Watson Moore's Monthly Investment Update

January 2019

Contents:

PERFORMANCE UPDATE
ASSET CLASS REVIEW
10% DROP NOTIFICATIONS
FINAL COMMENT

PERFORMANCE UPDATE

- **Global stock markets fell in December with the FTSE 100 falling 3.49%. The main US stock market fell 8.89% in sterling terms and Europe was down 4.76%. This caused our portfolios to fall between 1.55% and 8.35%.**

- Concerns of a global economic slowdown have caused the current stock market correction. A correction is deemed when a stock market falls between 10-20% from its high and it moves into a bear market when it falls 20% or more.

- 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.

- On the negative side there are signs that the global economy is slowing and a higher probability that a global recession will occur within the next two years. This is occurring at the same time that money is being taken out of the economy (Quantitative Tightening) and is causing stock markets to fall.

- On the positive side stock markets appear to be good value and if we don't get a global recession then this could be a great time to invest. For example, the FTSE 100 is now paying a dividend yield close to 5%.

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

Portfolio	Performance % 1 month	Performance % 1 year
Foundation	-1.55	-3.91
Cautious	-2.48	-7.67
Balanced	-2.97	-6.80
Adventurous	-5.06	-6.81
Dynamic Equity	-7.06	-4.30
Income Generating	-3.61	-6.64
Third Industrial Revolution	-8.35	-1.98
Retirement Investment Solution 1	-2.96	-6.08
Retirement Investment Solution 2	-3.59	-5.98
Retirement Investment Solution 3	-4.18	-5.89

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

We have experienced a correction in global stock markets, which is a fall between 10% and 20%. In addition, nearly every asset class made a loss in 2018. The exceptions were UK gilts which made a gain of 0.13% and cash. The current correction has caused the FTSE 100 to fall over the last two years from 7,142 to 6,700.

The trend following portfolios have been positioned relatively defensively, with less equity exposure than 'normal'. Within the equity exposure we have investments in 'defensive equity' funds which tend to be concentrated in defensive sectors such as consumer goods and healthcare. If we do get a recession then it is companies that produce well-known brands within goods that we are going to continue to use, like chocolate and nappies, that tend to outperform. The selected funds have more exposure to these types of goods.

The reason that we have more cash in the trend following portfolios is that we are now faced with a potentially slowing global economy. This has led to most stock markets falling below trend and the chances of a recession occurring within the next two years has increased. In addition, we have Brexit negotiations to deal with and whilst sterling has fallen, there is a stronger chance of getting a more extreme outcome i.e. a 'no deal' or we remain in the EU. We are fearful that a 'remain' outcome will cause sterling to rise and our overseas holdings to fall in value in sterling terms.

Whilst the news flow appears to be all doom and gloom, there is still much good news around as the global economy is still growing and we have low inflation, low unemployment and low interest rates. We also have the possible ending of the 'Trade War' in sight. The correction has also led to certain pockets of good value within stock markets and this can be demonstrated by the FTSE 100 which is currently paying a dividend income of 4.82%. If we do not get a global recession, then today could prove to be an excellent time to invest. If, and when, markets start to move into positive trends then the trend following portfolios will start to invest some of the cash and we can hopefully benefit from the next upward growth cycle.

