Watson Moore's Monthly Investment Update

December 2018

Contents:

PERFORMANCE UPDATE

- **The FTSE 100 fell 1.60% in November. In addition, UK Government bonds fell 1.10% and inflation-linked bonds were down 3.90%. Our portfolios ranged between -0.26% and +1.83%.**

- The reason why the Dynamic Equity and Third Industrial Revolution portfolios rose significantly was that they are predominantly invested overseas and with Sterling falling over the month, returns from the overseas equity funds that they invest in were positive.

- If we experience a 'no deal' then it is likely that Sterling will fall, and this could help to protect our portfolios as the returns from our overseas investments will benefit. This is exactly what happened after the Brexit vote in 2016.

- Whilst Brexit continues to dominate our news headlines, there are many other factors affecting our wealth which are more important. On the positive side we are beginning to see recent lows in global stock markets hold especially in the US and UK stock markets. We are also in a period in which seasonal returns are strong, with a possible 'Santa Rally' approaching. A thawing out of the 'trade war', a falling oil price and interest rate expectations lowering - all could just be the catalyst required for a strong end to the year.

- The performance of the portfolios over the last month and year is shown below:

Portfolio	Performance % 1 month	Performance % 1 year
Foundation	-0.26	-1.49
Cautious	-0.07	-4.62
Balanced	0.22	-2.97
Adventurous	0.65	-0.69
Dynamic Equity	1.27	4.35
Income Generating	0.08	-1.61
Third Industrial Revolution	1.83	8.61
Retirement Investment Solution 1	0.20	-2.43
Retirement Investment Solution 2	0.36	-1.63
Retirement Investment Solution 3	0.51	-0.87

Please note that these figures do not include the Standard Life platform or Watson Moore's fees.

Trend Following Signals

The table below shows whether the asset class is either in a positive trend (✓) or a negative trend (✗). The portfolios will have more exposure to those asset classes in a positive trend and less (if any) to those in a negative trend. These are the main asset classes we monitor:

Asset Class	Trend Signal	Asset Class	Trend Signal
Global Equity	✓	**Emerging Market Equity**	✗
UK Equity	✗	**Commodities**	✗
Europe ex UK Equity	✗	**UK Corporate Bonds**	✗
US Equity	✓	**UK Corporate Bonds (Short dated)**	✗
Japan Equity	✗	**UK Index Linked Bonds**	✗
Pacific Equity	✗	**Global Bonds**	✗
Gold	✓	**UK Gilts**	✗
Global Property	✓	**Emerging Market Bonds**	✓
		Overseas Corporate Bonds	✓

Summary of Portfolios - *So how will Brexit affect our portfolios?*

This is the tough question that we are being asked by many clients. The honest answer is that we don't know as we don't know what deal (or no deal) we are ultimately going to have, when that deal will be implemented' and how each asset class will react to the outcome. If we look back to the vote in 2016, the chances of 'Leave' winning were small and the experts predicted that stock markets would fall if 'Leave' won. As we know, 'Leave' did win and stock markets, after going down for a few hours, rallied significantly. We then witnessed a shock 'Trump' victory and again the experts predicted that stock markets would fall . . . they surged higher instead. The experts also predicted that Leicester City would never win the Premier League!

We therefore know that predicting the outcome of events is difficult and even if you predict correctly, you may incorrectly predict how investment markets react. However, we do have some clues as to what will happen if we get the extreme events that are being mentioned in the press and from this, we can look at possible investment outcomes.

What will happen in a 'no deal'?

The Bank of England has forecast that the worst possible scenario (a disorderly Brexit) would see the UK economy contract by 8%, unemployment rise to 7.5%, house prices fall 30%, inflation rise significantly and interest rates rise to 5.5%. **They also predict that Sterling will fall significantly.**

We could therefore see our holdings in overseas Equities appreciate significantly due to the falling Pound. This could also help increase the value of the FTSE 100 as over 70% of the companies' earnings within the FTSE 100 come from overseas and thus will be worth more when converted back to Sterling. Rising interest rates will cause bonds to fall but our bond exposure has been significantly reduced this month. Of course, if this scenario causes the global economy to contract as well, then we could see global stock markets crash. If this occurs, then our trend- following process will hopefully ensure that the portfolios that use this process will fall less than others.

What will happen if we remain in Europe?

