Watson Moore's Monthly Investment Update

September 2019

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PERFORMANCE UPDATE

- **Recession fears, Brexit worries, and trade tensions sent the FTSE 100 to its worst monthly loss in almost a year as it fell 4.08%. This proved to be a tailwind for our portfolios, but we are pleased to have minimised losses for the month to between 0.00% and 2.43% for the main portfolios. The Third Industrial Revolution portfolio fell by 4.55% as the highest risk sectors like Biotech fell the most.**

- Every main asset class that we monitor is above trend, which has resulted in our trend following portfolios accepting more risk. This risk has been rewarded over the last 6 months.

- The government is taking an aggressive approach towards delivering Brexit by suspending parliament for much of September and October. The majority in parliament, who oppose a 'no deal' outcome, will continue to do everything they can to stop 'no deal' from happening. It's hard to say who will win, and how. 'no deal' has become a bit more likely as has a General Election.

- China announced $75 billion of tariffs on US goods, with Trump retaliating with an additional tariff increase of 5%. Stock markets remain volatile every time Trump tweets!

- The yield curve inverted (see article later in the update) which potentially signals that a global recession is coming within the next 2 years.

- The performance of the portfolios over the last month, 6 months, and one year are shown below:

Portfolio	Performance % 1 month	Performance % 6 months	Performance % 1 year
Foundation	0.00	10.30	6.84
Cautious	-1.31	5.94	-0.73
Balanced	-2.03	7.50	0.10
Adventurous	-2.02	9.45	-0.33
Dynamic Equity	-1.95	11.91	4.43
Income Generating	-2.43	5.30	3.05
Third Industrial Revolution	-4.55	7.97	-0.04
Retirement Investment Solution 1	-1.16	8.56	2.68
Retirement Investment Solution 2	-1.32	8.93	2.72
Retirement Investment Solution 3	-1.47	9.29	2.76

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

Every main asset class that we monitor continues to be above trend and as a result our trend following portfolios are now fully invested. Despite a difficult month in August, this additional risk is being rewarded as the returns over the last 6 months have been good.

Cautious, Balanced and Adventurous portfolios

The main investment philosophy that the portfolios utilise is trend following. This means that you invest more in the asset classes that are going up and reduce exposure when they are below trend. However, due to the increased volatility of both bonds and equities, both the Balanced and Cautious portfolios were close to being above the acceptable risk level for the clients that have some or all their wealth invested into them. Therefore, we reduced the level of equity holdings within both portfolios and increased the level of bond holdings. For the Balanced portfolio the level of equity reduction was just 2.5% and for the Cautious portfolio it was around 4%.

The Adventurous portfolio did not require any reduction in risk but did switch out of overseas corporate bonds and into inflation linked bonds. Inflation linked bonds are higher on the momentum scale due to the fear of inflation moving significantly higher in the event of a no deal Brexit.

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 portfolio has made significant gains over the last 6 months.

Foundation portfolio

The portfolio remains fully invested. This means that it is taking more risk than normal, and we are being rewarded for this. The bond part of the portfolio is performing extremely well because interest rates globally are falling. In fact, it is our best performing portfolio over the last year.

The Foundation Portfolio is our most diversified portfolio and will invest in bonds, equities, property and alternative assets such as gold. The portfolio is suitable for a 3/10 (low risk) investor but has a tolerance band so that it can drift between a 2 and a 4-risk profile (very low risk to lowest medium risk). The tolerance band is very helpful as it allows the portfolio to lower the risk during difficult economic times and increase the risk if asset classes are trending higher, which they are now. Due to the portfolio being fully invested, as well as equities and bonds being more volatile than normal, we needed to reduce the equity level within the portfolio in order to keep the portfolio within its risk band. The overall equity reduction was around 6.5% and we increased the amount invested in gold, bonds and infrastructure.

Income Generating portfolio

No changes were made to the Income Generating portfolio. The portfolio has a large weighting in UK equities due to the high level of dividends that UK companies are paying. However, Brexit has caused UK equities to underperform somewhat and the portfolio was our worst performing one last month. We do believe that UK equities are considerably undervalued, and the level of income offered from the FTSE 100 is extremely high. Once we have some clarity over Brexit, we do believe that UK equities will become favourable again for overseas investors due to the high level of income being offered and that the Income Generating portfolio will benefit significantly. The portfolio overall is paying a yield of 3.84%.