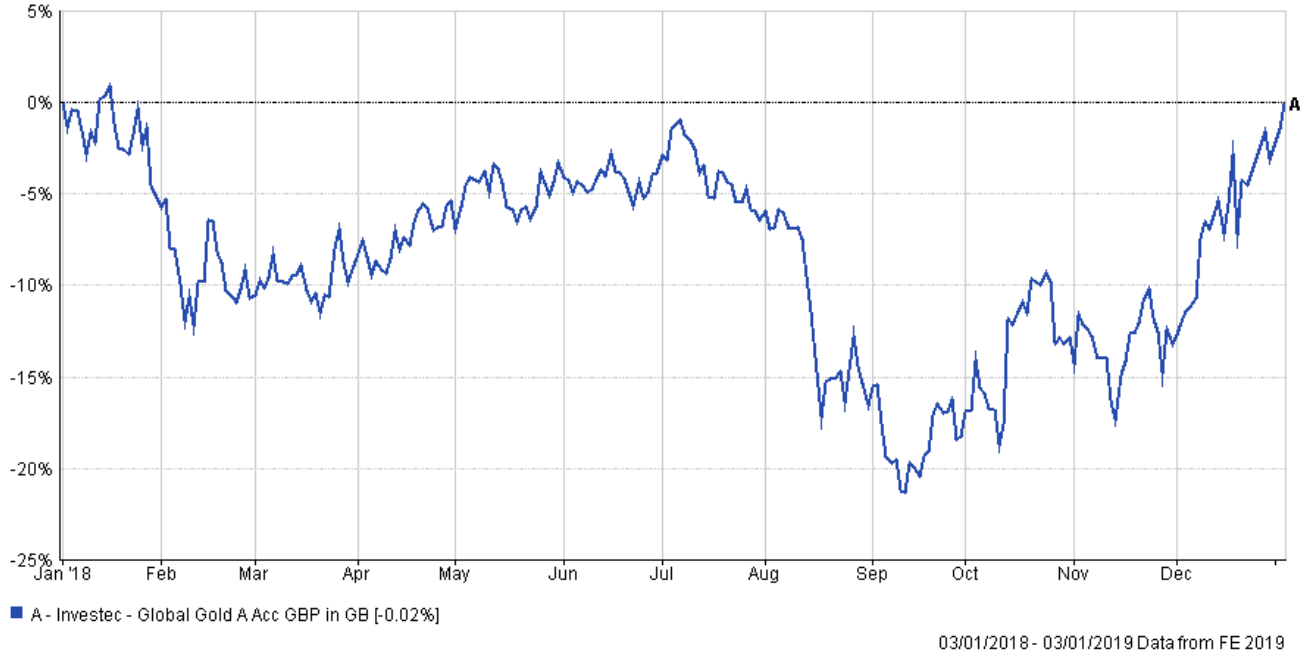
Cautious, Balanced and Adventurous portfolios

This month we saw a further reduction in equity exposure on all three portfolios as most equity markets fell below trend. The summary of the asset allocation of the portfolios is as follows (figures in percentages and are estimates):

Portfolio	Cash	Market Neutral Funds	Bonds/Other	Equities
Adventurous	35.0	10	11.6	43.4
Balanced	42.5	10	16.3	31.2
Cautious	44.0	10	20.2	25.8

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. This month a gold mining fund was included for the first time as it is now high up on the momentum scale. You can see from the chart below how it has started to move significantly higher over the last few months:



In addition, property companies were included, and Japanese and North American equities were removed.

Foundation portfolio

The Foundation portfolio decreased its exposure to equities and the allocation to equities is now 33%. The allocation to bonds increased and now stands at 30.5%. This is a very diversified portfolio with commodities, gold, cash and market neutral funds making up the balance.

Income Generating portfolio

No changes were made this month. We are beginning to see income generating asset classes outperform and, with a yield of nearly 5% on the FTSE 100, there appears to be some great opportunities for income seekers.

Third Industrial Revolution portfolio

No changes were made this month.

Retirement Investment Solution portfolios

The trend following part of these portfolios significantly decreased its exposure to equities but increased the exposure to bonds this month. The portfolios 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

