equilibrium

Investment Newsletter

January 2019

Neal Foundly
Investment Analyst
Equilibrium Investment Management

Man vs Machine vs Market

Well, it's not constantly dark and it's not raining all the time.

The dystopian picture that the film *Blade Runner* (1982) painted of life in 2019 was pretty grim and fortunately incorrect.

The premise of the film is that Harrison Ford's character, Rick Deckard, is tasked with tracking down rogue 'replicants' - robots who look and act like humans - and retiring (killing) them. Fortunately, the prediction that we would have troublesome humanoid robots running amok has also proved untrue.

They're coming

That said, when it comes to the financial markets, the invasion of the machine is more visible.

Passive funds and algorithmic trading have increased their proportion of the overall investment world markedly over the last decade with over a third of all investments run by machines either for index funds, exchange-traded funds or specialist funds that can program computers to trade autonomously at speeds of less than ten milliseconds.

A prominent hedge fund manager stepped down from his post recently and opined, "the market itself is becoming more difficult to anticipate as traditional participants are imperceptibly replaced by computerised models."* Lethal stuff!

Equilibrium Asset Management LLP (OC316532) and Equilibrium Investment Management LLP (OC390700) are authorised and regulated by the Financial Conduct Authority and are entered on the financial services register under references 452261 and 776977 respectively. Registered Offices: Brooke Court, Lower Meadow Road, Handforth Dean, Wilmslow, Cheshire SK9 3ND. Both companies are registered in England and Wales.

Investment Newsletter

January 2019

equilibrium

Man 1: Machine 0

Computers do not take bank holidays or rarely take into account the sensibilities of the festive period with many commentators ascribing big market movements in December to the increasing volumes from computer-driven trading.

These movements increased market volatility measures in the market which play an important part in valuing defined return products. In the first week of 2019, whilst the market was in a dip, and taking advantage of the heightened volatility, for most clients we were able to strike a new dual index (FTSE 100 and S&P 500 Index) structured product with a 16.05% coupon per year.

This was one of the highest rates we have seen since we started investing in these products and well exceeds the average returns from the indices over the long term. Whilst the potential returns are attractive, as with all investments it's not without its risks. At the end of the six years, if the product does not mature (this is not guaranteed), investors will only get their original capital back unless one or both of the markets is down 40% or more on that day. Importantly, if the markets are below this "barrier" then investors lose money in line with the worst performing market. So if this is down 42% on the maturity date (for example) then investors lose 42%.

In addition, the product was struck with Citigroup, one of the higher rated global investment banks. Whilst not a guarantee, that should hopefully provide additional security.

Man 2: Machine 0

In early December 2018, we bought a Vanguard FTSE 100 tracker fund on one of the bigger declines in the market. In the second week of January, when the market was in a happier, risk-embracing mood, we sold this position for a profit of around 3.5%.

This is a little lower than our usual 5% target for these trades but taking a profit allows us to buy again on further dips (likely, given the ongoing issues around Brexit and trade talks).

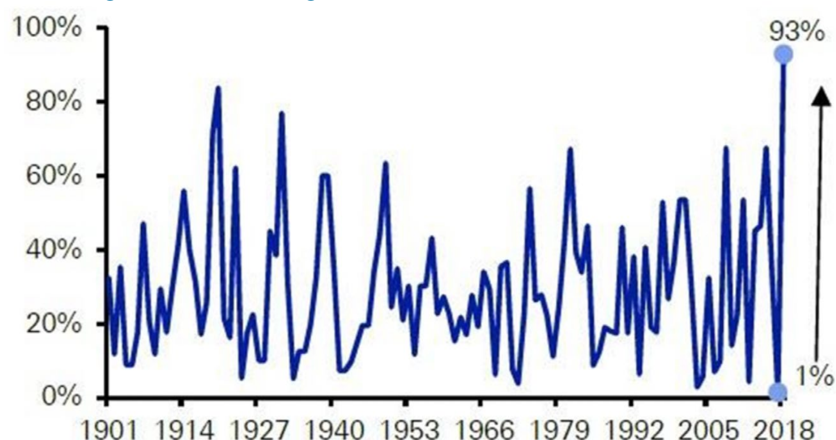
Dangerous year

As you might have read, 2018 was not a vintage year for any of the asset markets.

Chart One is from Deutsche Bank~ and shows that an incredible 93% of assets surveyed by the German bank had a negative total return year in 2018 (in dollar terms). Last year was the worst on record on this measure - worse than the years of the Great Depression:

Perhaps it was ominous that *Blade Runner* should feature a whole raft of businesses that suffered severe problems in the years shortly after the film's release such as Atari, Pan Am, RCA and Coca-Cola (the film even had the working title "Dangerous Days" in production).

Chart one: Percentage of assets with a negative total return in $ terms



Total return

Source: Deutsche Bank, Bloomberg Finance LP, GFD. Note, returns YTD are until December 2020

Equilibrium Asset Management LLP (OC316532) and Equilibrium Investment Management LLP (OC390700) are authorised and regulated by the Financial Conduct Authority and are entered on the financial services register under references 452261 and 776977 respectively. Registered Offices: Brooke Court, Lower Meadow Road, Handforth Dean, Wilmslow, Cheshire SK9 3ND. Both companies are registered in England and Wales.

Not enough robots

That said, we do not believe that we are at the end of the economic cycle. Yes, there have been downgrades to the growth expectations for 2019/20 but not to the extent of the falls in most markets, leaving many valuations lower.

A key risk we are watching is if the shaky markets actually serve to erode confidence, both for consumers and also companies, which could become self-fulfilling in tipping the economy into weaker or negative growth resulting in a recession.

This is particularly the case in the UK where the Brexit entanglement has served to significantly increase risks.

