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Investment Newsletter

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Fear assets in a greedy market

The headline in last week's Financial Times read, "US Economic growth enjoys longest winning streak in history", highlighting that the economy is having its longest uninterrupted period of expansion since 1854.

Now in its 121st month of growth, the US economy's record-breaking run has served to propel the US stock market to its all-time high, returning 360% since the depths of the Credit Crisis.

It has been more of a slow jog than sprint. It has been surprising that the stock market has done so well given the anaemic pace of economic recovery compared with previous cycles – initiatives such as quantitative easing have served to buoy the markets more than the broader economy.

So, all well and good. However, as seasoned investors, our job is sometimes to look in the opposite direction - consider selling when everyone else is buying; being fearful when others are greedy.

This raises the question, however, as to what assets we should be looking to buy in anticipation of any potential economic storm clouds.

We have had questions from several clients on this matter which often boil down to two queries – "Shouldn't you buy gold?" ...and "Why don't you have Bitcoin in the portfolios?"

The short answers to both the questions are: 1. They are not investments, and, 2. they are manipulated markets. You will have to read on to the end to see what our preferred asset would be, but first a bit of detail on those short answers...

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Bit dodgy

Bitcoin is not an investment but an unregulated store of value. In the same way that the Financial Conduct Authority (FCA) does not regulate sterling, it does not regulate Bitcoin.

The key to the "value" in Bitcoin is that supply is limited to a total of 21 million by the year 2140. However, as we have seen, there is no limit to the supply of these "limited edition" currencies, whether it be Ethereum, Litecoin, Ripple, etc., or the new kid on the block, Facebook's Libra. The holder of a cybercurrency is therefore vulnerable to their chosen asset becoming unpopular (and thus worth less) if a newer, better option comes along.

After a recent review, the FCA declared that cryptocurrencies and their derivatives are "akin to gambling" and valuing them was "nearly impossible".

They noted that two analysts using the same Bitcoin valuation model separately managed to get to values of between $20 and $8,000. Whilst they cannot ban the currency, the FCA intends to bar retail investors from any derivatives or investment products based on them.

In terms of manipulation, the Bank of England report on cryptoassets last year said not only are they vulnerable to manipulative activities, but "there is evidence of them already occurring".

If you think that's all a bit rum, in their academic paper "Sex, drugs and Bitcoin", researchers from the University of Sydney last year concluded that approximately one-quarter of bitcoin users and one-half of bitcoin transactions are associated with illegal activity.

Fool's gold?

So Bitcoin is a bit Wild West, but surely nothing is as pure as gold? Gold is also a store of value and like all commodities, is unregulated (not subject to insider trading, false market regulations, etc.).

The global nature of commodities and the absence of regulation has meant there is a long history of commodity price manipulation - even last week China said it was investigating "abnormal behaviour" in iron ore prices.

Back in 2014, the FCA looked at the 'gold fix' – the twice daily process whereby five banks determine the gold price. They found that Barclays Bank had been manipulating the price for most of the previous decade and fined them $44m (due to the false market in gold derivatives).

Another key problem is valuation. The costs of storage, transport and insurance eat into investment returns before you move onto the demand and supply dynamics (of the 100% above ground there is about another 28% waiting to be dug up with new supply growing around 2%pa). There is no income on gold and so if the price is flat, the costs will result in negative returns.

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Of greater interest…

Our chosen asset for fearful market conditions are government bonds. This may sound like a boring choice, but that's the point. In turbulent markets boring is good. Governments rarely default (especially if you avoid Central and South America), the markets are liquid which means you can continue to buy and sell, they are low in cost and you get paid interest to hold them.

(This latter point regarding interest is generally true although there is now $12 trillion of mainly European and Japanese government debt that have negative yields which is less appetising.)

How do these different assets match up in tough market conditions?

Whilst 2018 was not a year of recession, over 90% of assets fell over the year, making it pretty painful. As Chart One shows, both gold and (in this case, US) government bonds fared much better than world shares.

I have not included the Bitcoin price on the chart, but it fell over 75% in 2018 having risen 1,300% in the previous year. This underlines the point - if assets are to be preserved, even grown, in tough economic or market conditions then bonds may not be sexy but they will do the job and pay an income whilst you wait.