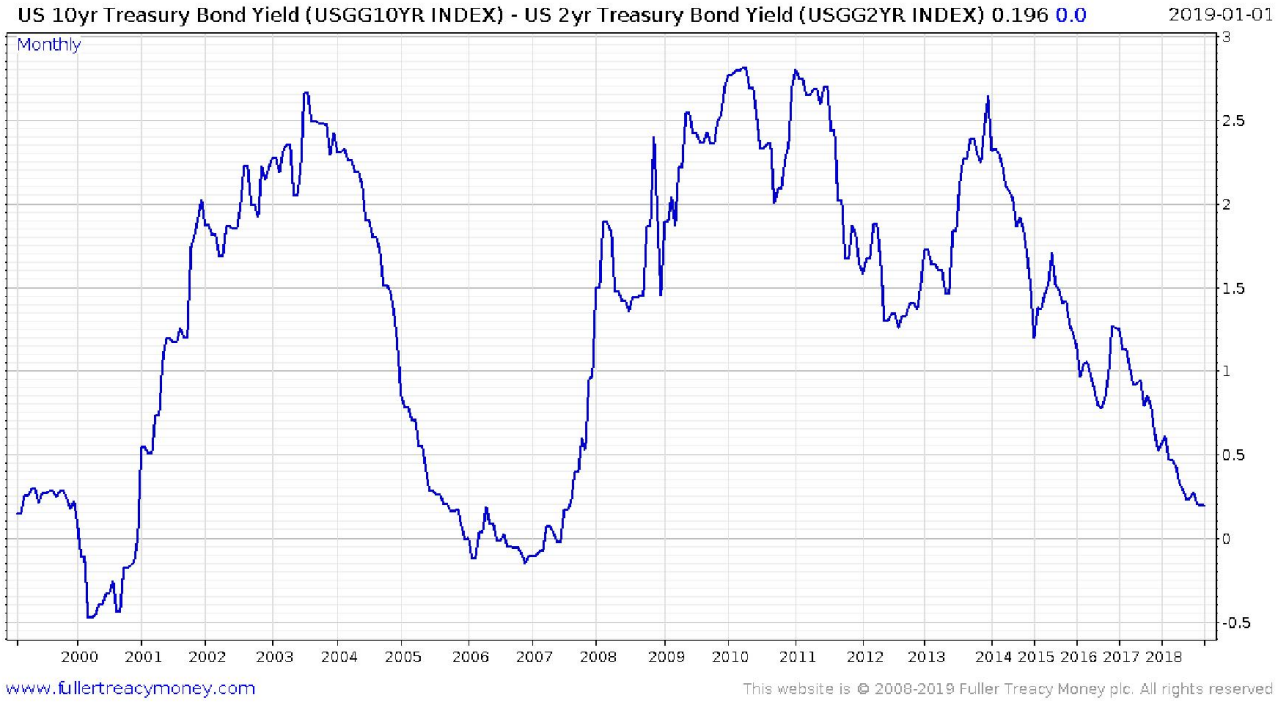
December saw most stock markets fall below trend and the trend following portfolios reduced their exposure. Bonds performed much better as money flowed into less risky asset classes and exposure to them increased. The higher risk portfolios such as the Dynamic Equity portfolio, are extremely volatile at the moment and will be correlated to equity markets.

ASSET CLASS REVIEW

This section will give you an insight into our current thinking, and we have attached some charts that look interesting. With the global economy still growing and the US expected to register 3% growth in 2018 (the quickest annual expansion since the global financial crisis); unemployment at a 50-year low in the US; interest rates remaining low globally; and inflation remaining in check – we look at why we are currently experiencing a stock market correction.

A possible inverted yield curve

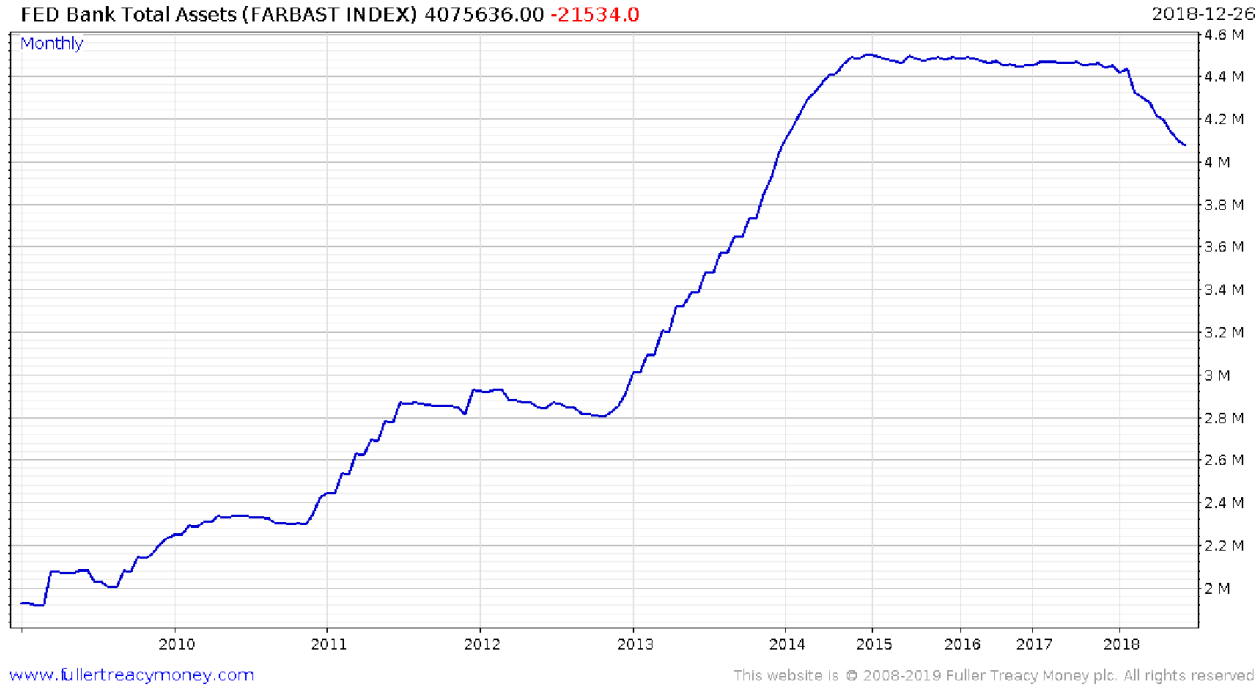
The chart below is important as it can signal a global recession within two years. In fact, the US yield curve has inverted before each recession in the past 50 years. It offered a false signal just once in that time. The chart below shows the difference between US 10-year Treasury bond yields and 2-year Treasury bond yields. US Treasuries are bonds issued by the US Government and the yield is a measure of the annualised return an investor can expect to receive for holding the bond until it matures. In normal circumstances you expect to receive a higher return for holding the bond for a longer period. However, on rare occasions the yields in the short term are higher than long term yields (this is called an inversion). When the blue line in the chart goes below zero then it is 'inverted', and the chart shows that the last two inversions coincided with the stock market crashes of 2000-03 and 2007-09:



The chart shows that as interest rates in the US have risen recently, investors are worried that the economy will slow and that they will be forced to be cut again in the future in order to stimulate the economy again. Investors are now worried that we will see another inversion and therefore the chances of a global recession have increased.

Quantitative Easing is being reversed – Quantitative Tightening is now here

Quantitative easing is simply the introduction of new money into the economy by the central bank. It was used after the financial crisis in order to stimulate the economy. A lot of the new money found its way into asset prices and we saw stock markets and property prices increase significantly from 2009. The chart below shows the total assets of the US central bank (FED) and you can see how much it grew since 2009. You can also see that in 2018 it started to fall, and this coincided with stock markets falling.



If this line keeps falling and if we do not get more stimulus from somewhere (i.e. Government Infrastructure spending) then global stock markets could continue to fall.

Trump

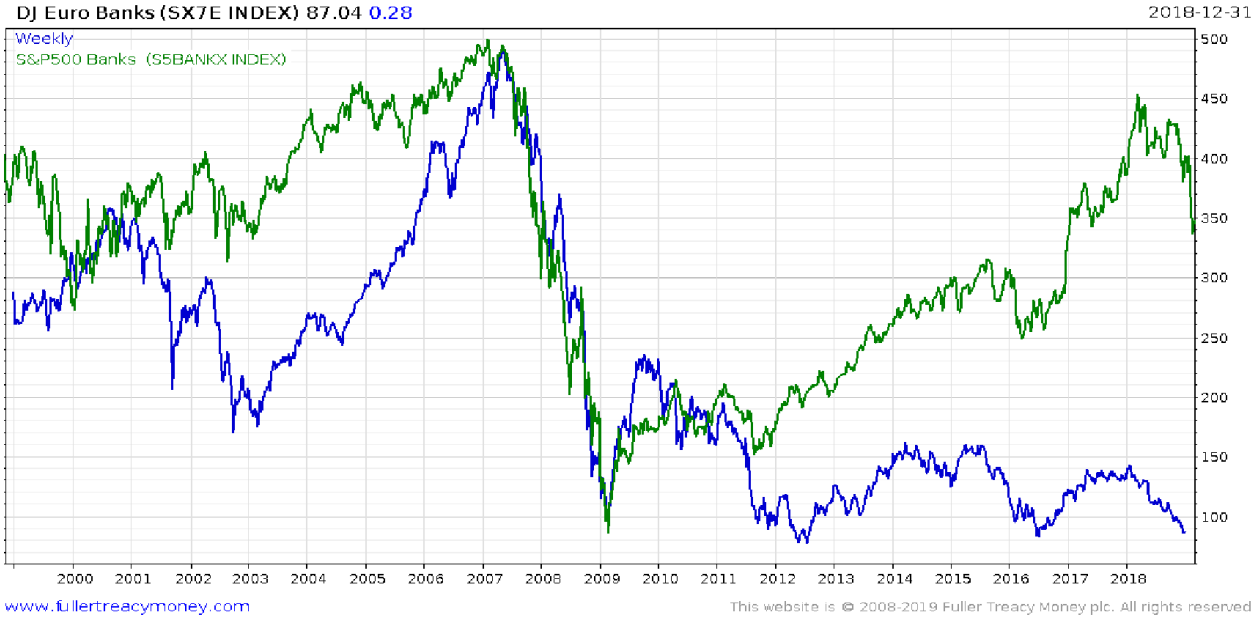
When Trump won the Presidential election in October 2016, the US stock market jumped. He then cut taxes for companies and it continued on its upward trend. However, as we have all been reading in the press recently, Trump has become even more unpredictable and his actions are having a negative effect on the US stock market and global economy. The chart below is the Russell 2000 which is a US stock market for smaller companies. It is a good bellwether of the US economy and you can see that it has nearly fallen to the same level at which Trump came into power:

Recession in Germany?

