Return	3.78%
Standard Money Market	-0.65%	Global Bonds	5.57%

Data from Financial Express Analytics, dates as above.

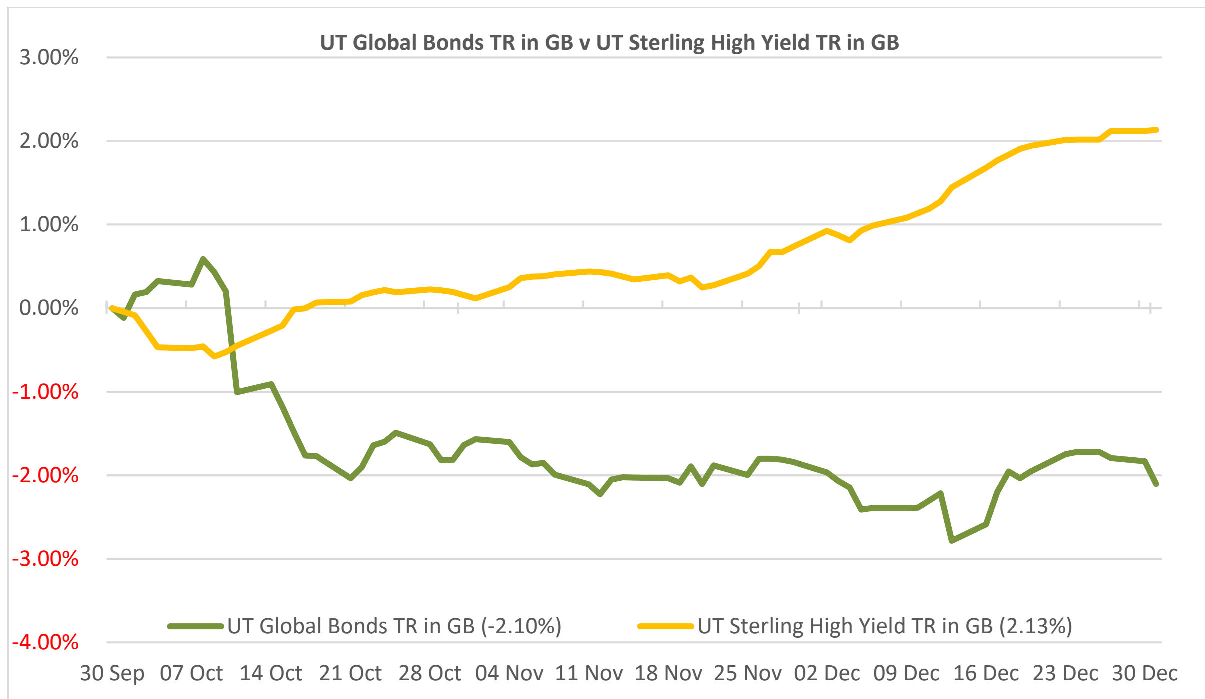
FIXED INCOME

Sterling Bonds

The final quarter of the year was quite a testing one for domestic fixed income investors and pretty much entirely driven by politics. With a UK general election in December and both main parties suggesting an end to austerity (although the absolute definition of austerity is a little confusing) the bond markets decided to tread water or slip back a little.

Capital markets like certainty. A potential change of government would create uncertainty for the bond markets as the future movement of interest rates, inflation, Sterling and the amount the sitting government is likely to spend / tax etc. But, with the main parties all talking about spending in their manifestos, the difference between supply and demand affected prices and yields accordingly. As the 6-week campaigning period came towards a close and the polls suggesting who would win got narrower, the bond markets became more jittery.

With the election now behind us, one uncertainty has been removed. But uncertainty stays among us. The Conservatives winning by a large majority has caused other questions to be asked and the markets now look forward at the next uncertainty – Brexit – and the fear that PM Johnson might push for a harder Brexit because he has a commanding position in the House of Parliament. January 31 is not far away, and the sensible commentators are suggesting an extension is the obvious route to take, but with a mandate from the people, who knows what will happen in the next quarter. One thing that is probably safe though is interest rates are unlikely to move and the currency is likely to be the "pressure gauge" defining how smooth the withdrawal from Europe will be. A simple rule of thumb – if you get more Euro or Dollars for instance for the same amount of holiday spending money next year compared to this year, then the weaker the Brexit and the closer the economic ties to the EU.



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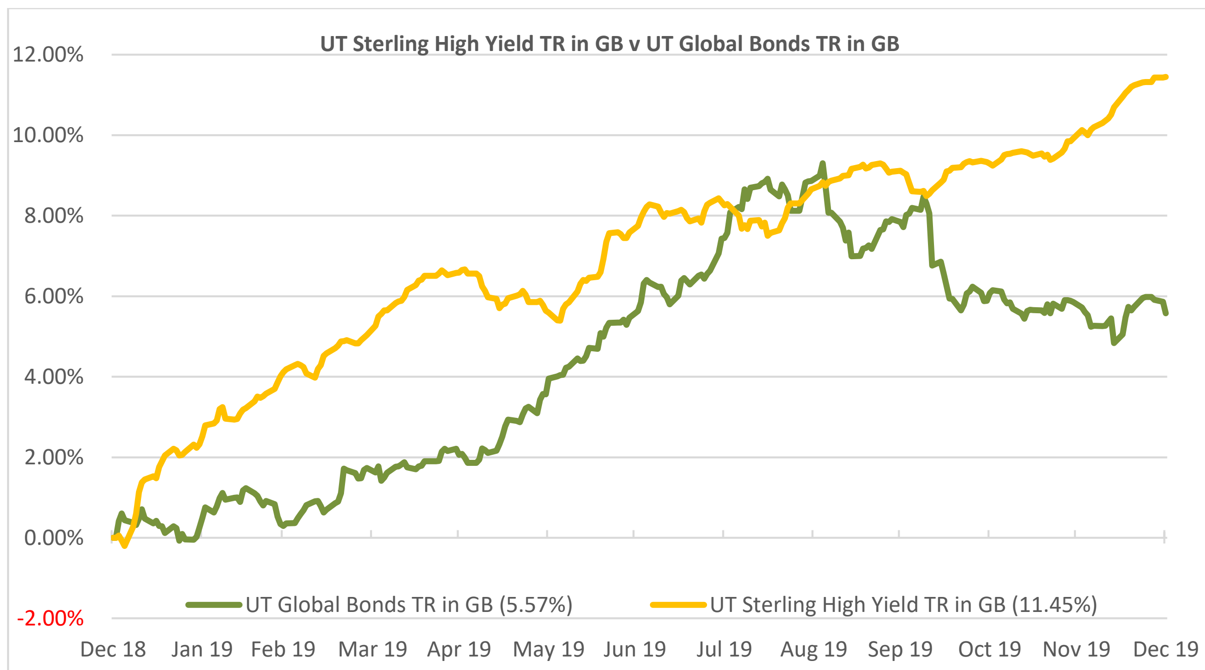

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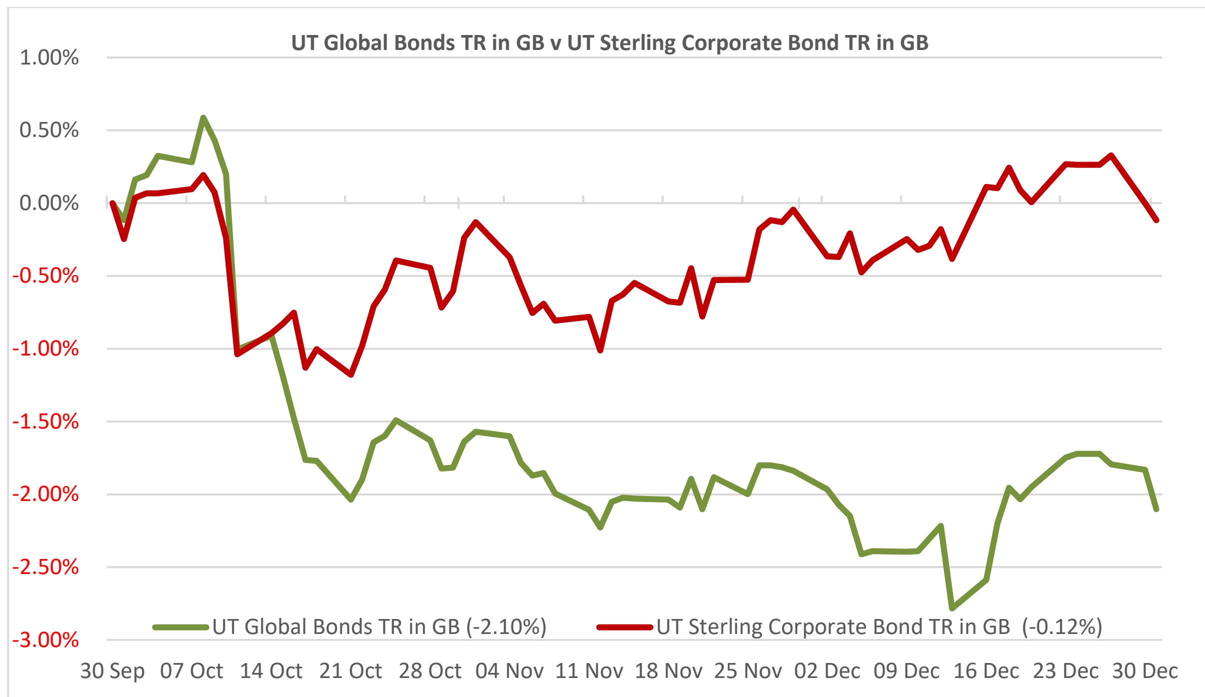

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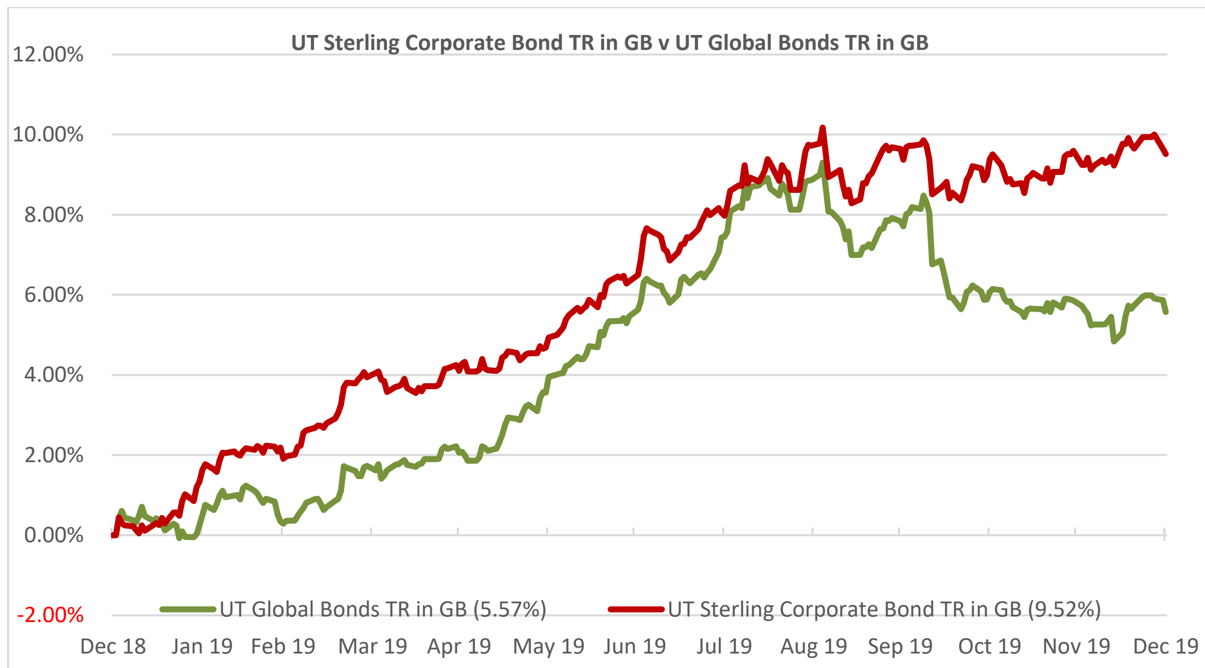