Third Industrial Revolution portfolio

No changes were made this month. This is our highest risk portfolio and has performed exceptionally well since we launched it. However, it will have periods in which it loses more than every other portfolio and last month it was our worst performing portfolio. Over the long term we expect the themes that the portfolio invests in (Biotech, Cyber Security, Robotics etc) to continue to perform extremely well.

Retirement Investment Solutions

No changes were made this month and the portfolios are fully invested. The Retirement Investment Solutions are invested in not only a trend following portfolio, but the Foundation and Dynamic Equity portfolios as well. The trend following part of the portfolio is fully invested.

ASSET CLASS REVIEW

This section will give you an insight into our current thinking, and below are some charts that look interesting. With bond yields at historic lows, a no-deal Brexit more likely, Trump still involved in tariff wars and an inverted yield curve, we look at whether the major equity markets are still above trend.

US Equities

The trend line is the red line and we can see that the main US stock market (blue line) is above the trend line still, despite a difficult and volatile August:

The dividend rate on the S&P 500 is now 1.95% whereas the yield on long term US government bonds is 1.91%. The yield from equities going above that of long-term bonds has only happened once before in the last 40+ years in the US and potentially shows why the US stock market is close to its all-time high and perhaps could move much higher as yield hungry investors turn their attention to buying equities.

FTSE 100 - just above trend

The FTSE 100 is just above trend at the end of the month. But with a dividend yield (including special one-off dividends) of 5.22% and a gilt yield of 0.48%, there is the potential for the FTSE 100 to grow significantly once we have more clarity about Brexit.

Europe – bounced off the trend line this month

The main European stock market bounced off the trend line this month and with a yield of 3.65% compared to a negative yield of 0.69% from German Bunds, you can potentially see why investors will invest in some of the biggest European companies:

Australia – racing ahead

Whilst this isn't one of the main stock markets that we monitor, it is included as it shows the potential other markets have as it is performing extremely well:

In Summary

With so much doom and gloom around, it may be a surprise to see that most stock markets remain above trend. We feel that the high dividend yields from equities are likely to support stock markets and potentially push them to new all-time highs. The Australian stock market surging higher may be the pattern that other markets follow.

WHAT IS THE INVERTED YIELD CURVE?

The yield curve finally inverted in August, causing stock markets to fall. But what is it and why does it matter?

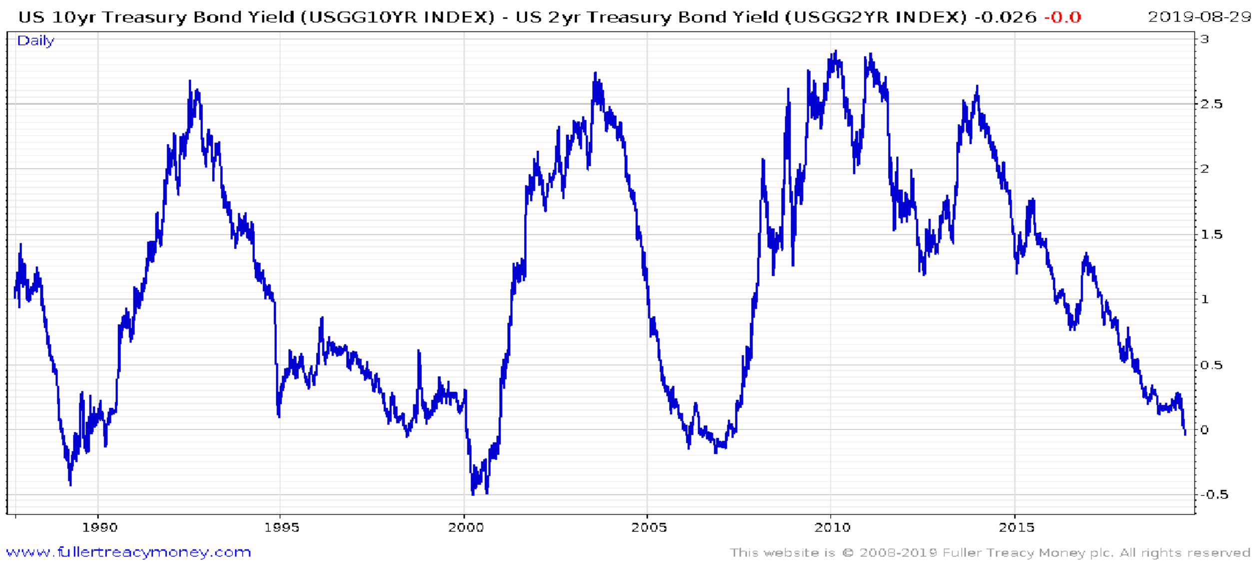
What is the Yield Curve?