Germany, Sweden, Switzerland, Japan, Italy, Canada and Mexico all have reported a negative growth in a quarter and it is looking increasingly likely that Germany will be one of the first major economies to fall into recession (two consecutive quarters of negative growth). This has not helped the top 50 companies in Europe and their share prices have been unable to grow back to their pre-2009 level, let alone their 2000 level.

A new European Banking crisis?

Deutsche Bank is one of the world's best-known banks and its share price fell 57% last year. The bank is in such a bad financial position that people think it will have to be nationalised. The chart below compares the share prices of European banks (blue line) to US banks (green line) and we can see how, since 2011, US banks have recovered but European banks have fallen further. A healthy banking system is good for the economy and this chart demonstrates how bad Europe has been compared to the US at repairing their banks.



In Summary

Stock markets have corrected despite what appears on the surface to be a healthy global economy. However, there are certain charts that do not look healthy and point to a possible recession going forward.

10% Drop Notifications

Our investment update is designed to regularly communicate to our clients how each of our portfolios is performing, why they are going up or down and how the portfolios are positioned. In addition, we send correspondence when a major event occurs that could affect the performance of your wealth. For example, we emailed all clients on the day after the Brexit vote to inform them that due to the fact that sterling had fallen significantly, they had probably made money that day. Unfortunately, this level of communication is very rare in the IFA and wealth management industry and this has led to some new rules being implemented that are designed to help clients understand more about their portfolios.

What are the new rules?

For any discretionary managed portfolio (this is a portfolio that makes fund switches without you having to agree to them every time), if it falls by 10% within a quarterly reporting period then you will be notified that the portfolio you are invested in has fallen 10%. If the portfolio falls a further 10% during this period, then you will receive another notification. These rules have been brought in by new European legislation under the legislation framework called MiFID II.

How likely is it that a portfolio falls by 10% in a quarter?

Since January 2008 the FTSE 100 has fallen by 10% or more in 5 quarterly periods. During this period, we would have only had to send out two notifications for the Adventurous portfolio. In the current quarterly period we have had to send out 10% notifications for some of our clients invested in the Dynamic Equity, Third Industrial Revolution and Adventurous portfolios. The reason why only some clients received the notifications is that everyone is currently set up on different start dates for the quarter. This will be changed so that every client is aligned to the same quarterly reporting period shortly.

What is wrong with the rules?

We believe that the new rules have been badly thought out and do not give investors the whole picture of how their portfolios are truly performing. These are the flaws:

- They only relate to ISAs and investments - not pensions. More than half of our clients' wealth is invested in pensions, so this seems absurd. However, we are working on the technology that will allow us to notify our pension clients as well.
- A portfolio could fall 9% in each quarter over a year, but clients will not receive a notification.
- A portfolio could drop 10% in the first month of a quarter but then go up 10% in the next month. Only a drop notification will be issued and clients will not be notified of the gains.
- A 10% drop from time to time for a higher risk client is expected and should not be too concerning, but a 10% drop for a more cautious client will be more worrying. We believe that all risk clients shouldn't be treated the same.

Summary

Despite these flaws we welcome the new rules and will notify you if the portfolio you are invested in falls by more than 10%. However, we believe that the Investment Update is a much more useful form of communication.

FINAL COMMENT

2018 saw most asset classes fall and we enter 2019 in a less than positive mood, with most global stock markets in a downward trend. Our objective is to try and minimise losses (for most of our portfolios) once we have experienced the first significant stock market falls. This is the reason why we have much more cash in the portfolios and less invested in equities. Whilst we do not know what the future direction of stock markets will be in 2019, our investment philosophy is flexible to increase risk if they move up and to somewhat protect wealth if they fall further. And finally……

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

Tel: 01708 250624

Email: chrismoore@watsonmooreifa.com

www.watsonmooreifa.com

Authorised & Regulated by the Financial Conduct Authority