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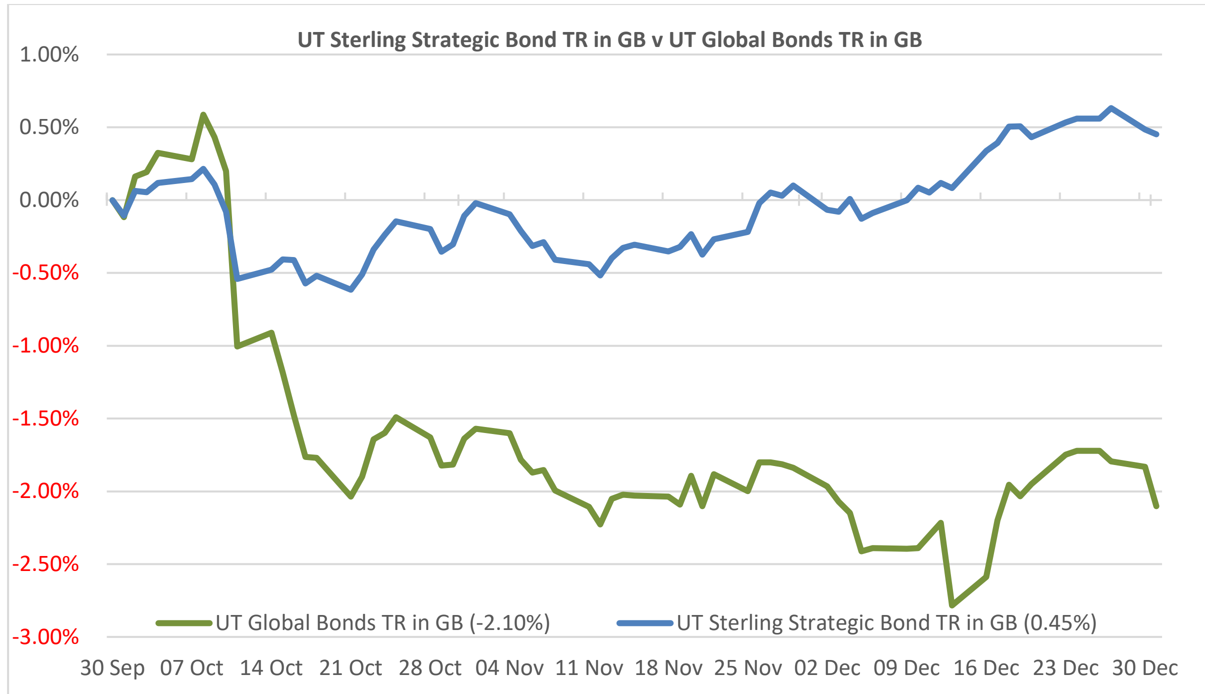

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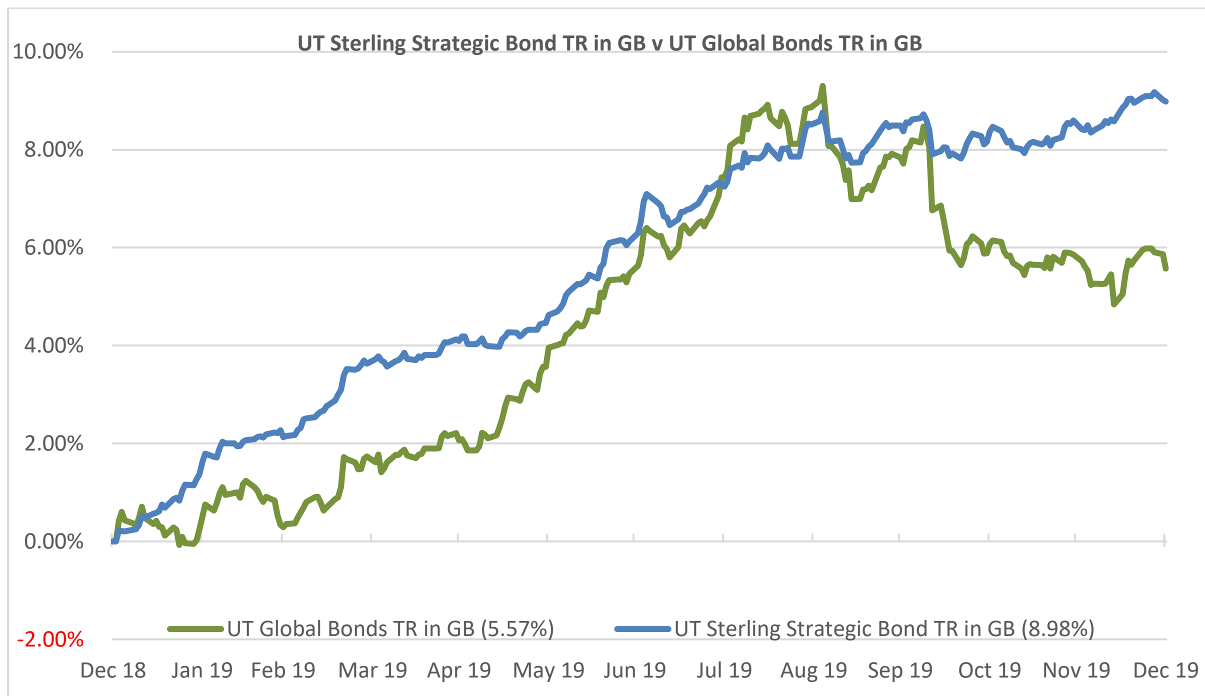

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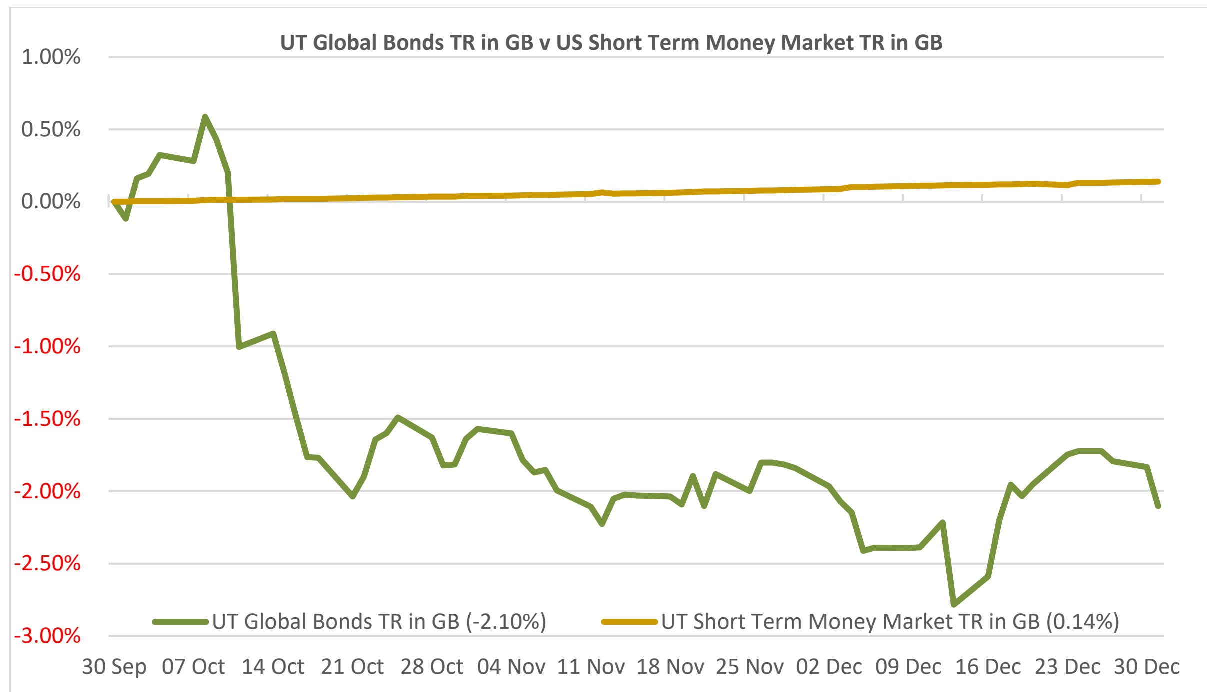
Global Bonds

The positive returns seen in this sector in the first half of 2019 were undermined, in large part, by the rapid volte-face taken by the Federal Reserve in the United States. Having abruptly ended their easing cycle, the Federal Reserve have indicated that they do not intend to make any changes for the foreseeable future. Chairman Jerome Powell said recently that he felt that rates were now at a sensible level he and predicted the US economy will see a "sustained expansion". He did express concern about the “unsustainable path" of increasing debt but reiterated that they are unlikely to cut interest rates further unless there is a "material reassessment of our outlook".

This is good news for American businesses but, with other major central banks also appearing intent on maintaining interest rates, bond yields look likely to remain at their record low levels. The advantage of the global bonds sector is the broad range of regions in which we can invest. We will allocate to this on a selective basis where it is suitable from a diversification perspective.

Although an interim resolution appears forthcoming, the trade war between America and China continues to have an impact on all sectors of the economy and one of the effects of the tariffs that both sides have implemented is an increase in the prices of key goods. As a result, one of the risks as we look forward into 2020 is a period of slower growth and rising inflation. Although it is by no means a certainty, a rise in inflation could reduce the diversification benefit of stocks versus bonds but could make the inflation linked bond sector more attractive, especially within the broader global bonds universe.

Emerging Market Debt assets have been a welcome refuge from the world of negative yielding debt, but they do come with an increased level of risk, especially when the impact of currency moves is taken into account. The era of ultra-low interest rates has seen emerging markets massively increase their levels of borrowing with the World Bank reporting that total debt has jumped to 170% of GDP. This could prove challenging when interest rates start to rise again but this does not seem a likely outcome as things currently stand. We will continue to use these assets but with caution, and with additional consideration to the possibility of volatility in currency markets.



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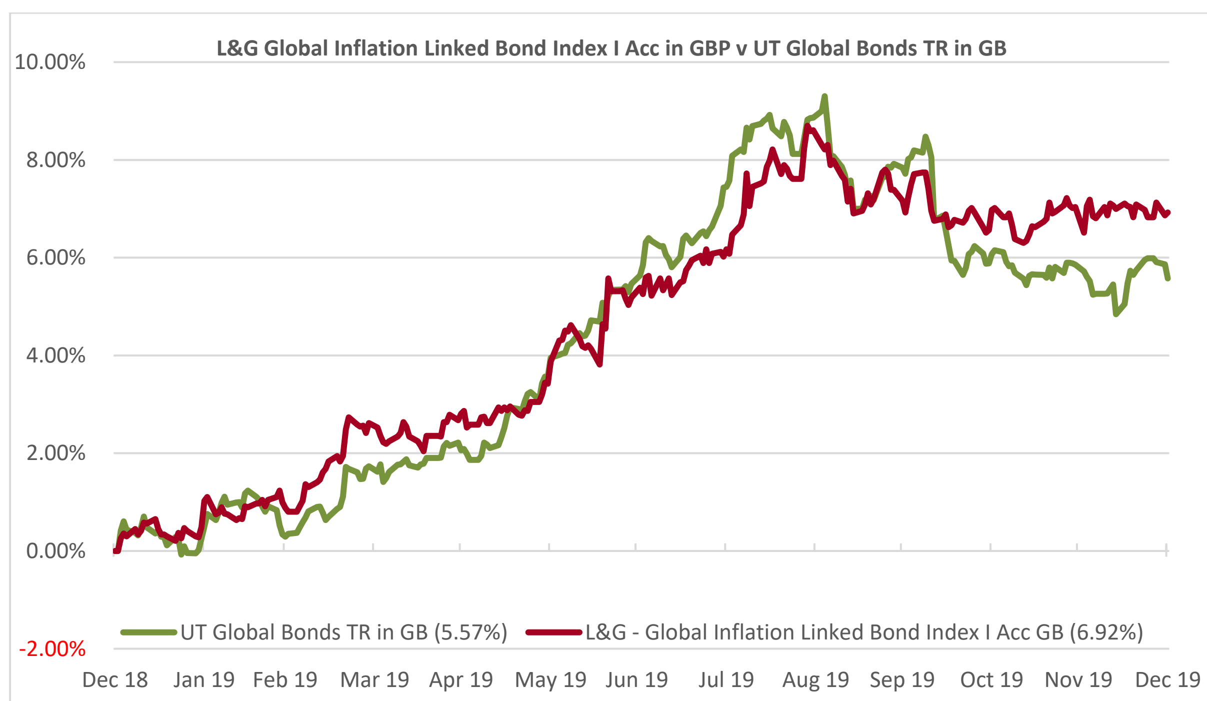

