Watson Moore's Monthly Investment Update

June 2019

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PERFORMANCE UPDATE

- **Global stock markets fell in May with the FTSE 100 falling 2.87% and higher-risk emerging markets losing 4.56%. Most of our portfolios fell due to this. Despite the losses experienced by most global stock markets, our lower risk portfolios benefitted from positive returns in the bond funds that we invest in, as well as the more defensive equity funds. This helped minimise losses in our lower-risk portfolios, with the Foundation portfolio rising.**

- Trump's trade war with China appeared to worsen as he warned that 'we're not ready to make a deal' and that tariffs worth hundreds of billions of dollars could 'go up very easily'. In addition, he opened up a tariff war with Mexico, which could potentially result in severe damage to both economies.

- May has been the worst month for Sterling since 2016 as it shed more than 3% as the chance that politicians would eventually agree on a Brexit deal receded. Theresa May announcing her resignation has increased the chances of a "no deal"

- The trend following portfolios slightly reduced their exposure to equities, but most stock markets remain above trend.

- The FTSE 100 is yielding close to 5% which is historically high and shows that there is great value once the uncertainty surrounding Brexit recedes.

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

Portfolio	Performance % 1 month	Performance % 1 year
Foundation	0.98	1.47
Cautious	-0.53	-2.93
Balanced	-0.55	-2.94
Adventurous	-0.98	-3.19
Dynamic Equity	-1.36	2.58
Income Generating	-1.34	2.26
Third Industrial Revolution	-4.07	1.75
Retirement Investment Solution 1	-0.61	-1.39
Retirement Investment Solution 2	-0.77	-1.00
Retirement Investment Solution 3	-0.93	-0.64

Please note that these figures do not include the 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

Perhaps the biggest news that affected our wealth during May was the resignation of Theresa May. The impact of this is that we now have a much greater chance of a "no deal" and a lower chance of a softer Brexit. The favourite to replace Theresa May is now Boris Johnson and he has a 50/50 chance of winning according to the bookmakers. He has promised to lead the country out of the European Union on October 31st with or without an exit deal. He also knows that if he doesn't, then the disastrous results for the Conservative party during the European elections could be repeated in the next General Election.

The result of this has seen Sterling falling over 3%, which in turn has assisted our portfolios. The chart below shows the average price of Sterling against a basket of other currencies over the last 3 years and you can see the recent fall:

The effect of this is that the main US stock market fell 6.35% during May but this translated to a loss of only 3.14% in Sterling terms.

Cautious, Balanced and Adventurous portfolios

Exposure to equities was reduced a little as the UK and emerging markets went below trend.

In the Adventurous portfolio, exposure was added to healthcare.

The Balanced and Adventurous portfolios also switched into inflation linked gilts and out of overseas corporate bonds.

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. There were no changes this month and the current momentum asset classes are US, Pacific and North American equities as well as property, healthcare and technology sectors. The UK equity exposure has been changed from the Edinburgh Investment Trust to the 7IM UK Value fund. 2% was moved this month and the balance should be transferred over the next three months. The investment process for the 7IM fund looks to find undervalued UK companies, with strong fundamentals and potential for earnings growth. We believe that this fund will produce better long-term returns than the Edinburgh Investment Trust as there are many undervalued UK companies as a result of overseas investors not wanting to invest in them due to the fear of Brexit. When Brexit is resolved then money may come flooding back into them.

Foundation portfolio

The Foundation portfolio is benefitting from its high weighting in bond funds as they rose significantly last month, offsetting the losses in equities. This month exposure to UK equities in the trend following part of the portfolio was reduced.

Income Generating portfolio

Exposure to UK equities was further increased this month due to the fact that the dividend yield on the FTSE 100 is close to 5%. In addition, we switched out of the Invesco Perpetual High Income fund and into the 7IM UK Value fund as the dividend yield is over 1% higher. The switch summary is as follows:

Sell (this represents 7.5% of the portfolio)	
Invesco Perpetual High Income	100%
Merian Global Equity Income	25%
Buy	
Man GLG UK Income Fund Professional	2.5%
7IM UK Equity Value	5.0%

This switch will take the dividend yield on the portfolio to over 3.8%.