We would probably see Sterling appreciate which would cause our overseas holdings to fall in value. An appreciating Sterling could also cause the FTSE 100 to fall. However, we could also experience UK and European stock markets move significantly higher as the uncertainty is removed and overseas investors start to feel much more comfortable investing in UK and European companies again. We do have some exposure to UK and European stock markets so could benefit, but overall, we are underweight equities which will help protect the portfolios a little from an appreciating currency.

In Summary

Whilst Brexit is important to us, the global economy does not appear to be affected by it. We have experienced a small correction in global stock markets due to various factors such as the trade war and rising interest rates. This is why we are generally underweight equities at the moment. However, there are some tentative signs of stock markets recovering and a possible 'Santa Rally'. In addition, a 'no deal' will probably see Sterling fall and this will help our wealth.

Cautious, Balanced and Adventurous portfolios

Last month we saw a big reduction in equity exposure on all three portfolios as equity markets fell below trend. This month we saw a slight increase in the Adventurous portfolio only, as it reinvested in US smaller companies due to them breaking back above trend. The Cautious portfolio significantly decreased its exposure to Bonds as the trend from four Bond asset classes turned negative over the month. Bonds are much more volatile than normal, so we are expecting to be buying and selling them until a longer-term trend develops. The Balanced and Adventurous portfolios changed its bond exposure from the UK to overseas as currency changes mean that overseas bonds are outperforming.

Fund	Cautious	Balanced	Adventurous
iShares S&P SmallCap 600			+5.0%
iShares Corporate Bonds 1-10 Years	-2.5%		
iShares Corporate Bonds	-2.5%		
iShares UK Gilts	-2.5%	-5.0%	-2.5%
iShares Index Linked Government Bonds	-2.5%	-5.0%	-2.5%
iShares Overseas Government Bonds		+5.0%	+2.5%
iShares Overseas Corporate Bonds		+5.0%	+2.5%

Dynamic Equity portfolio

The momentum philosophy that forms the core of this portfolio attempts to invest more money in those markets that are experiencing the strongest growth. No changes were made this month and the portfolio remains overweight US equities which have benefitted from Sterling falling.

Foundation portfolio

The Foundation portfolio decreased its exposure to UK gilts, Inflation Linked Bonds and Corporate Bonds as they broke below trend.

Income Generating portfolio

No changes were made this month.

Third Industrial Revolution portfolio

The portfolio began to bounce back from the recent losses experienced. This is mainly due to currency but also the fact that some of the sectors it invests in appear to have been oversold and are rebounding.

Retirement Investment Solution portfolios

The trend following part of these portfolios significantly decreased its exposure to equities last month and Bonds this month. The portfolios now hold a significant amount in cash. The Retirement Investment Solution portfolios are invested in not only a trend following portfolio, but the Foundation and Dynamic Equity portfolios as well.

Summary

November saw many Bond markets fall below trend and some of our portfolios have reacted to this, by lowering their risk.

ASSET CLASS REVIEW

This section will give you an insight into our current thinking and below are some charts that look interesting. This month, and in the Christmas spirit, we look at why we should be more positive about investment markets.