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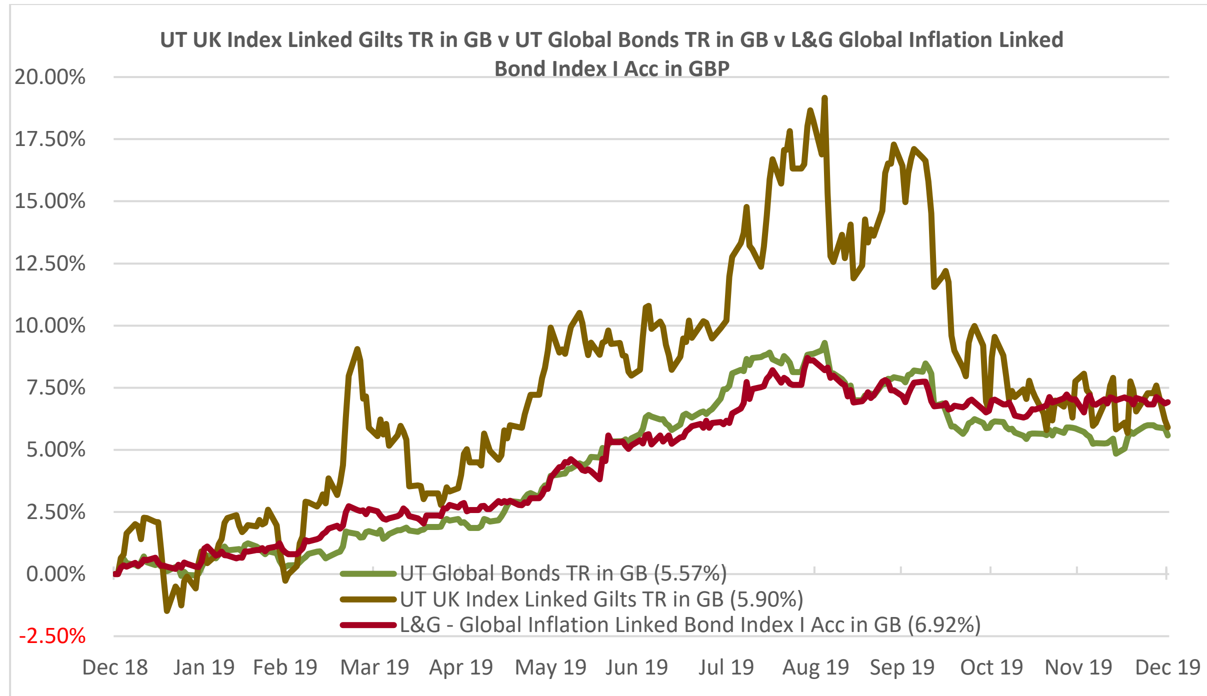

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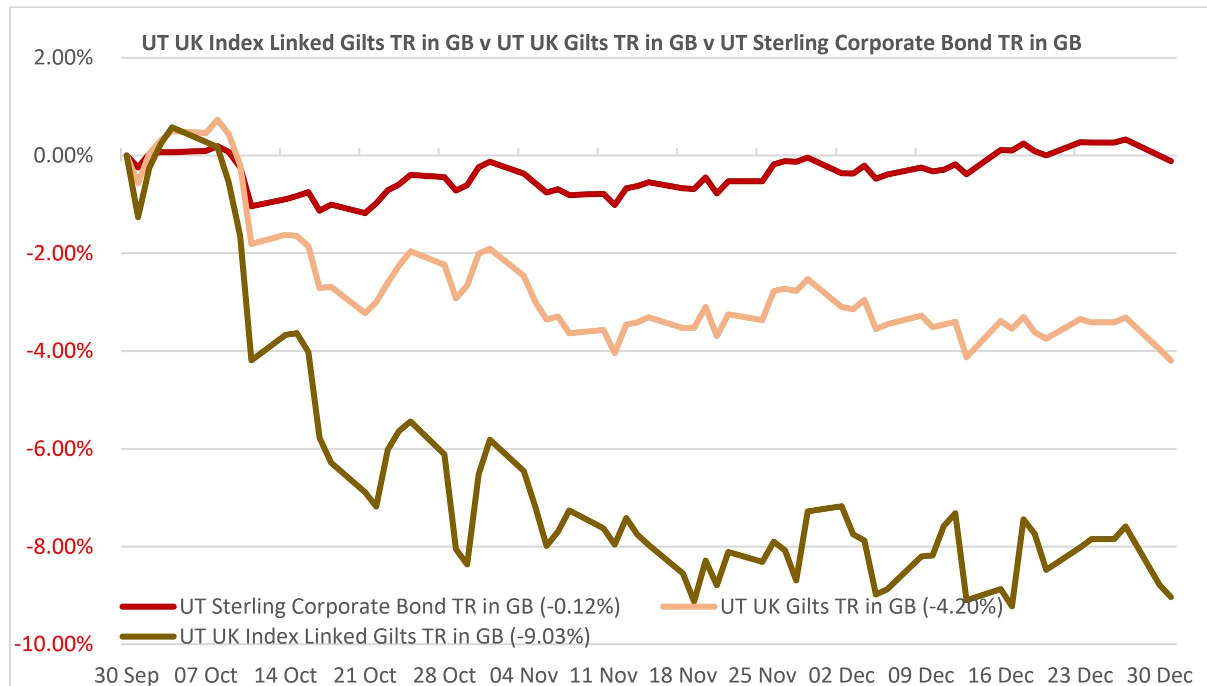
UK Gilts

Over the quarter the return on UK Gilts was negative with movements driven mainly by political factors such as trade tensions and Brexit as opposed to interest rate changes. Overall, the very bearish investor sentiment at the start of the quarter eased with optimism over a possible US-China trade deal and reduced political uncertainty following the UK general election. As investors began to gain confidence in upping their equity allocations, they did so at the expense of government bonds.

With the Bank of England voting to hold the base rate at 0.75% at its December meeting the interest rate environment remains stable, although the BoE will be concerned about recent economic data indicating falling retail sales in November and recessionary conditions in the manufacturing sector.

Separately, the BoE has announced that Andrew Bailey, the current head of the FCA will take over the role of governor of the BoE when Mark Carney's term comes to an end in March 2020.



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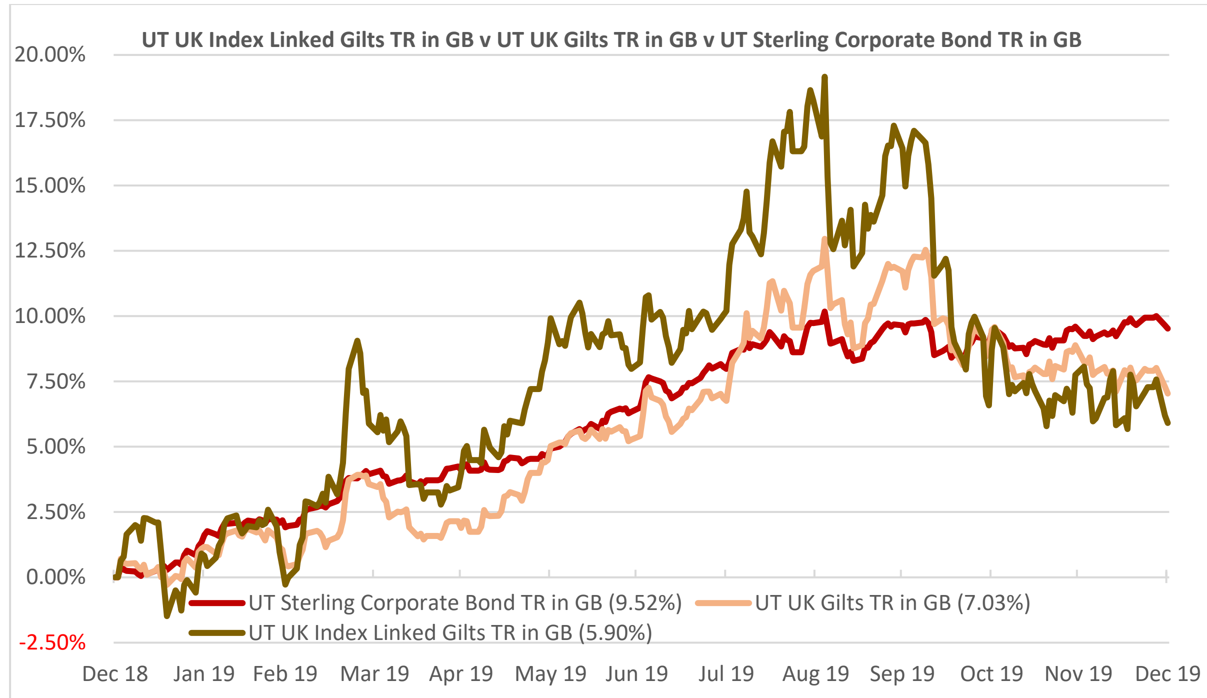

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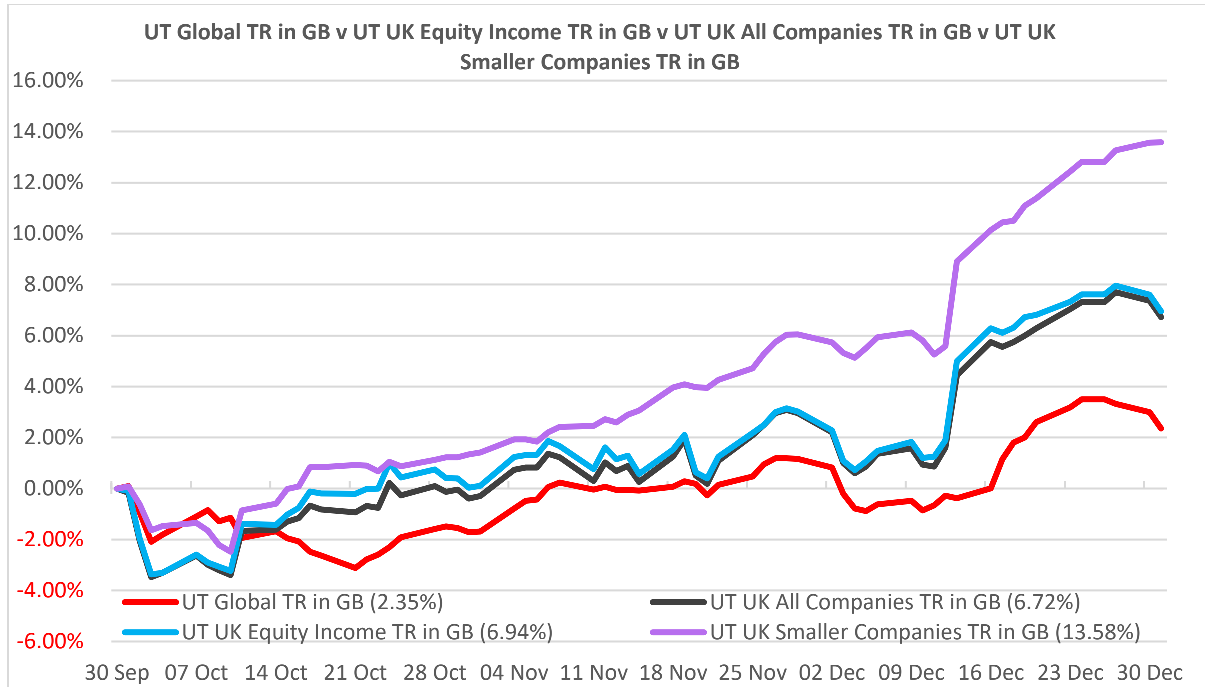
DEVELOPED MARKET EQUITIES

UK

The “will they, won’t they” Brexit saga continued into the final quarter of the year and saw the 31 October leaving date from the EU put on hold again as Prime Minister Boris Johnson called a December General Election which the Conservative’s won with an emphatic majority, so offering greater clarity for Brexit. The UK equity market rallied sharply on the news, boosted by the prospect of an end to the political stalemate and a period of stability, and helped lift UK equities and sterling over the quarter. In addition, the election result meant that the UK could pass a European Union withdrawal bill, activating a transition period during which little will change, until the end of 2020.

For investors, the UK equity market had been generally flat during the quarter until the election but ended the year in positive territory following the result, with the small and mid-cap markets strongly outperforming the large cap companies, as many of the more domesticated stocks were the main beneficiaries of the election result. These stocks were further benefited by the strengthening of Sterling on the likelihood of a positive outcome for Brexit, which saw GBP/USD move from $1.22 at the start of the quarter to $1.32 by the end. The election also removed the threat of nationalisation for some utility companies, as the sector rallied 6% following the result.