Third Industrial Revolution portfolio

No changes were made this month.

Retirement Investment Solutions

The trend following part of these portfolios invested in Healthcare but sold out of UK, emerging markets and smaller global equities this month. Thus, cash was increased. The Retirement Investment Solutions are invested in not only a trend following portfolio, but the Foundation and Dynamic Equity portfolios as well.

Summary

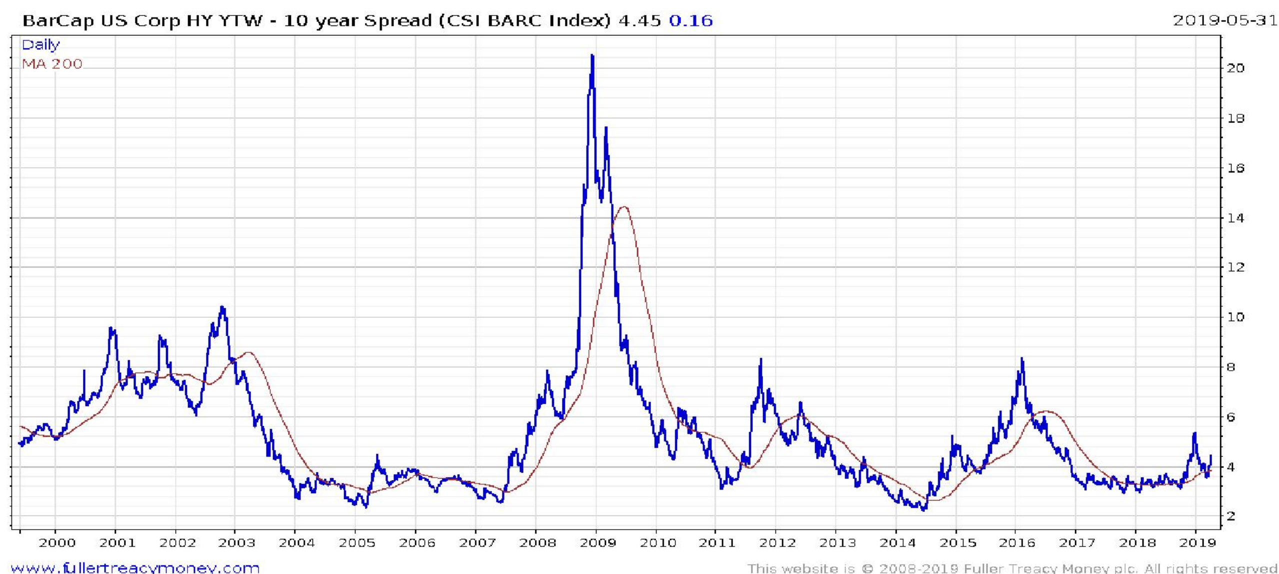
May saw a few equity markets fall below trend and exposure was reduced. Bonds are currently outperforming, and this helped our lower risk portfolios.

ASSET CLASS REVIEW

This section will give you an insight into our current thinking, and below are some charts that look interesting. With global stock markets falling in May and concerns that the trade war will cause an economic recession, we look at the charts that may be able to predict whether we are due a recession.