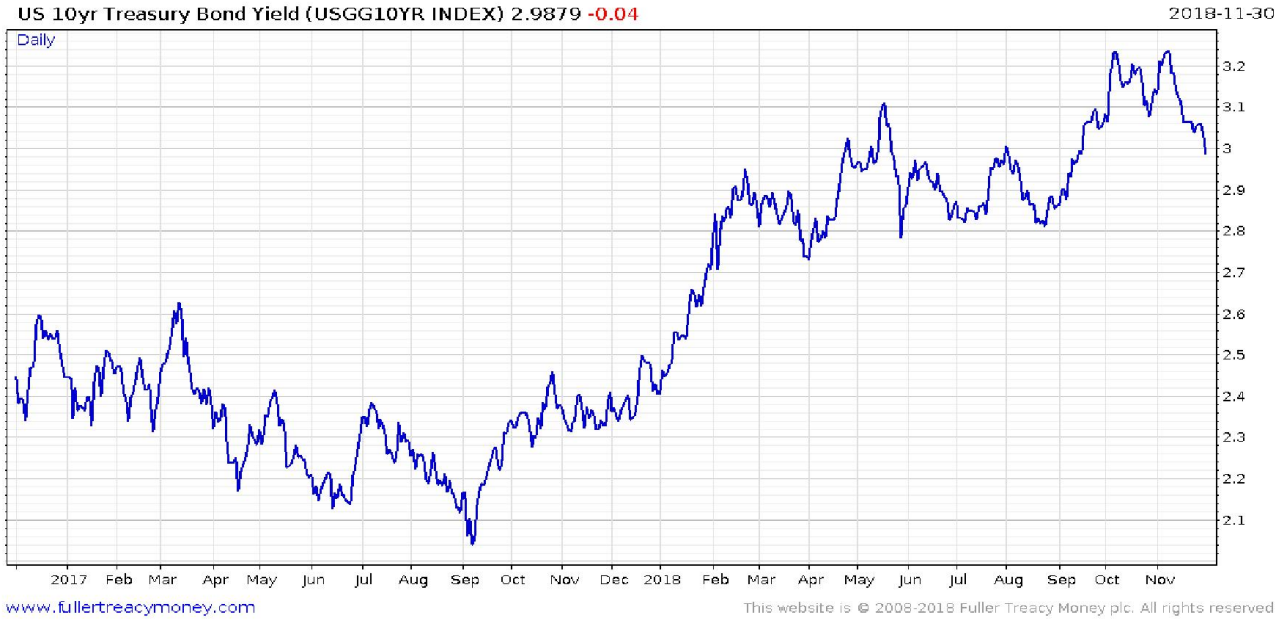
The oil price has fallen significantly

The near 30% fall is extremely important as the price of oil is effectively a tax on our wealth, through higher petrol prices and transportation costs. The chart below shows how the price was trending consistently higher due to the global economy improving. You can then see the sudden and dramatic fall:

Whilst we know that economic growth in China is slowing, it is not the reason for this fall. We believe Trump has done a deal with Saudi Arabia. In return for them pumping more oil he has decided to put a line under the murder of Jamal Khashoggi. A lower oil price is good news for the global economy.

Interest rates not increasing as much as we thought

One of the reasons for the two stock market corrections in 2018 has been the fact that the global economy is improving a little too quickly. The result of this has been rising interest rates in the US and the fear that they will continue to rise and cause the next recession. Over the last month there have been many comments that they won't rise as much and the chart below shows the yield on US Government Bonds falling from over 3.2% to under 3%. This is a good measure of how high future interest rates will be over the medium term.



The FTSE 100 bounces off the floor again

Last month we looked at how the FTSE 100 couldn't stay above 7,000 until it broke above the level in December 2016. We called this level a "ceiling". Once it broke above the ceiling, the ceiling acts as a floor which the FTSE 100 keeps bouncing off. This month we have seen the FTSE 100 drop below 7,000 but then bounce back above it very quickly. We thus have a strong 'support zone' or floor.

The support zone for the US stock market has been tested again and bounces higher