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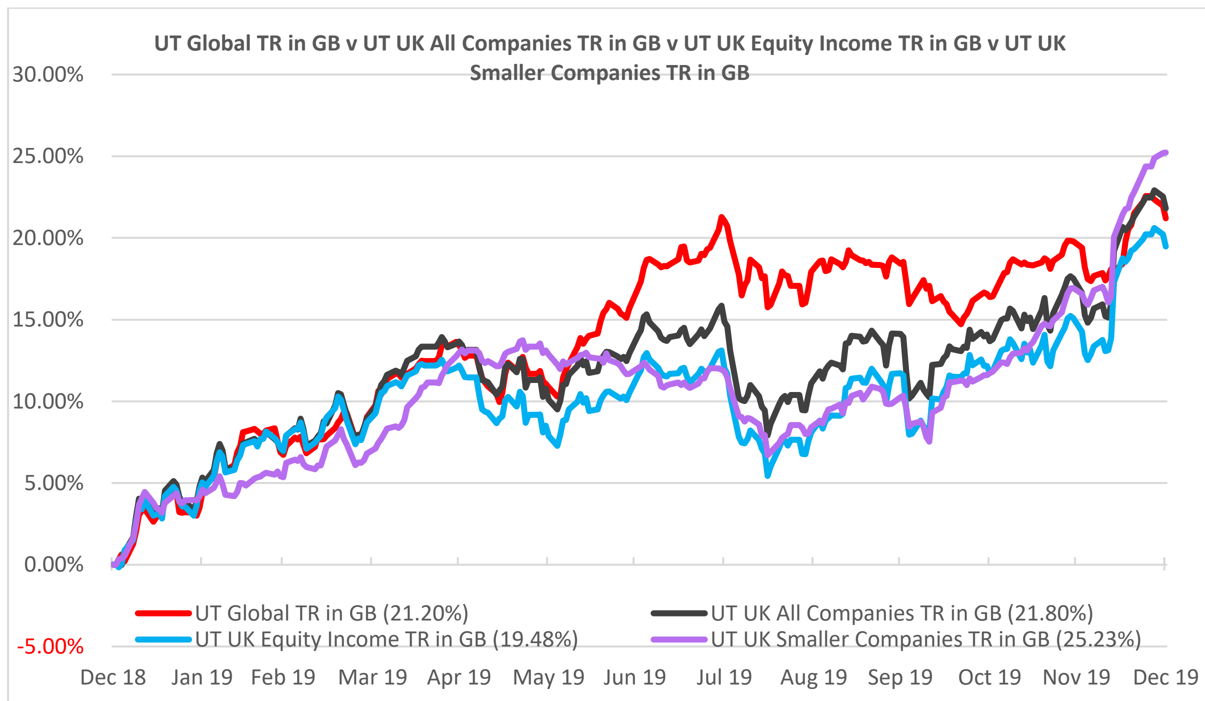

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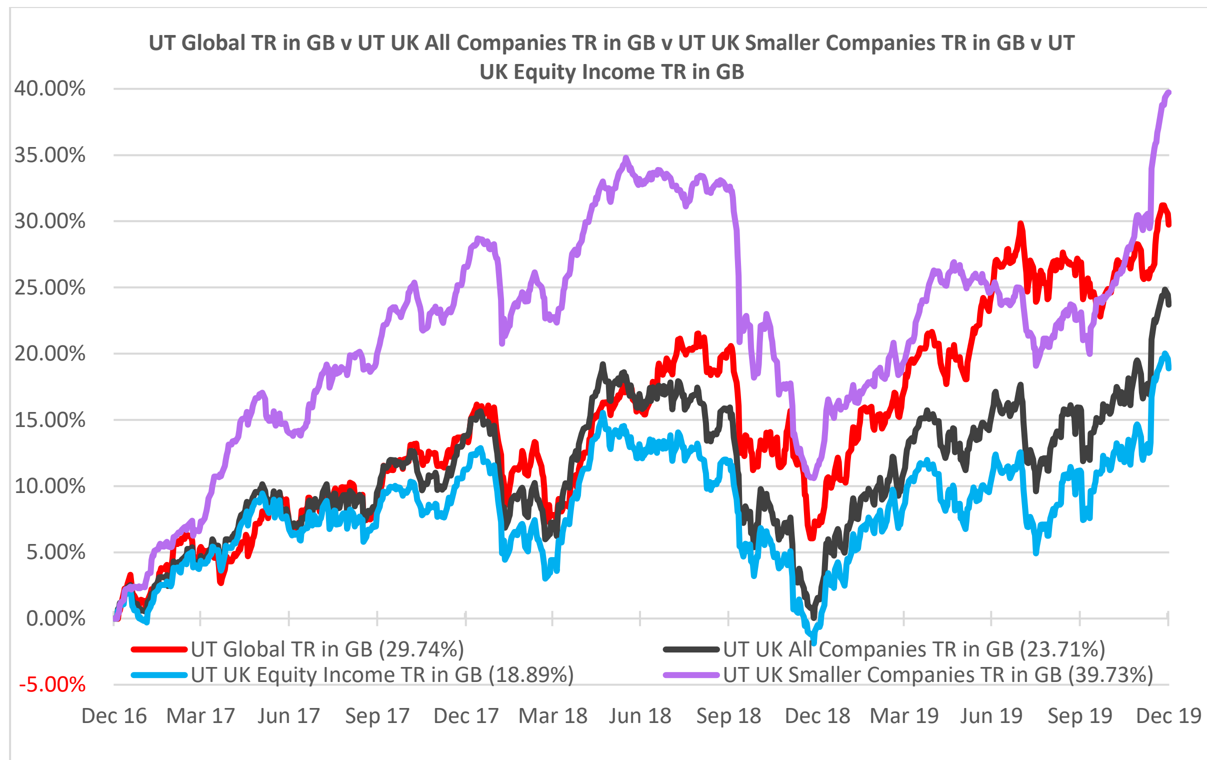


31/12/2016 – 31/12/2019 Data from FE fundinfo 2020

Europe

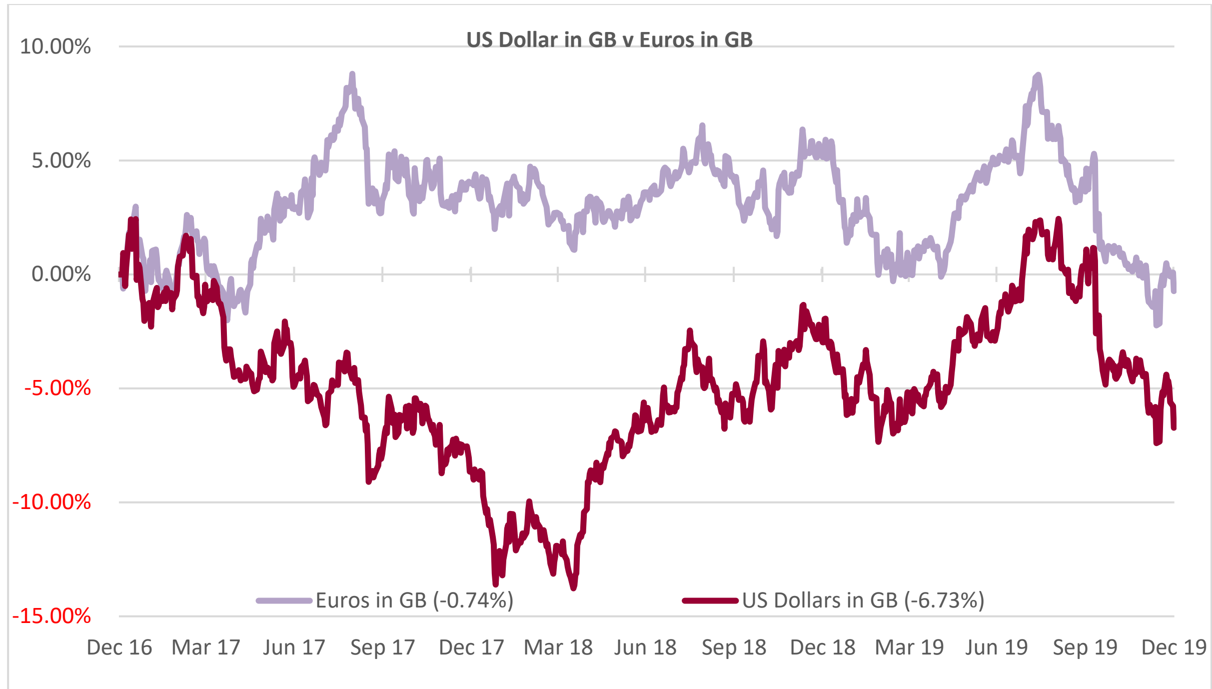
Most individual European markets performed in a similar way in the final quarter of the year, with one exception – Ireland, whose market rose significantly higher than the rest. But, looking at the third quarter, Ireland was a laggard in a big way, so it could be argued that Ireland was only playing "catch up."

From an economic perspective, there was not a huge amount to report on – Mario Draghi stood down as the President of the European Central Bank – a position he has held since 2011. He was replaced by Christine Lagarde (who used to chair the International Monetary Fund.) Christine is a very experienced leader and takes over a trading bloc that is in much better shape than when Mario took over. In his last couple of formal speeches, Mario made it known to the Governments and Central Banks of the European nations that the reins of economic policy have to change to fiscal policy rather than monetary policy. The ECB really cannot cut interest rates to stimulate economic growth any further from the -0.50% (yes, you read that right, base rates in Europe are negative) and the shift to fiscal policy (i.e. tax reform) has to do the heavy lifting from here on.

As an interesting anecdote, there is a bank in Denmark that offer a 10-year fixed-rate mortgage with a negative interest rate, meaning if you take out an interest-only mortgage at the end of the period you owe less than you borrowed….

Although Ms Lagarde takes over an economy in a better shape than Mr Draghi took it over, Europe is still not really doing well. Germany – the largest economy in the bloc – is struggling with recession, Italy is not faring much better and France continues to struggle with political discord – the Gilets Jaune movement shows no sign of slowing down having now been demonstrating for over a year. Next year we expect to see interesting ideas to stimulate the individual economies. As the European equivalent of Quantitative Easing morphs into a different format, we expect to see innovations like "green" bonds, focused infrastructure investment, or a European equivalent of "cash for clunkers" type approach to stimulate growth.

European growth is likely to be about 1.00% this year and forecasts suggest a 1.00% to 1.25% number for the year ahead. Unfortunately, this number is less than inflation, so actual growth is flat to negative.



