

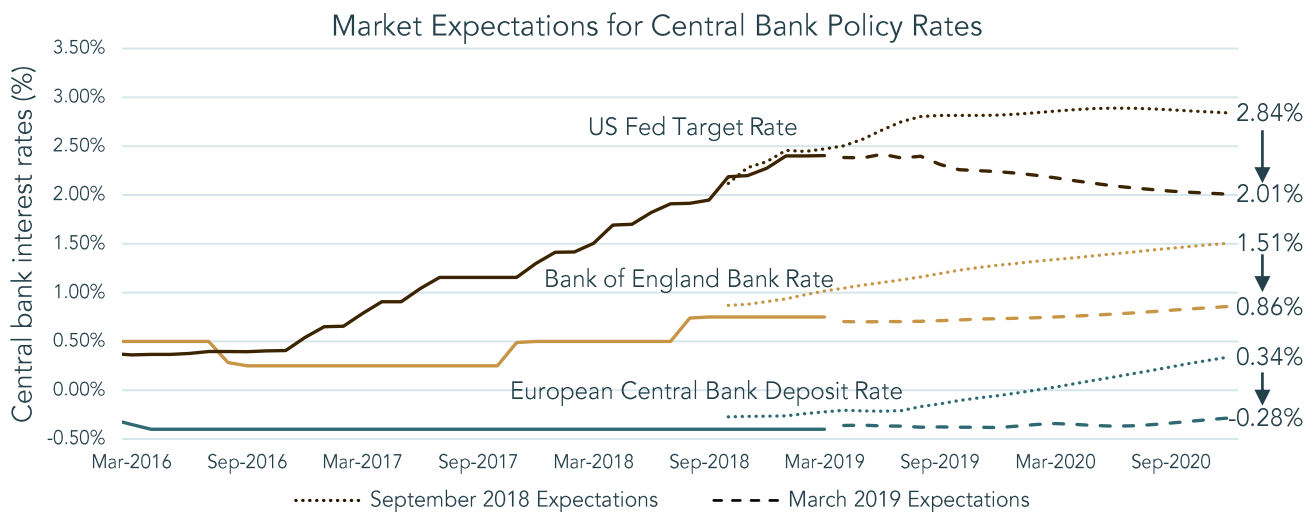


## Investment Letter – Q1 2019

“The size of the Chinese economy is \$13 trillion. In the future, obsessing on the rate of growth is not meaningful, because of the law of large numbers. The reality is, the absolute dollar amount of new wealth creation in the Chinese economy will be well over \$800 billion each year”. Joseph Tsai, Alibaba’s Vice Chairman, 2019.

Last year’s slump in assets was driven, in part, by a fear that the Federal Reserve was raising interest rates too aggressively, whilst simultaneously reducing its balance sheet. On January 4<sup>th</sup>, Jerome Powell spectacularly reversed this view, saying that the Fed would now be cautious and data-dependent with its policy decisions. Fast-forward to the end of the quarter and the narrative now features a commitment to pause interest hikes for the remainder of the year and freeze the unwinding of post-crisis quantitative easing. The impact of the change of tone this quarter was significant, with global equity markets rallying strongly. For Sterling investors, however, a strengthening pound diluted these returns.

The chart below shows how different today’s market expectations for future central bank interest rates are compared to expectations as recently as September 2018. The market has moved from pricing in 2 US rate rises in 2019, to predicting a rate cut in the same period. This reversal has had a meaningful impact on government bonds, by pushing up prices dramatically in the final month of the quarter.



Source: BlueBay Asset Management, 2019

Trade wars were another driver of markets in 2018. However, as we moved into the New Year, President Trump retracted his threatened additional tariffs on Chinese goods. This move was positively received by markets, which are now pricing in a deal of some description in the coming months. It is becoming clear that although China wants a trade deal, it is not as desperate as Trump’s tweets imply. Although Chinese companies are reporting falls in US export orders, the increase in demand from Emerging Markets and domestic consumers has mitigated any lost trade with the US. The structural change of China’s economy, from a manufacturing economy to a more consumer focused one, is providing some protection from any future tariffs that may be implemented.