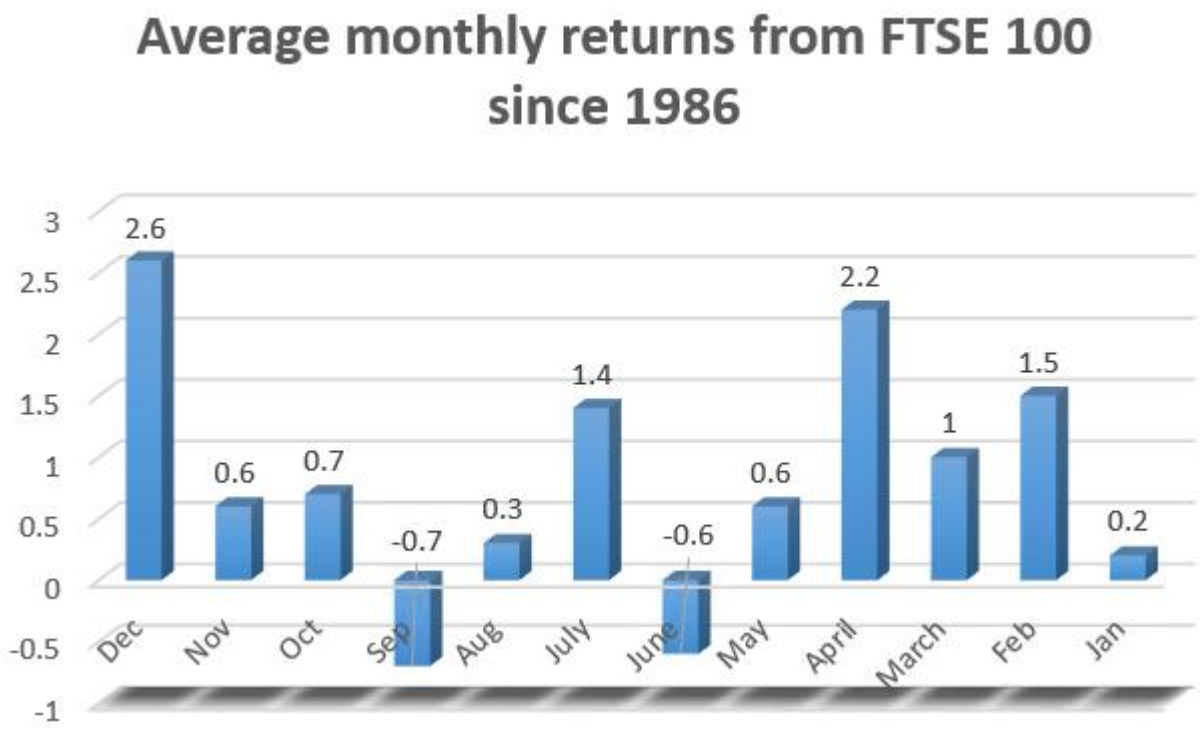
The US stock market had been increasing in almost a straight line until early 2018. Since then it has been trending sideways but every time it starts to fall to 2,600 it bounces. This month we saw it start to fall back to 2,600 but then bounce again. The fact that we have a strong support zone is very positive.

In Summary

Whilst our newspapers are full of Brexit and the problems that our country is facing, the most important factors affecting global stock markets are more positive. We are seeing lower input costs (oil price), interest rates not expected to go up as much as we feared and global stock markets bouncing off important support zones. When we add in a potential 'Santa Rally' then we do have reasons to be cheerful in the run up to Christmas.

THE SANTA RALLY

As the name implies, a 'Santa Rally' is the term for when stock markets post positive results in the run up to Christmas and the New Year. UK investors, for instance, have come to expect the FTSE 100 to achieve a good return in December. From 1986 to 2017, the FTSE made an average gain of 2.6% in the last month of the year and has only fallen four times. The chart below shows the average monthly return for each calendar month from the FTSE 100 and you can see the effects of the Santa Rally.



Quite why this phenomenon should occur is unclear, and in truth there are probably several factors behind each individual rally, but a few of the major theories on why markets rally in December include:

- Seasonal goodwill among investors, who are more willing to buy around Christmas.
- Markets rising on lower volumes over the holiday period.
- Fund managers rebalancing their portfolios before the end of the year.
- People investing their Christmas bonuses.

It isn't just the FTSE 100 that has benefited from a Santa Rally as most global stock markets have similar seasonal statistics. Interestingly, there is no agreement about when the Santa Rally period really starts with different sources offering conflicting answers. Does it last the whole of December? Or just the week before Christmas? Or something in between? One source, however, found that the biggest rises in indices typically occur from 14th – 16th December.

While you can get a broad idea of when a Santa Rally might start by looking at historical data, each year's Santa Rally will be different. It might start early, it might start late, or it might not start at all. You can only know for sure if a Santa Rally has taken place once it is already over. This year markets could recover from the October correction and this could mean we see another strong December.

Whatever the reason, and whenever it occurs, we know that historically December is a great time for investing money and it just leaves us to say, "Happy Christmas!"

FINAL COMMENT

Brexit is dominating our news and there is much uncertainty as to what is going to happen. We have a wide range of potential outcomes including 'remain' and a 'no deal'. Our portfolios are taking less risk currently, not from fear of Brexit, but from the fact that the trends on many markets have been broken. This will help protect the portfolios somewhat during this volatile period. In addition, we are overweight US equities which should do well if we get a 'no deal' and Sterling falls.

Whilst Brexit is important to the UK, the biggest factor affecting our wealth is still the global economy. There are many potential catalysts that could cause the markets to rally higher in December.

Watson Moore Independent Financial Advisers Limited
54 Station Road
Upminster
Essex
RM14 2TU

Tel: 01708 250624

Email: chrismoore@watsonmooreifa.com

www.watsonmooreifa.com

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