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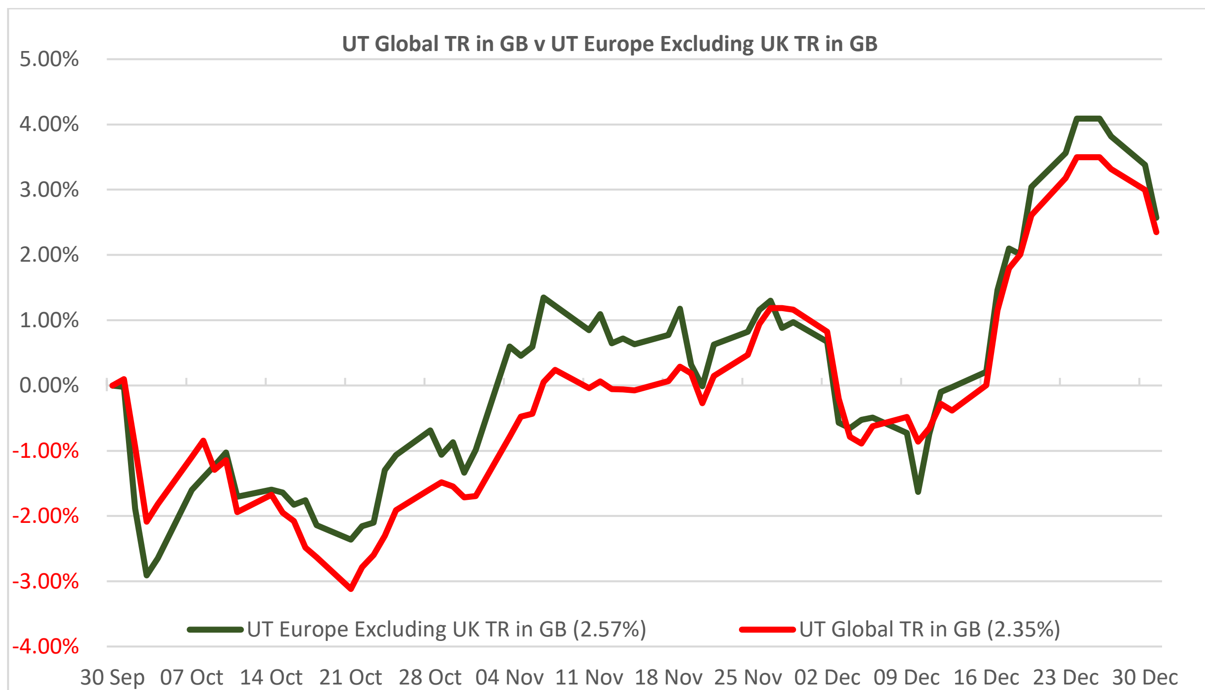

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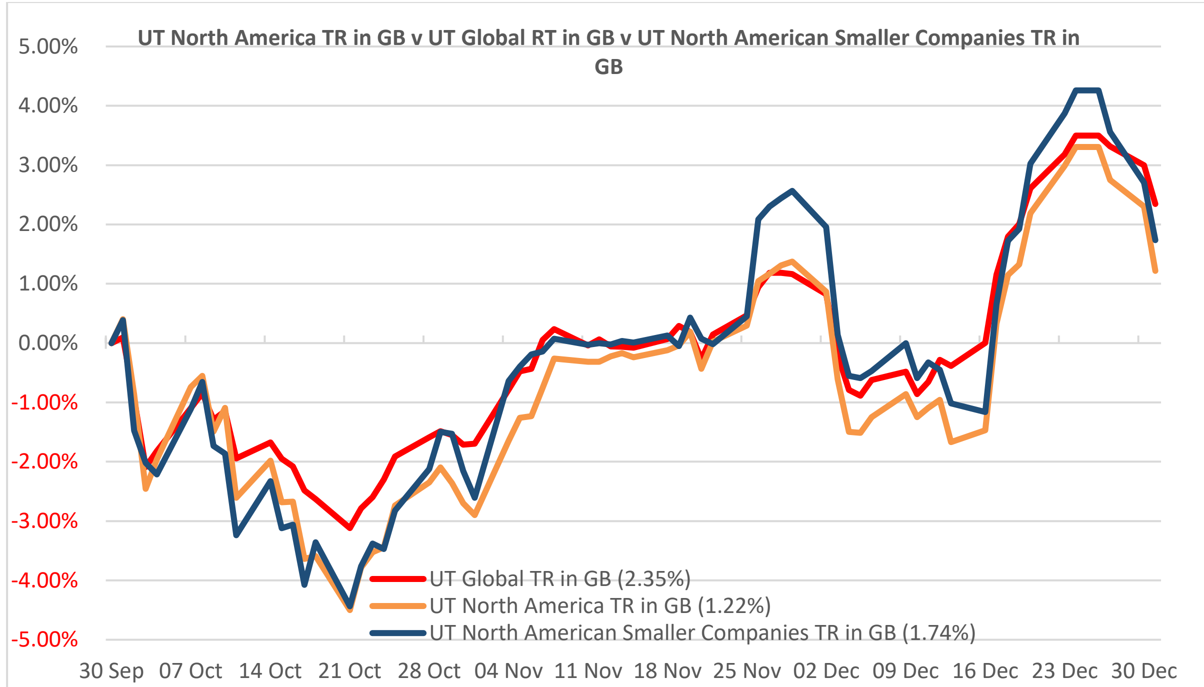
US

The strong run for U.S. markets seen over 2019 struggled a little over most of the final quarter as a late cycle move by central banks to ease monetary policy was not enough to reduce the pressure caused by ongoing trade tensions. The rhetoric around the trade war has largely been led by President Trump and has fluctuated from acerbic to accommodating. Each salvo has led to a spike in volatility as investors attempted to interpret what it could mean for returns. Despite efforts to claim the opposite, the trade war does seem to be having an effect on the American consumer and also on many areas of the U.S. economy. In agriculture, for example, a $16bn aid package has been needed to support the sector because of reciprocal tariffs imposed by China.

2020 is an election year and whilst the view that China isn't playing fair is a largely bipartisan issue, the Trump administration will be keen not to let the dispute begin to have a demonstrable effect on the U.S. economy. Historically, presidents seeking a second term have not had much success when the economy has been weakening. As such, it was no surprise to see the two sides announce an initial agreement at the end of the quarter. This limited trade pact means that the U.S. will not impose the next tranche of penalties and in exchange the Chinese will purchase large amounts of American agricultural goods. U.S. markets reacted positively, heading to fresh highs, but with nothing formalised and the targets for exports so high, it would be wise not to rush to judgement about what this deal means for this vital relationship.

In the medium term the support provided by central banks will begin to have less of an effect and we do not expect much more in terms of new easing measures, at least in the first half of 2020. The Chairman of the Federal Reserve, Jerome Powell, has said that he feels that rates are in a "good place" and that further rate cuts would only come as a result of a material reassessment of their outlook. As a result, we will need to see corporate growth improve for momentum to be preserved and with an increasing focus on the election this could lead to a rise in uncertainty.

Another challenge that remains from our previous update is the search for value in a region which has seen such sustained expansion. Earnings growth and other economic indicators have remained robust and have provided a relatively benign market in which to invest passively, however, if this picture changes it could mean that a more active approach would become worthwhile. Although most economists maintain that the chance of a recession is low, with corporate earnings turning negative for the first time since 2016 we must remain alert to potential challenges ahead.



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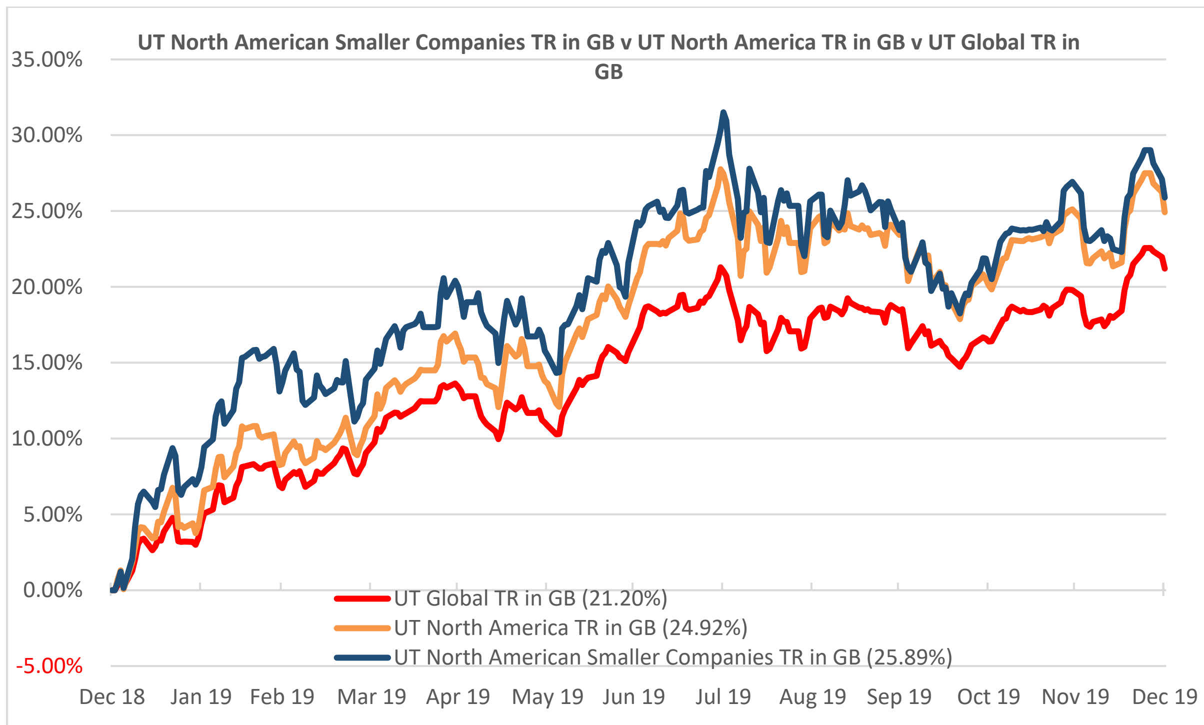

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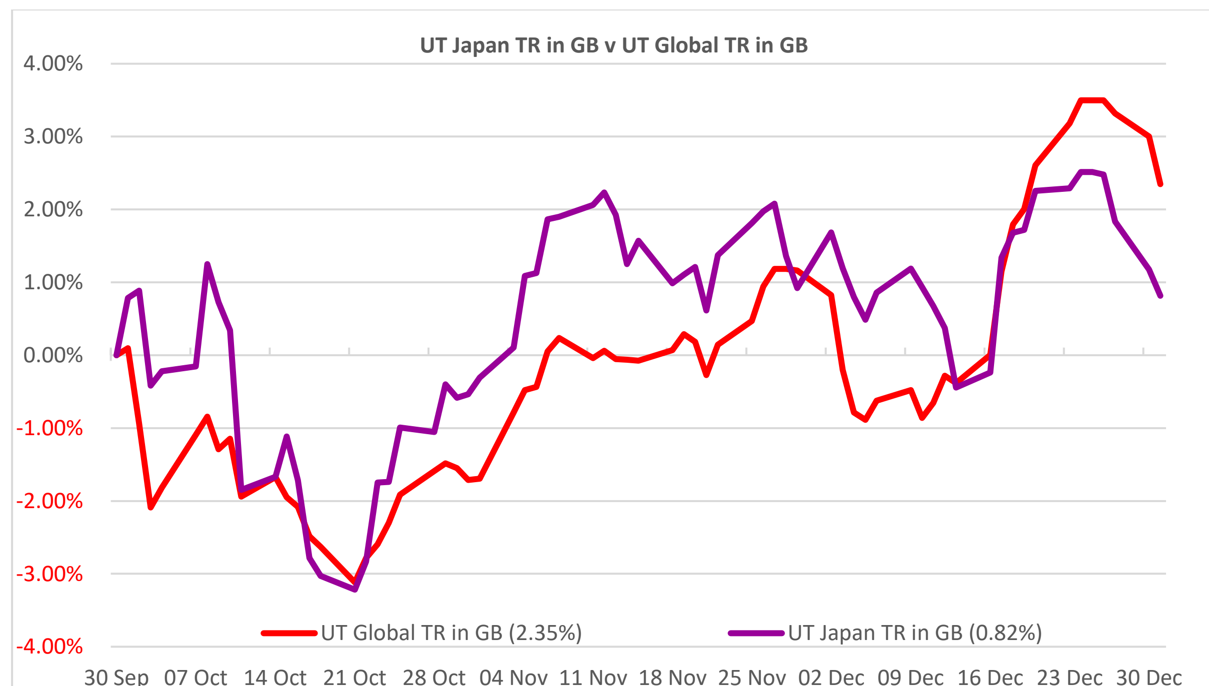
Japan

The final quarter of 2019 saw an extension in Japanese equities' strong performance, although for sterling investors currency movements reduced the attractiveness of overseas equity returns. Trade tensions have tended to weigh on Japanese equities as Japan is a major trading partner to both the US and China, with a high percentage of Japan's exports going to China in particular. Japan's equity market has been more sensitive to news on a trade deal than domestic factors, although there have been some corporate restructuring announcements that have been welcomed by the market during the quarter.

Looking ahead, with half of Japan's largest companies' revenues coming from exports, the impact of protectionist policies has had a negative impact on Japan's equity market. Although politics is in protectionist mode at present, an improvement in the manufacturing environment and stronger Chinese economic growth could give Japanese equities a boost. As Japanese equity valuations are cheap and corporate governance continues to improve, there is further return potential in the asset class – although investors may need to wait until some of the macro headwinds abate before these are realised.