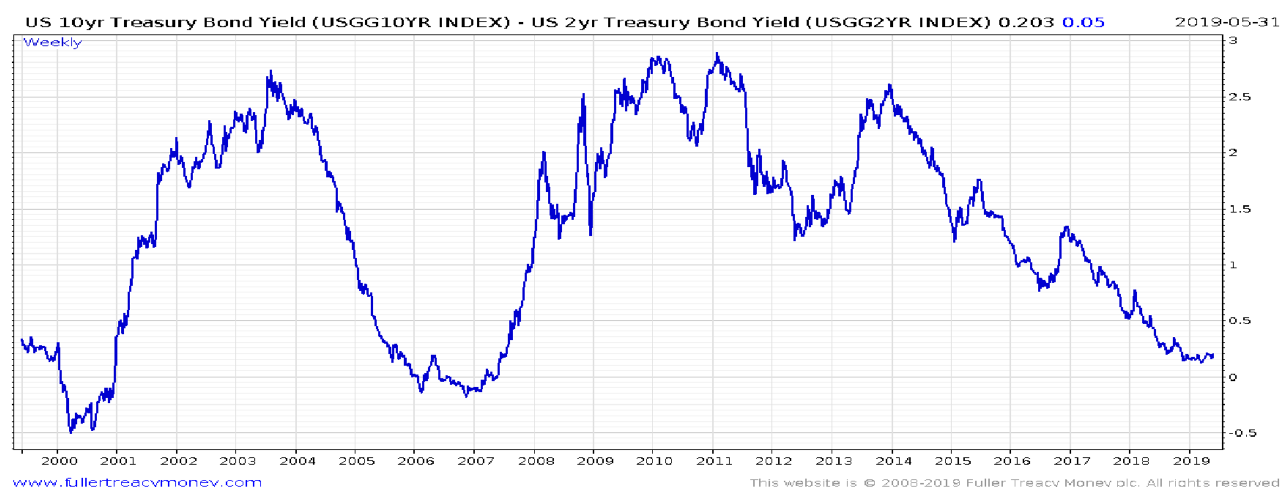
Riskier companies borrowing costs are rising a little

The chart below is essentially the difference in the interest rate that higher risk companies can borrow at compared to the risk-free rate (i.e. lending money to the US Government). It is known as the 'High Yield Spread'. High Yield Spreads, which had widened out and were one of the primary causes of recessionary fears in the fourth quarter last year, contracted substantially. However, over the last few weeks they have started to creep up again though not yet at a worrying level:



A possible inverted yield curve

We last wrote about this chart in the January update 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 after continually falling, 2019 has seen the blue line remain level and slightly above the inversion level. This is good news.

Purchasing Managers' Index (PMI) remains in expansion

The PMI is a monthly survey sent to senior executives from over 400 companies in 19 industries. The survey includes questions about business conditions and any changes, whether it be 'improving', 'no change', or 'deteriorating'. The headline PMI is a number from 0 to 100. Above 50 represents an expansion and below 50 a contraction (possible recession). As you can see, the level is still expansionary though the trend is falling:

Technology – the leading sector is falling

The technology sector has been the leading sector in the US, driving markets higher. The leading sector tends to lead in both directions and when it starts to fall it can drag other markets down with it. The chart below is of the US based Nasdaq, which is a stock market full of technology companies. As you can see, it has fallen significantly over the last month:

This is a worrying sign but is symbolic of the fact that Trump's trade war is mainly about technology and this is causing technology stocks to fall.

In Summary

Stock markets are more volatile than normal and over the last year-and-a-half we have seen some dramatic swings but overall, they have hardly moved. Talk of a global recession has been a headwind for them but the charts above do not yet show that a recession is due, rather that the global economy is slowing down. We should expect this to continue until a resolution is found to the trade war. We believe that the catalyst for this will be the fact that Trump will want stock markets to go up in the run up to the next Presidential election in November 2020.

BREXIT OPPORTUNITY

We believe that Brexit has created a good investment opportunity and we have been taking advantage of this with some of our recent fund switches. The opportunity is simple – investing in higher yielding UK companies.

UK companies are cheap

The UK's tortuous exit from the European Union hangs over our stock market, deterring overseas investors from scooping up attractively cheap shares. Investors repeatedly point out the UK is home to multinationals with resilient earnings, trading at depressed prices because of the Brexit debacle. When we factor in that around 75% of the FTSE 100 revenue is from overseas, we could argue that the FTSE 100 should not be that affected by Brexit. The chart below compares the performance of the top 350 UK companies to the MSCI World index and the lower the line goes means that the UK stock market is underperforming and cheap compared to other stock markets:

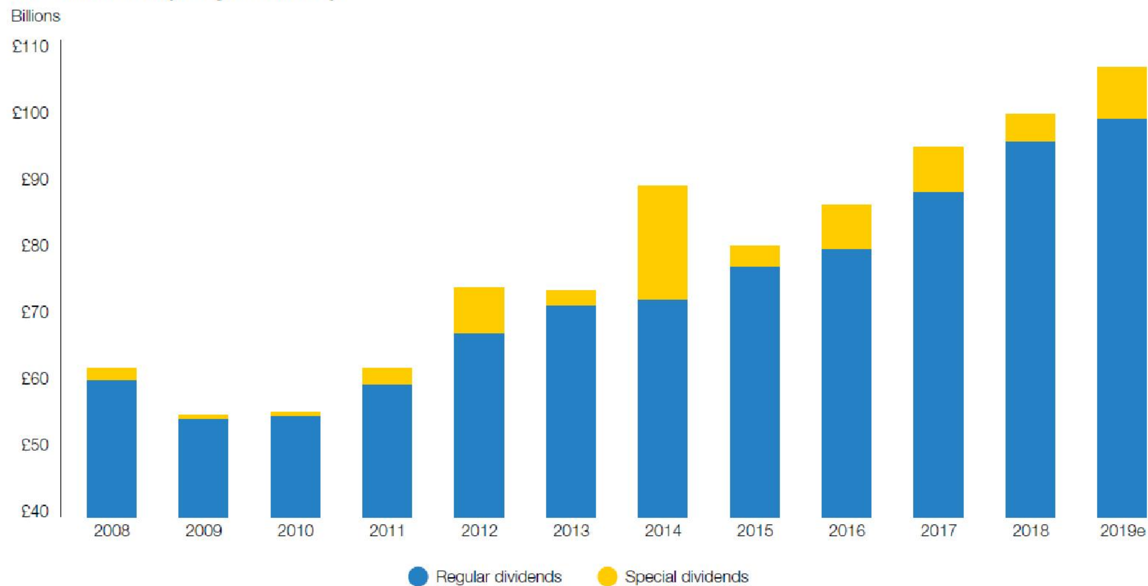
High Dividend Yield

UK dividends jumped 15.7% in Q1 2019 to £19.7bn, easily a first quarter record. The dramatic increase was mainly influenced by very large special dividends, with the biggest impact coming from BHP. The global mining group paid a huge £1.7bn special dividend from the proceeds of the disposal of its US shale oil interests, on top of a healthy increase in its final dividend.

In addition, when Sterling falls, this provides a boost to overseas earnings once they are converted back to Sterling. This could help to increase the number of special dividends paid in the short term as May saw Sterling fall by more than 3%.

The dividend yield on the FTSE 100 (as of the 31st March) is now 4.54% but when you add in the special dividends this takes it to 4.98%. Essentially, if share prices don't move and dividends don't rise (or fall), you get your money back over the next 20 years. However, you also have to remember that you are hopefully buying into a rising income and your yield should steadily rise, expressed as a percentage of your initial entry price.

The number of dividends that UK companies have paid over the years has continued to increase as the chart below shows:



If you want to monitor the dividend yield then this website is very good - www.dividenddata.co.uk

What are the drawbacks?

The FTSE 100 could fall further; dividends from companies could fall (Vodafone cut theirs recently); Jeremy Corbyn could get elected; and a soft Brexit could cause Sterling to rise significantly (the overseas earnings when converted back to Sterling would fall).

The FTSE 100 is also relatively concentrated with the five biggest companies – **HSBC Holdings**, **Royal Dutch Shell** (both A & B shares), **BP** and **AstraZeneca** – making up 29.07% of the index. Oil and gas alone make up 14.29%. This means that if one of these companies struggles then the whole index could fall significantly.

Summary

Brexit has created a good opportunity to invest in UK companies as they are cheaper than other regions and offer a high and rising dividend yield. Over the last few months we have been increasing exposure to UK equities and higher dividend paying funds within some of the portfolios (although this month saw the UK fall below trend, so exposure was reduced in the trend following portfolios). They are not yet high on the momentum scale so not all the portfolios have increased exposure, but they will if UK equities start to move higher on the scale.

FINAL COMMENT

May saw global stock markets fall but the defensive equity and bond funds rise. The recession indicators are not showing that we are due a recession but instead are indicating that we are experiencing a global slowdown. This is not surprising considering that Trump is engaging in trade wars, but we do feel that with the election less than 18 months away, he will want to see the US stock market rise significantly before then. This means that we are likely to see some announcements of trade deals shortly.

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