Heartwood Investment Management

27 December 2018

Our thoughts

Market observation

It has been a tumultuous fourth quarter for financial markets and investors. No single development can be attributed to the broad-based weakness, rather a layering of concerns that has unnerved investors and pushed sentiment down to depressed levels. Thin trading volumes at this time of year may have also exacerbated market moves.

Confidence in the global economic cycle is being slowly reappraised, although talk of an imminent US recession is overly pessimistic in our view. While some macroeconomic data indicators have slightly deteriorated, in many ways the underpinnings of the US economy remain strong: unemployment remains very low, inflation-adjusted wages are rising and consumer spending growth is robust. Whilst the same cannot be said for most of the rest of the world, some of the headwinds facing Europe, Japan, China and the UK could soon start to reverse. The most significant of these relates to the Chinese economy which could start to benefit from recent efforts by the authorities (including tax cuts) to stimulate economic activity. Even in the UK we should expect some clarity and a shift away from Brexit-related uncertainty after the first quarter of 2019.

One of the main drivers of the economic cycle is, of course, the decisions made by policymakers. In recent days, all eyes have been on the US in this regard. The Federal Reserve (Fed) increased interest rates last week, the ninth time during the current economic cycle. Moreover, it has been reducing the size of its balance sheet, termed 'quantitative tightening' or QT. The combination of both these policy actions has caused the price of 'money' to rise, with the aim of controlling future inflation. Thankfully the Fed has demonstrated a willingness to be pragmatic and to slow the pace of future interest rate rises - a welcome step for financial markets. But the major concern last week was actually related to President Trump when it appeared he was considering replacing the Chairman of the Fed, something which would raise serious questions about central bank independence and thus rattle investors' nerves. Simultaneously the US government entered into a partial shutdown over a political impasse regarding border security. Though the economic implications of this are limited it does not bode well for bipartisan politics now the mid-term elections are out of the way. And if all that wasn't enough, the ongoing trade dispute between the US and China rumbles on. Together, these issues raise doubts about the outlook for the US economy and by extension, the rest of the world.

Outlook

There are a great many crosswinds driving financial markets at the moment including a number of potential positive catalysts, such as a resolution to the US-China trade dispute. The onus is now on policymakers to help turn sentiment around, which is more probable than possible in our view. In other words, we feel that some financial markets are pricing in a worse outcome than is likely to be realised. Positioning-wise our strategies are broadly neutral equities, underweight bonds and have been adding to diversifiers such as gold and hedge funds. Finally, it is important to highlight that during this period of market volatility, our strategies are behaving consistently with their risk profiles.
We will keep you updated on future developments.

The Heartwood Investment Team

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