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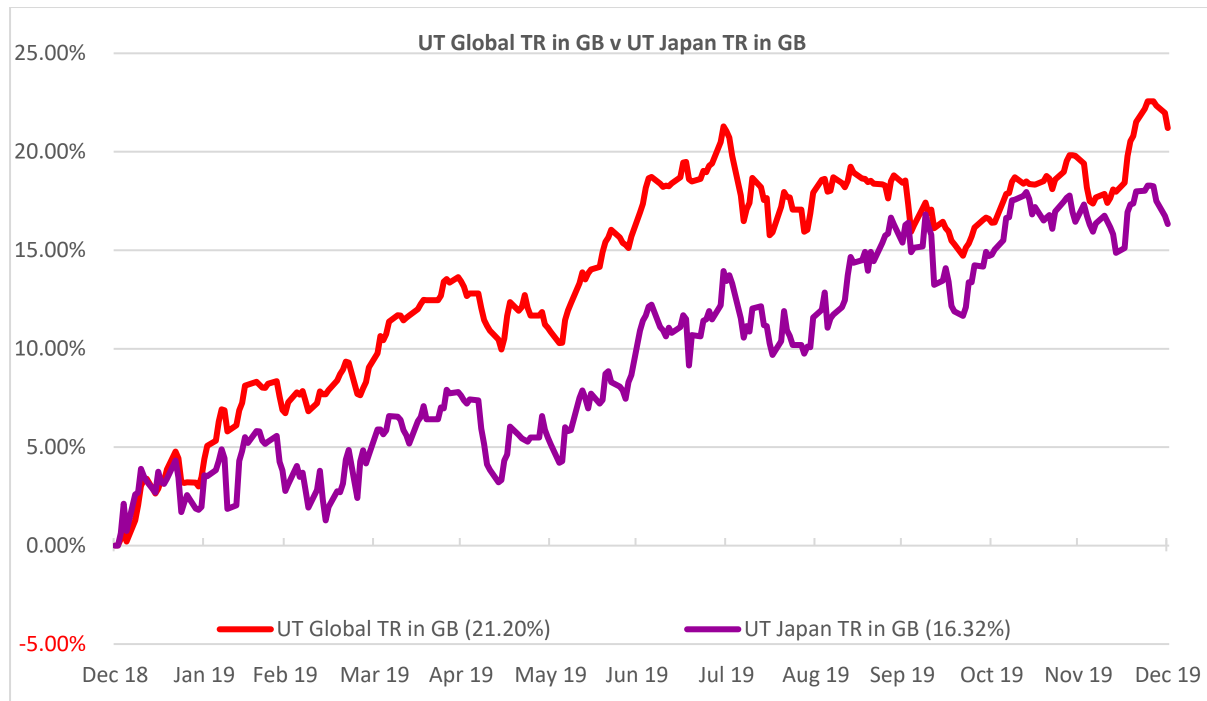

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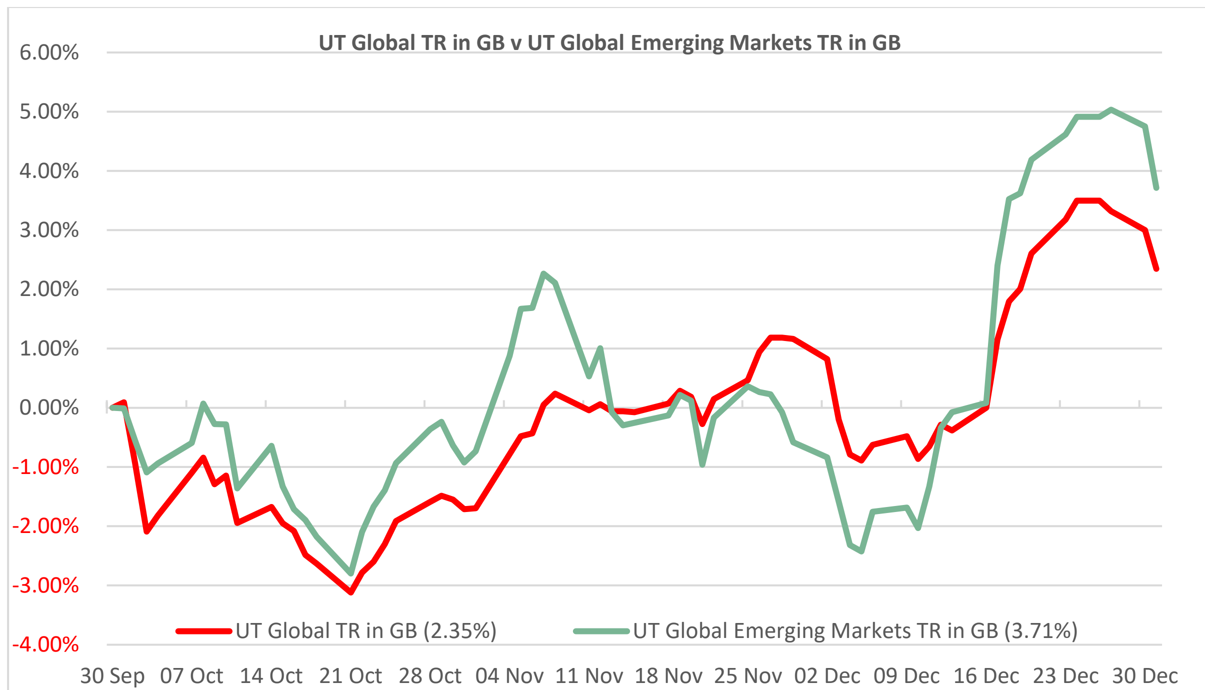
EMERGING MARKETS

Emerging equity markets registered broad gains during the final quarter and outperformed developed markets to cap off a successful year for the asset class, as investors responded positively to the news that the US and China had reached agreement on Phase One trade negotiations. Higher commodity prices, a weaker US dollar and lower interest rates – they were cut in Brazil, Mexico and Russia – also provided a positive backdrop for investors as equity markets in Latin America, EMEA and Asia all enjoyed healthy gains. However, a mixture of economic, political and corporate factors continue to effect sentiment across the region.

Elsewhere, the Indian equity market had a volatile but positive quarter, as the Reserve Bank of India surprised the market negatively by keeping interest rates on hold and sharply reducing its economic growth forecasts for the full year ahead by 110 basis points.

The gradual fading of sanctions risks, higher oil prices and lower interest rates combined to ensure Russian equities finished the year as the best performing equity market in 2019.



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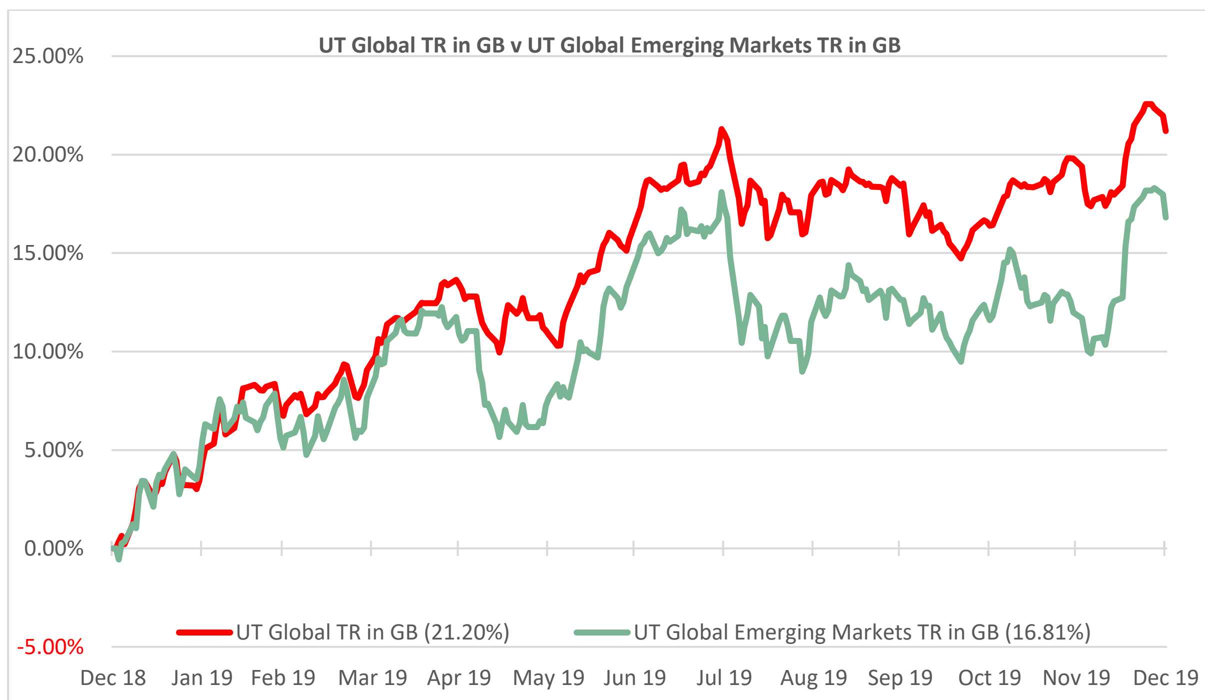
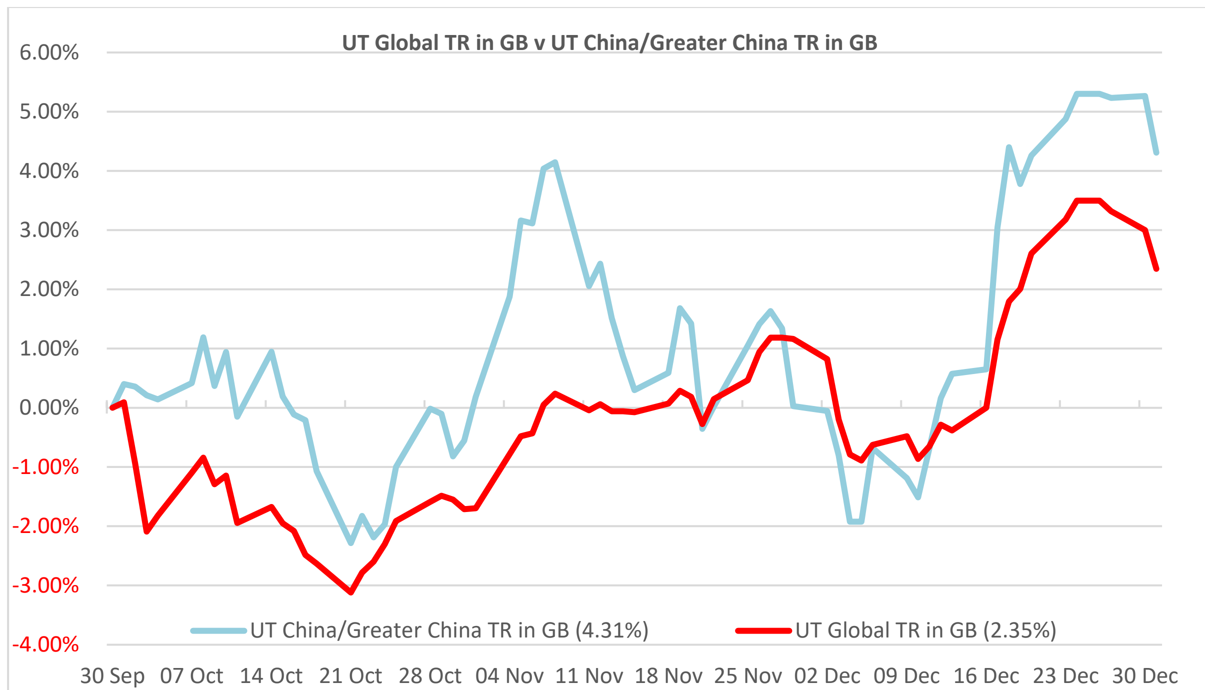


31/12/2018 – 31/12/2019 Data from FE fundinfo 2020

ASIA PACIFIC/CHINA

In 2019, investor sentiment across the region continued to be impacted by the US-China trade tensions, as well as seeing mixed economic data. Against this backdrop, however, equity markets were among the best performing regions over the final quarter. Chinese equities were driven higher on the improved outlook for trade, while China's economic data came in ahead of expectations, showing a broad improvement across industrial production and retail sales.

The fourth quarter also saw two significant political risks avoided, at least for now. US tariffs on China were scheduled to increase on 15 December on $160bn of Chinese imports, but a Phase One trade deal, which will be signed on 15 January, avoided that outcome and provided a significant relief for equity markets. The fact that the US also didn't impose tariffs on European Union auto exports also helped support equities. How long the trade peace will last is anyone's guess, but the market ended the quarter cheered by the fact the worst-case scenario for trade had, at least for now, been avoided. At the same time, China has agreed to increase its purchases from the US.