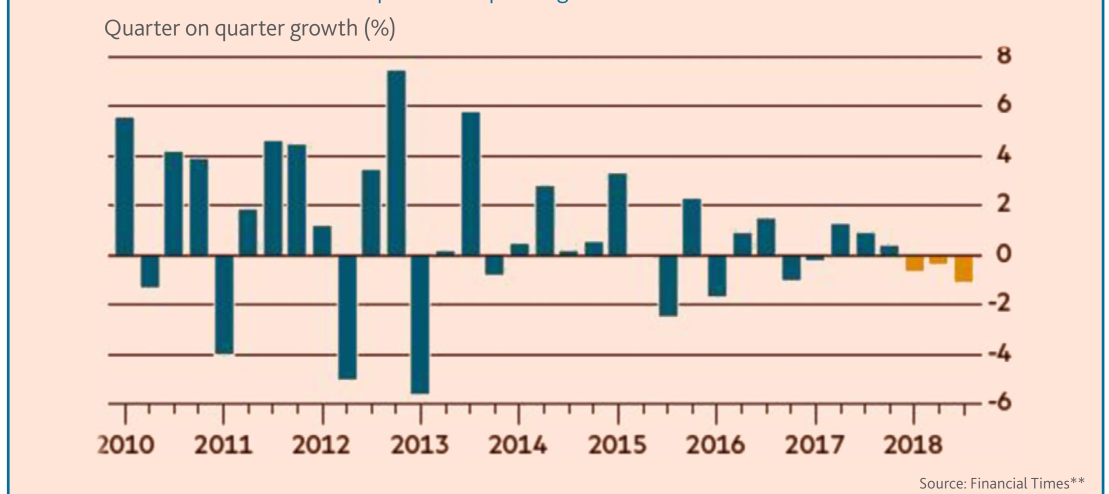
As Chart Two shows, it is notable that since the referendum in 2016, the growth in investment (including plant, machinery and equipment) by UK companies has been historically weak, if not negative – it has now declined for three consecutive quarters.

Blade Runner portrayed 2019 with killer androids and flying cars. Clearly, predictions are not easy!

We do not gamble clients' money on highly uncertain binary situations but rather look to take advantage of opportunities that can be generated in markets as a result. As our recent trades demonstrate, we can try to turn these situations to our clients' advantage.

As for the rise of the machines, we agree with Deckard: "They're either a benefit or a hazard. If they're a benefit, it's not my problem".

Chart two: UK business investment quarter-on-quarter growth



Source: Financial Times**

~https://www.zerohedge.com/news/2018-12-21/2018-officially-worst-year-record-93-all-assets-down

*Financial Times, 9 January 2019, "Volatility: How 'algos' changed the rhythm of the market")

**Financial Times, 8 January 2019, "Why Investment by UK companies continues to fall"

Disclaimer: The content contained in this newsletter represents the opinions of Equilibrium Investment Management. The value of your investments will fall as well as rise and you may not get back the original amount invested. The commentary in this newsletter in no way constitutes a solicitation of investment advice. It should not be relied upon in making investment decisions and is intended solely for the entertainment of the reader. All returns within this piece are quoted before fees and charges unless stated otherwise and are representative of the returns of the product/asset class, rather than the return of the portfolio as a whole.

Equilibrium Asset Management LLP (OC316532) and Equilibrium Investment Management LLP (OC390700) are authorised and regulated by the Financial Conduct Authority and are entered on the financial services register under references 452261 and 776977 respectively. Registered Offices: Brooke Court, Lower Meadow Road, Handforth Dean, Wilmslow, Cheshire SK9 3ND. Both companies are registered in England and Wales.

Investment Newsletter

January 2019

equilibrium

General economic overview

Many key indicators point to slowing economic growth across many major economies. The markets are watching the developments in the Brexit process carefully to determine the potential impact on the economies of both UK and Europe. In any outcome other than full approval of the Prime Minister's proposed transition plan, it would be difficult to see the Bank of England raising interest rates until the second half of 2019 (as of time of writing, MPs were still debating the proposed deal).

So far, the government shutdown in the US has not had a notable effect on the economy or markets. However, should this persist into February it is likely to become a more tangible risk which, when combined with concerns over the progress of the trade talks with China, is likely to increase investor caution and market volatility.

Equity Markets

Earnings estimates were downgraded towards the end of 2018 for this year and next. However, many markets fell more than the earnings reductions and now stand at lower valuations. The UK and Japan markets remain good value, but with sharp falls in December, the US market is looking better value than for some time, especially compared to Europe which is continuing to see downgrades to corporate earnings.

Fixed Interest

Bond returns are likely to be in the 3-5% return range this year. If economic growth continues to slow this could cause issues for poorly rated corporate bonds in highly indebted companies. We hold a mixture of corporate and government bonds, including some inflation linked bonds.

Commercial Property

The outlook for the retail sector in the UK remains moribund. We have deliberately chosen property funds with low retail exposure and higher exposure to prime offices (outside London) and industrial units which benefit from the growth in online retailing. We are cautious about the outlook and remain underweight given Brexit risks.

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 and property, and slightly underweight traditional equity. This is balanced by additional holdings in defined returns and alternative equity, giving a risk/return profile of slightly above our average position.

These represent Equilibrium's collective views. 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 adjust weightings to reflect the above views. These are not personal recommendations so please do not take action without speaking to your adviser.

Equilibrium Asset Management LLP (OC316532) and Equilibrium Investment Management LLP (OC390700) are authorised and regulated by the Financial Conduct Authority and are entered on the financial services register under references 452261 and 776977 respectively. Registered Offices: Brooke Court, Lower Meadow Road, Handforth Dean, Wilmslow, Cheshire SK9 3ND. Both companies are registered in England and Wales.