A yield curve shows the relationship between the yield (income) on the same bond but at different lengths until it matures. Generally, in developed countries, the curve of the yield plotted against maturity will slope gently upwards, reflecting the fact that investors expect to be paid more interest for locking in their investments for a longer period than a shorter one. The higher the rate they expect, the steeper the curve will be. It is very similar to when you go into a bank. They usually offer a better interest rate the longer you fix the term that you deposit your money with them. Therefore a 3-year fixed rate bond pays more interest than a 1-year fixed rate bond.

A downward sloping (or 'inverted') yield curve suggests that investors expect long-term interest rates to fall and is often taken as a sign that an economic downturn is on the way. Investors are happy to lock in long-term yields today because they expect them to be even lower in the future, which suggests they expect low inflation, or even deflation, which tends to go hand in hand with recessions.

Why does it matter?

An inverted yield curve has happened before every single one of the last seven US recessions, with recession following inversion within 24 months. There has only been one "false positive" in that time. The yield curve over the last 30 years can be seen below and you can see that the recessions between December 2007 and June 2009; March 2001and November 2001; July 1990 and March 1991 were preceded by an inverted yield curve (when the line goes below zero on the right-hand scale):



Should we panic?

On average, the S&P 500 has grown by 2.5% after a yield-curve inversion in the three months after the episode, while it has gained 4.87% in the following six months, 13.48% a year after, 14.73% in the following two years, and 16.41% three years out, according to Dow Jones Market Data (see table below):

Date of first 2/10-year inversion	3 months later	6 months later	1 year	2 years	3 years
8/17/1978	-10.14%	-6.10%	3.06%	19.64%	24.88%
8/20/1980	13.44%	2.27%	5.59%	-8.69%	32.49%
12/9/1988	6.10%	17.93%	25.87%	18.31%	36.54%
5/26/1998	-0.90%	8.49%	19.26%	25.96%	16.81%
12/30/2005	4.16%	1.76%	13.62%	18.44%	-28.65%
Average	2.53%	4.87%	13.48%	14.73%	16.41%

Four main reasons not to panic

1. The yield curve predicts recessions but does not give us the time they will happen. On average a recession has been over 15 months away from a yield inversion.

2. Economic data at the moment points to a global slowdown but no recession. In fact, we appear to be in a great position with low unemployment, rising wages, low interest rates and low inflation.

3. The dividend yields on major stock markets are extremely high when compared to bonds, and investors wanting an income from their wealth might turn to equity markets and cause them to grow significantly. Historic data shows equity markets tend to do well in the year after an inverted yield curve.

4. Trump needs to do a deal with China before November 2020 as he wants the stock market to rally before the Presidential election.

In Summary

We have experienced a volatile August mainly due to the panic caused by the yield curve inverting. Whilst this is a worrying moment, history suggests that we should not be panicking as stock markets tend to go up in the short term after the inversion.

FINAL COMMENT

Brexit, Trump’s trade wars and an inverted yield curve are causing concern for many investors. However, most stock markets remain above trend and offer extremely high dividend yields when compared to bonds. We believe that this is a reason why equity markets might move higher over the short term.

We also believe that Trump wants a deal with China to happen in order to assist him in being re-elected President. This will push stock markets higher, but progress is likely to be made closer to the election in November 2020.

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The past is not necessarily a guide to future performance. The value of any investments can go down as well as up and you may not get back the full amount invested. Taxation is subject to change and you may have to pay tax on any gains. The Watson Moore portfolios are unlikely to exactly mirror our clients' portfolios due to the timing of the initial investment and the speed of response to our fund switch recommendations as well as the effect of charges. The figures above therefore assume a client invested on the launch day and have responded immediately to our recommendations. As from the middle of 2016, the portfolios have been run on a discretionary basis by our sister company WM Capital Management. All figures and charts are provided by Financial Express.