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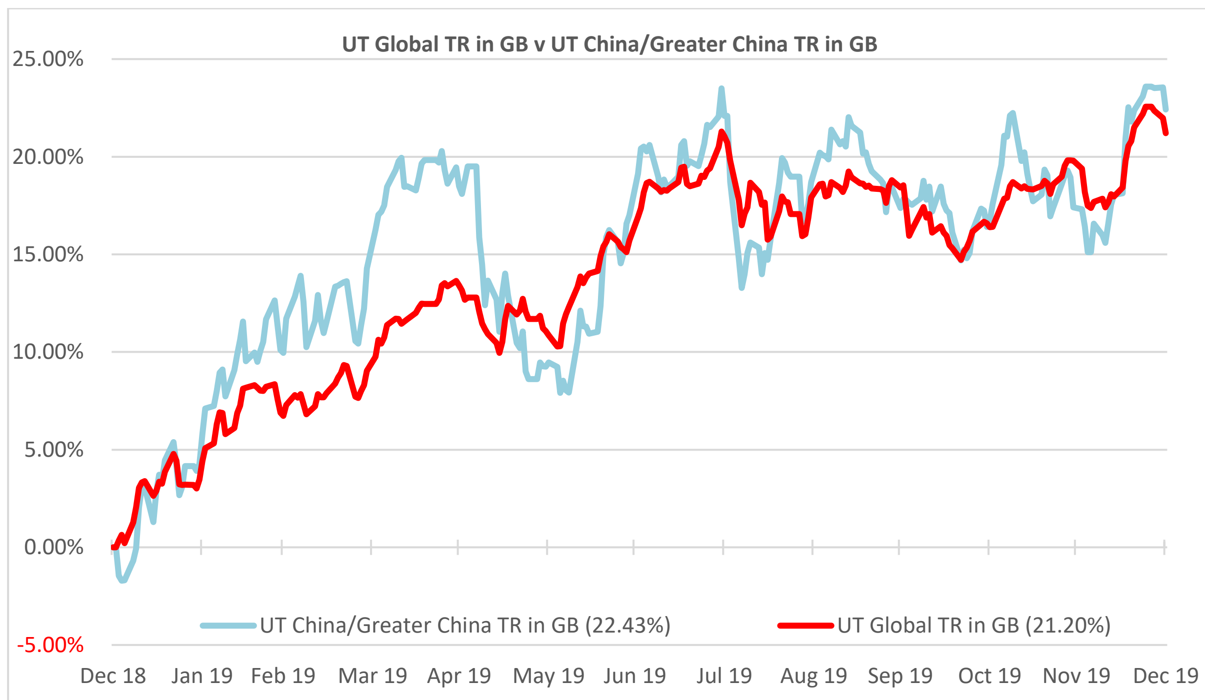

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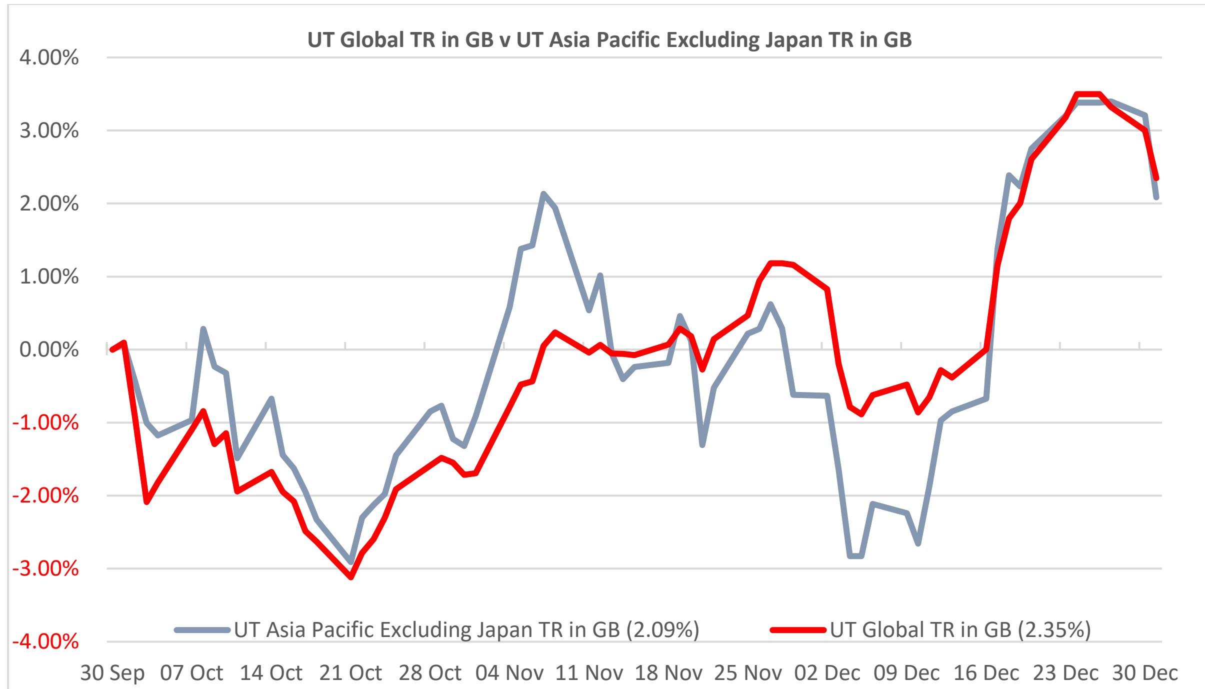

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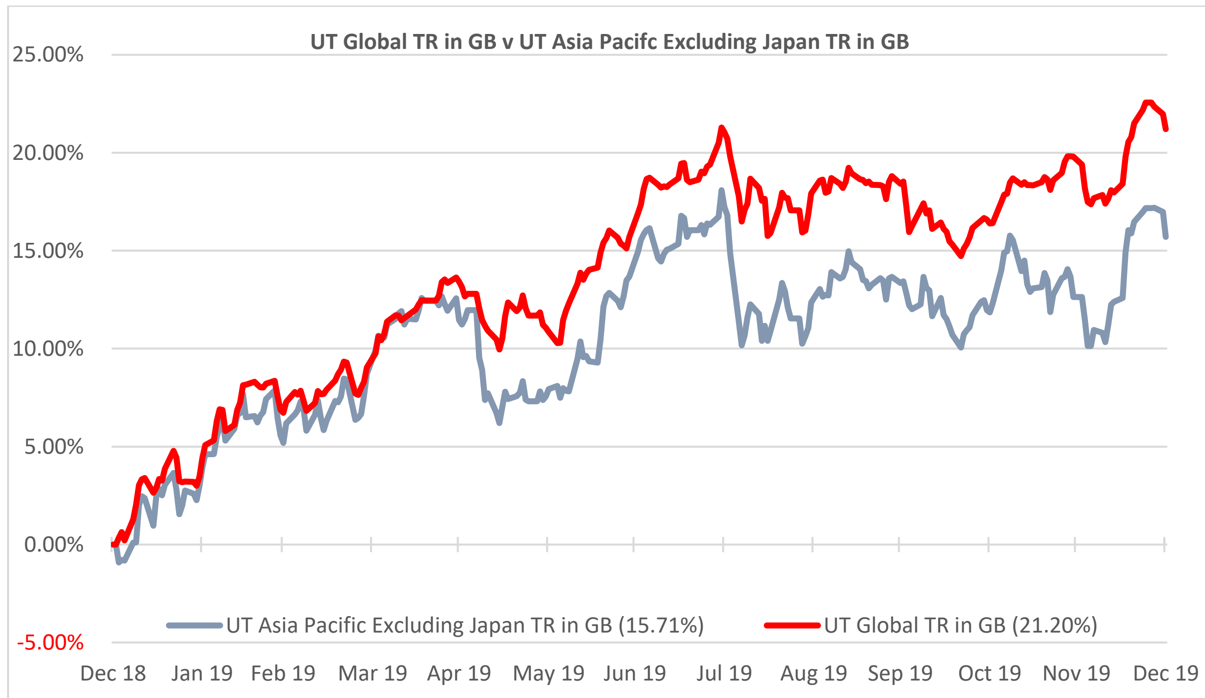


31/12/2018 – 31/12/2019 Data from FE fundinfo 2020

COMMODITIES

Many key sectors such as oil, copper and wheat enjoyed a strong quarter but, as ever, this was countered by weaker returns in other areas such as precious metals which contracted as their defensive characteristics were less in favour towards the end of the period. Industrial commodities like coal and steel also struggled over the quarter as a result of American trade disputes which have prompted a slowdown in manufacturing. This has particularly affected China as well as Germany which has seen car production fall to levels below that seen following the global financial crisis.

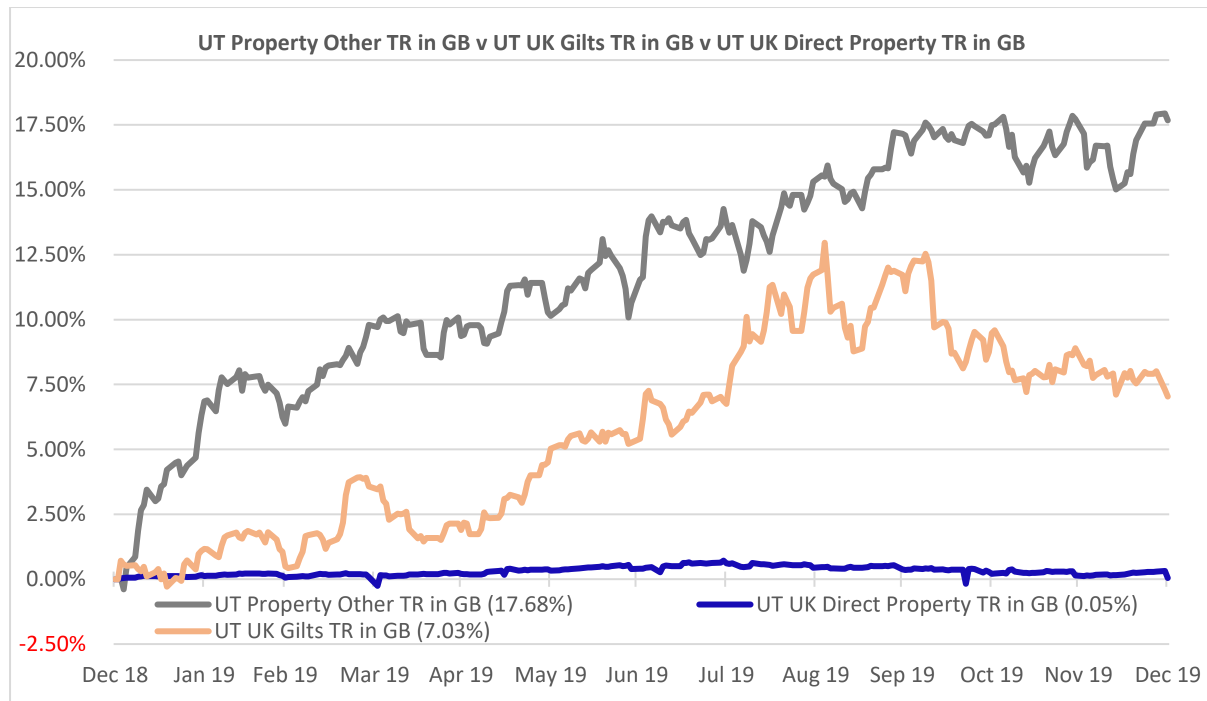
The oil price was helped by the big story of the quarter: the Initial Public Offering (IPO) of Saudi Aramco at the start of December. The world's largest oil company set the record for the largest ever IPO when it raised a record $25.6bn but it fell $300bn short of the $2tn total company value Crown Prince bin Salman had sought. The end to the 4-year long saga happened at the same time as OPEC were discussing further cuts to production levels in order to increase the oil price. The original cut began at the start of 2019 and involved an agreement to reduce production by 1.2 million barrels per day.

ALTERNATIVE STRATEGIES

UK Direct Property

UK property funds have been in the news as M&G announced the suspension of its Property Portfolio in December. M&G found the pace of redemptions had run ahead of the rate at which it was able to sell properties, which eroded the cash buffer in the fund and forcing the manager to suspend. The challenges faced by M&G are common to all the managers of 'bricks and mortar' property funds; with many investors trimming their allocations over the course of 2019, as political uncertainty and post-Woodford liquidity concerns have been front of mind. Changes in tax rules for offshore investors have also been a headwind for the asset class, although a minor one as far as we can discern.