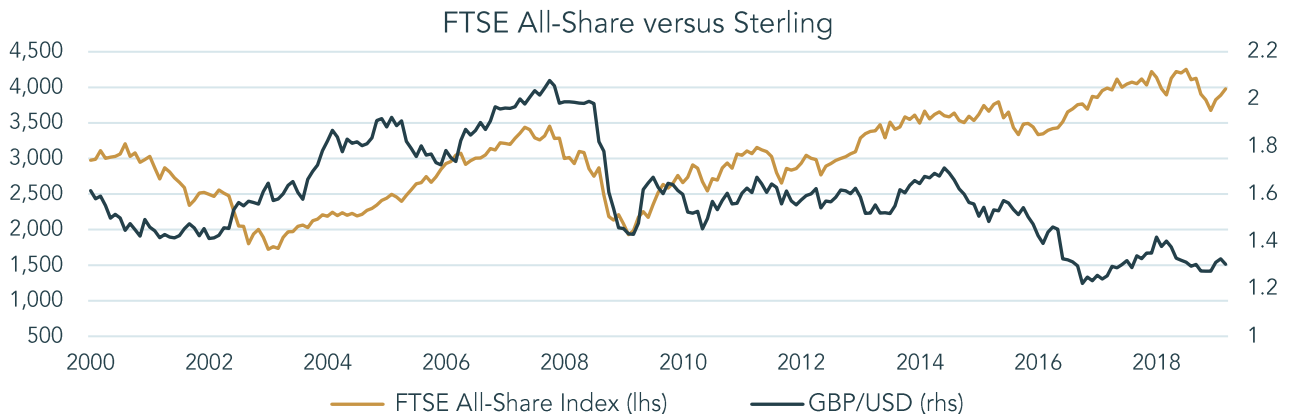
In the UK, with a clear path to a Brexit outcome yet to emerge, assets continue to be weighed down by uncertainty. In a significant, though unsurprising development, Theresa May requested a delay to the UK’s departure date from the EU. At the time of writing almost all outcomes appear still to be on the table, and we suspect by the time you read this letter the table may not look any different.

Despite the ongoing political turmoil around Brexit, we believe there are a number of reasons to be more positive about the UK. Firstly, as we entered 2019, UK equities were as unpopular among global asset allocators as they have ever been. This leaves valuations at attractive levels versus the rest of the world and presents opportunities for investors with a longer-term investment timeframe. We also believe there is latent value in smaller UK companies that are more domestically focused. These companies have been considerably overlooked in the last few years due to Brexit uncertainty, and now appear significantly mispriced. Looking at the currency, we feel the upside opportunity for Sterling is much greater than the

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downside risk. Recent history has created the entrenched view that the pound is inversely correlated to UK equities, so that as Sterling weakens, the equity market rallies. This was certainly accurate in the months post the Brexit referendum. However, the chart below demonstrates that more often than not, currency and equity markets actually move together for long periods of time, driven by sentiment. Our view is that we are moving into a time when Sterling and UK equity markets move higher in tandem.



Source: Bloomberg, 2019

Outside of the UK, we remain positive on Asian and Emerging Markets. By 2020, Asia will be home to half of the world's middle class, which gives us increasing cause for optimism in the region. Part of the reason markets turned against China last year was the slowdown in growth. The Chinese economy reported GDP of 6.4% which, whilst there will always be concerns on the quality of the data, still suggests China was one of the fastest growing economies in 2018. As the Alibaba Vice Chairman's quote highlights, China is growing from a much larger base. Therefore, its GDP last year may have been the weakest in percentage terms since 1990, but in nominal terms it generated a record quantity of new production, equivalent to the size of Mexico's economy, which is the 15<sup>th</sup> largest in the world. If you look at GDP numbers, adjusted for the impact of exchange rates on the price of goods, China is now the largest economy in the world, with 19% of the world's total output, versus the US with 15%.

Additionally, China maintains the ability to stimulate its economy following last year's monetary tightening, which was an aggressive but necessary way to manage the shadow banking sector. This year, China has embarked upon tax cuts and public spending to boost its economy. The size of the tax cuts is meaningful, highlighted by the fact that the number of urban workers paying tax has fallen from 44% to 15%, resulting in a huge increase in the population's disposable income. As for public spending, \$125 billion of new railway projects were approved in January alone.

By the end of the quarter, the Fed-induced positivity in markets had turned to concern as Germany recorded its worst manufacturing survey since 2011. This paused the uptrend in equities and pushed up the prices of conventional fixed income, bringing yields back down. Germany's 10 year government bond yield turned negative, meaning an investor is paying to own the bond. The amount of negative yielding debt in the world this quarter surpassed a staggering \$10 trillion. This statistic is one of many reasons why we continue to hold no conventional government or corporate bonds in the portfolio, preferring to own fixed income where you are rewarded for the risk being taken.

After two quarters of dramatically divergent performance for markets it would be easy to become too immersed in short-term noise. We invest with a greater degree of focus on the long-term as we believe that this is the right approach for our clients to achieve their objectives.

Fred Hervey  
Chief Investment Officer