To be clear, we are not bearish about the global economy. We remain cautiously optimistic and believe that economic growth in the major economies will be sluggish but positive. But it is incumbent on us to look at the best options at any point for different possible scenarios.

If people want to gamble, the casino doors are always open. However, we believe our clients rightly expect us to put their money to work in assets where there is a level playing field and we have scope to add value. There is a well-used phrase in poker and investments that if you look around the room and don't see the sucker, it's you.

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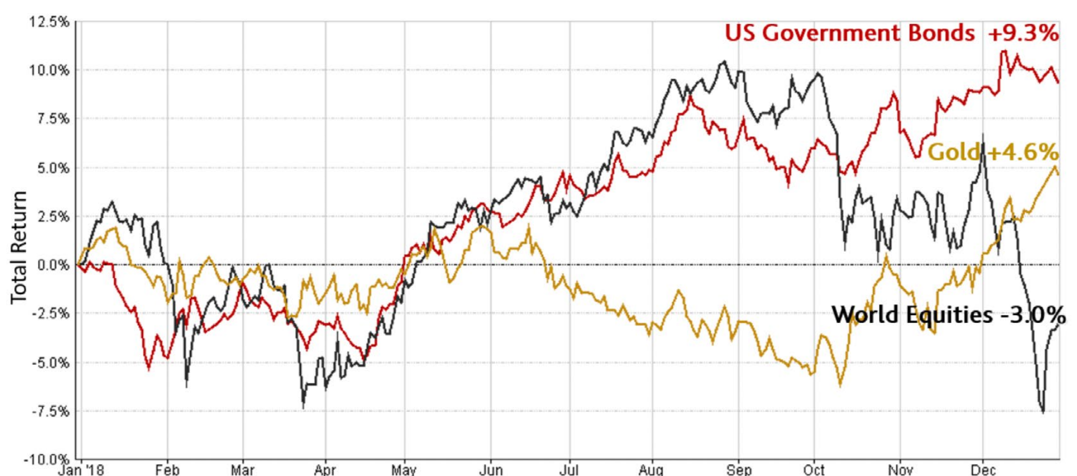
Chart one: 2018 Returns on Gold, Government Bonds and World Shares



Source: FE Analytics. Figures given in sterling terms; in US dollars the returns were bonds +3%, gold -2% and shares -9%

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General economic overview

The global economy appears to be going through something of a soft patch. In particular, manufacturing and trade numbers have been pretty poor around the world. This has partly been as a result of President Trump's various trade conflicts, particularly with China.

Whilst on balance we expect the economy to keep growing, there is the danger that a political misstep could push it over the edge. This is especially true in the UK where Brexit uncertainty is continuing to hurt growth.

We expect central banks on both sides of the Atlantic to cut interest rates, with the Federal Reserve making a move as early as this month. The Bank of England may well follow in the autumn.

Equity markets

As we said last month, some parts of the global market look relatively expensive given the current economic outlook. China, Japan and the UK look best value in our view, but each has additional risks associated. We are cautiously optimistic about stock markets but think it's important to be selective.

Fixed interest

Fixed interest has done extremely well this year with markets moving from expecting interest rate hikes to now expecting rate cuts. Yields are relatively low as a result of this move and so it is difficult to see similar returns over the second half of 2019. We are reducing risk in our fixed interest portfolio to guard against any global slowdown.

Commercial property

Commercial property has been hard hit by Brexit-related uncertainty. This is particularly the case in the retail sector. Given the rising risks and concerns over liquidity, we have reduced exposure to around 5% of most portfolios.

Cash

With interest rates remaining at record lows, returns on cash will remain below average for the foreseeable future.

Balanced asset allocation

For a typical balanced portfolio, we are underweight fixed interest, property and traditional equity. This is balanced by additional holdings in defined returns and alternative equity, giving an overall risk/return profile roughly in line with our long-term average position.

These represent Equilibrium's collective views and in no way constitutes a solicitation of investment advice. The value of your investments can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested. We usually recommend holding at least some funds in all asset classes at all times and adjusting weightings to reflect the above views. These are not personal recommendations, so please do not take action without speaking to your adviser.

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