Whilst other property managers have not yet been forced to suspend their funds, many have, like M&G, been steadily selling assets to meet redemptions. The daily liquidity offered by funds is very much at odds with the liquidity of commercial property but the FCA remains supportive of investors having access to illiquid asset classes through liquid fund structures. The regulator's guidance for property funds was published at the start of the quarter and emphasised the need for proper health warnings for investors and backed portfolio managers to suspend funds when necessary to ensure fairness to investors in the fund as well as those choosing to redeem. Liquidity will remain a significant consideration when deciding an appropriate allocation to property.



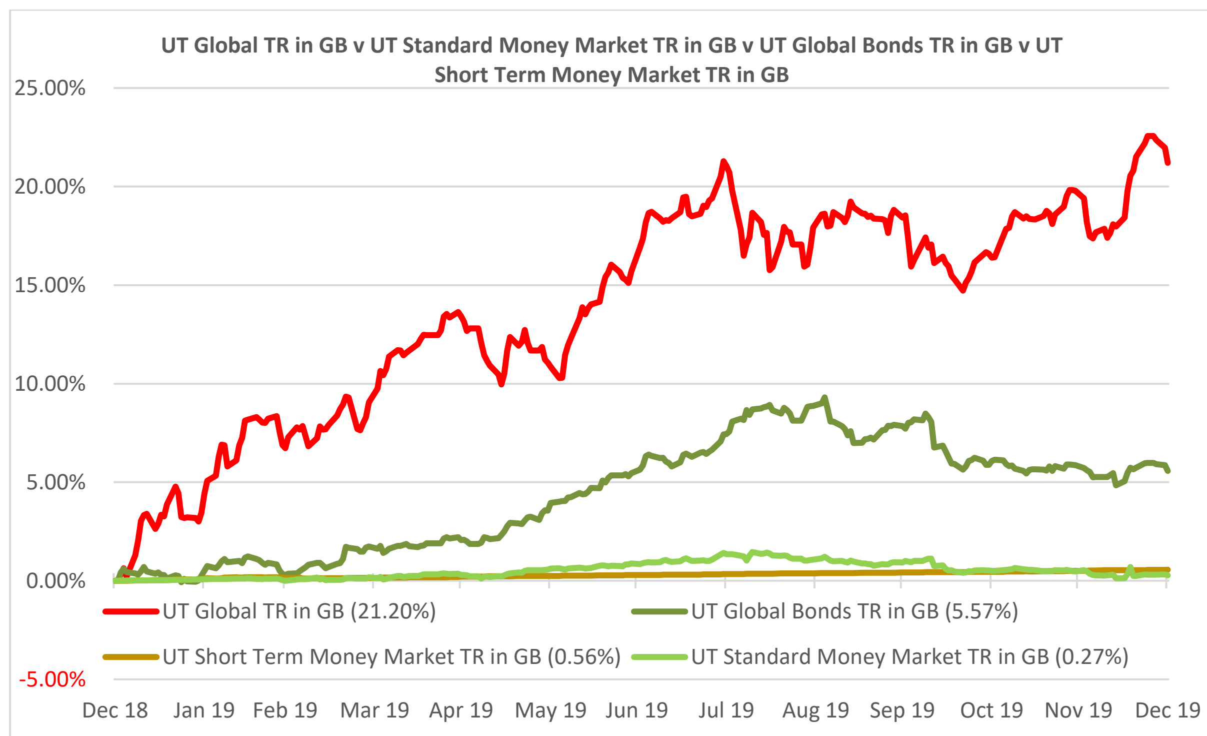
31/12/2018 – 31/12/2019 Data from FE fundinfo 2020

Cash / Money Markets

Across developed markets, the Federal Reserve, Bank of England, European Central Bank and the Bank of Japan all kept interest rates on hold during the fourth quarter with the expectation that interest rates are staying low and possibly reducing going forward, despite many economies looking to be in good shape. On the flip side to this, we have seen positive consumer spending, particularly in the US.

During the quarter, Mario Draghi - famous for his "whatever it takes" speech to save the euro - stepped down as President of the ECB to be replaced by Christine Lagarde, while the new Governor of the Bank of England was confirmed as Andrew Bailey, currently head of the Financial Conduct Authority, who will resume the role from Mark Carney in March 2020.

With near zero returns available from cash, short duration bond funds continue to be used across portfolios as a cash-like replacement as well as reducing portfolio volatility.

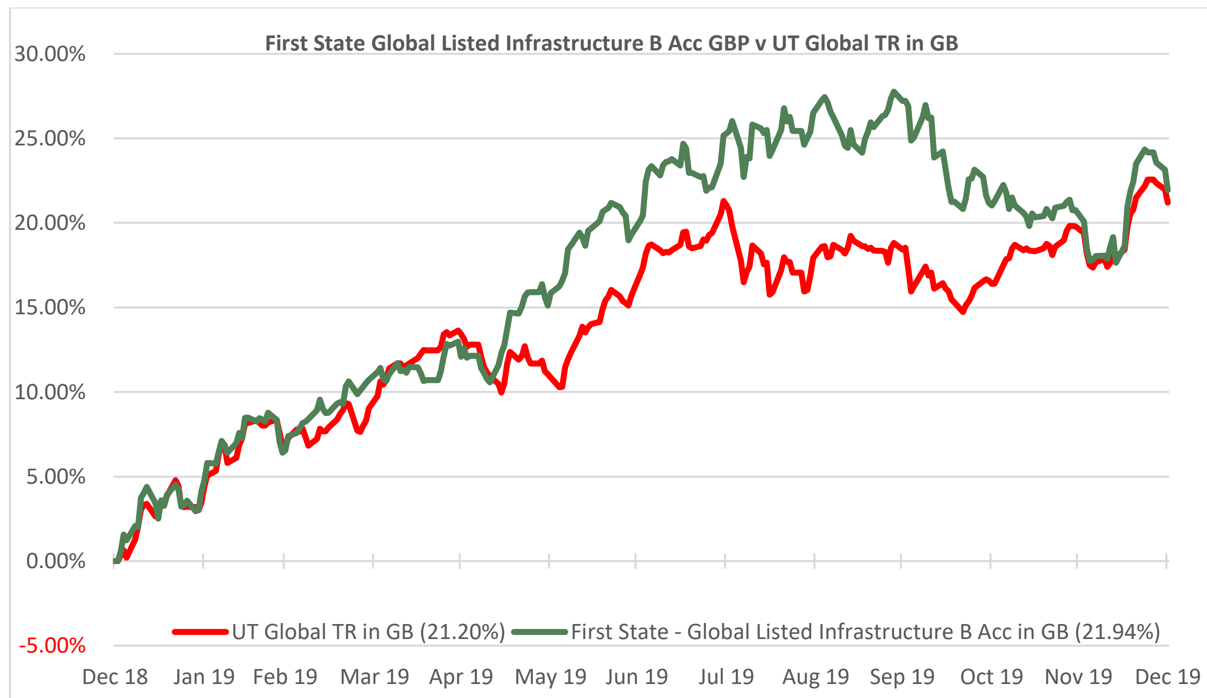


31/12/2018 – 31/12/2019 Data from FE fundinfo 2020

Infrastructure

This thematic approach is a defensive and diversified allocation towards global equities, and as such has continued to deliver positive returns over the last quarter against a backdrop of global uncertainty, again illustrating the resilience of the asset class in developed markets. Funds will typically invest either directly or indirectly in a broad range of global companies involved in the ownership and operation of infrastructure assets, including, for example, electricity, water, gas, telecommunications, airports, roads, railways, seaports and social infrastructure assets (such as hospitals and prisons).

During the quarter the Reserve Bank of Australia announced a 0.25% interest rate cut, supporting performance in the region, with toll roads and utilities among the beneficiaries. In Asia, optimism on US-China trade talks and positive corporate earnings figures were good for performance, while in Brazil legislation was passed that should lead to the privatisation of some infrastructure assets. This news led to share price gains for companies expected to benefit from the change. At a sector level, airports have been supported by healthy passenger volumes and corporate earnings numbers. Pipelines had a weak start to the quarter on the back of concerns around excess capacity and lower production expectations, but subsequently rebounded as investors sensed the sector had been oversold.



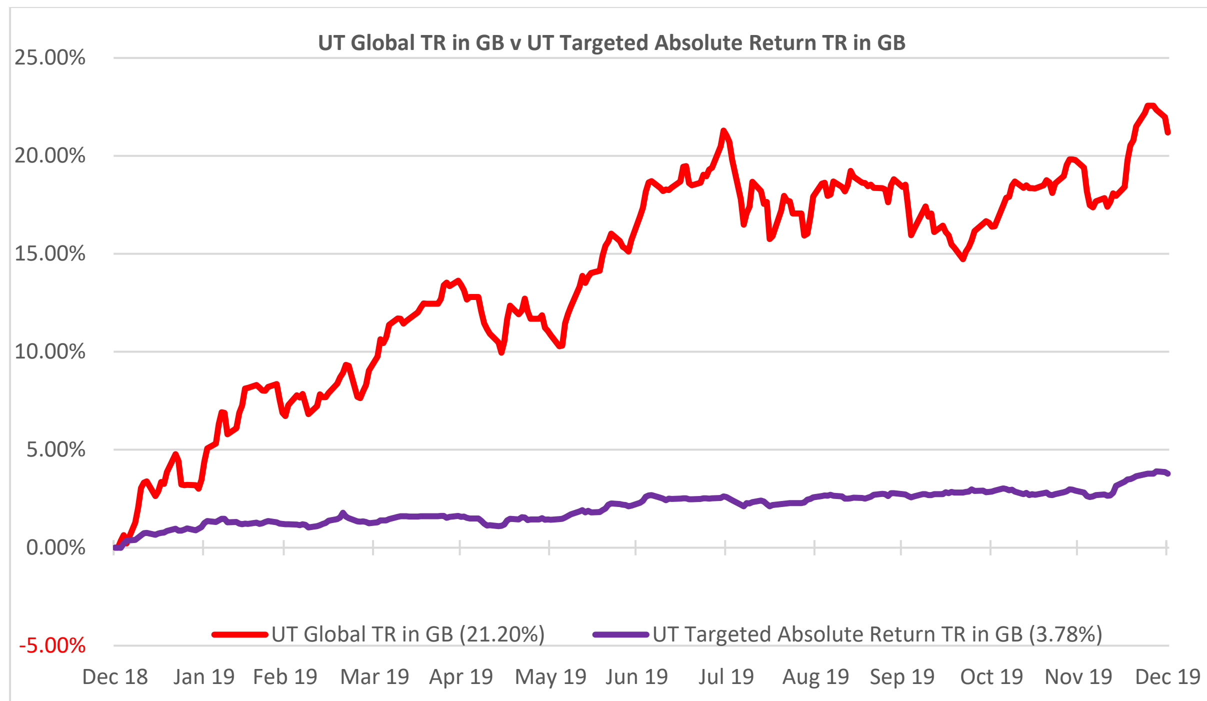
31/12/2018 – 31/12/2019 Data from FE fundinfo 2020

Targeted Total Return

Reporting on the returns from a sector with very little homogeneity is very difficult to write about. Typically, in a quarter the best performing fund can deliver a double digit (10%+) return. The worst fund can deliver a 10%+ loss and this quarter really is no different.

Managers in this space have the ability to use all of the available traditional investment instruments – equity, property, fixed income, currencies, commodities. They also have the ability to use derivatives to act both as a risk diversifier, but also to act as a performance enhancer. In the traditional space, should a manager like Vodafone, they can buy the stock and if they don't, they don't have to. In the derivatives space, the manager has the ability to "gear" the stock (in essence they can buy a lot more than they originally would have by borrowing) or they can "short" the stock if they don't like the company and think the share price will fall, they can profit from a falling share price by selling shares they don't own and then buying them back for a cheaper price!

It's not surprising that the range between best and worst is wide in this sector. Many managers will use these investment instruments though to both diversify and reduce specific risks and aim to deliver a balanced spread of returns. One thing is for certain though, the sector as a whole has struggled for many years as typically this approach needs enhanced levels of volatility to deliver consistent high levels of returns and for many years this just hasn't been the case. Since the global financial crisis, stock markets have powered ahead, fuelled by low interest rates, low inflation, quantitative easing and strong profit margins. Looking forward, with Brexit negotiations getting closer, trade war conversations between the US and China and the US and Europe still rumbling on, the potential impeachment of the US president and a forthcoming US election, a change of governor of the Bank of England, a recently appointed President of the European Central Bank, VAT changes due in Japan and a whole list of other factors, it's probably fair to say that the forthcoming 12 months could well bring some volatility.



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