ROCQ CAPITAL

First Quarter 2019

With global stock markets falling sharply in the final quarter of 2018, as the new year started there was some trepidation that such moves could gather further momentum. In fact, the steepness of the sell-off provided the conditions – with many stocks being oversold and sentiment depressed – for a strong bounce in equity markets in January. This continued, with a few wobbles, through February and March allowing most leading markets to post encouraging returns for the quarter as a whole. In Sterling terms, the MSCI World index rose by 9.8%, having fallen by 11.7% during the fourth quarter of 2018. A sample of other returns gives an idea of the broad strength: the US S&P 500 gained 10.9%, the UK FTSE 100 rose 8.2%, the Eurostoxx 50 in the Eurozone increased by 7.3%, the MSCI Emerging Markets Index added 7.5% and Japan's Nikkei 225 index posted a more muted 3.2% gain. Other risk assets such as corporate bonds also performed well.

Alongside the natural bounce that can be expected when sentiment is as low as it was in December, changes in tone and outlook at the US Federal Reserve were also an important driver of returns this quarter. The Fed has shifted its stance quite notably by the usual cautious standards of central bankers, having in October given indications that it would be hiking interest rates a number of times over the coming year before paring this back at each available opportunity since. At its March meeting the Fed's projections indicated that no further interest rate rises would occur, while pricing in the bond market suggests that investors expect the next move to be a cut in rates rather than a hike.

Other central banks also shifted to slightly more dovish settings during the quarter, most notably the European Central Bank (ECB) which downgraded its growth forecasts. This seems reasonable given economic data in the Eurozone has undoubtedly weakened in the past three months, with Germany's industrial sectors hit particularly hard by evidence of a slowdown in the Chinese economy. On that front, there were some encouraging signs from the Chinese authorities as they lowered interest rates and announced a number of small expansionary measures – though these will take a few months to be felt in the economy. With data weakening and central banks emphasising their patience, government bond prices rose during the quarter, particularly in March, as investors saw less likelihood of yields rising in this environment.

Politics remains a source of uncertainty and there were plenty of developments but little clarity during the quarter. In the US, trade talks with China are ongoing and while progress seems to be occurring the expected date for a deal on tariffs has been pushed back from March to June. Investors generally expect a deal to be agreed at some stage, though US-China tensions over trade and security are unlikely to go away. A further round of talks with North Korea came to nothing, but in better news for Mr Trump the long-awaited Mueller report on possible collusion with Russia did not contain the 'silver bullet' Democrats were hoping for – and therefore any talk of impeachment has faded.

The UK political establishment remains consumed by Brexit and rather predictably the issue has gone down to the wire. The pound has been very stable during the last three months despite the ebb and flow of negotiations and Parliamentary votes, while UK equity and bond markets have also been resilient. We start April without clarity on where we go from here, except that there is a lack of desire among MPs for No Deal and some willingness among EU heads of state to be flexible on timing and extensions.

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Outlook

While there has been some weakening of economic data, it has been mild and arguably not enough to merit the recent about-turn from the Federal Reserve. It is hard to avoid the conclusion that the volatility and market weakness in October and December spooked policymakers and encouraged this shift to a more accommodative stance. This could be regarded as pragmatic, but also runs the risk of the world's most important central bank being pushed and pulled by the latest movements in the US equity market, which is not a position of credibility. However, as we mentioned last quarter, a weaker or at least stable dollar would provide added impetus for emerging markets to rebound from their historically low valuation levels – and this seems to have begun since the turn of the year. By contrast, during 2018 the likelihood of rising US rates was making the US dollar attractive relative to other currencies, resulting in an appreciating dollar which almost always poses problems for emerging markets.

Consumer activity looks healthy, buoyed by very low unemployment levels in the US and UK, and overall the global economy continues to grow at a solid if unspectacular pace. While the recent data from the Eurozone manufacturing sector has been weak, we would expect some degree of pick-up once the easing measures from China start to have an effect. Nonetheless, the fragility of the European economy is of some concern, with the banking sector still receiving special liquidity assistance from the ECB ten years after the financial crisis. We are limiting exposure to this region where possible.

In our last quarterly commentary, we highlighted our view that UK stock market valuation levels had become very attractive when compared with the rest of the world, with investors and allocators understandably staying away while Brexit negotiations lurch on. Diving further into this, it is the more domestically-orientated companies of small- and mid-size that have been particularly shunned, and it is in these areas that we see the greatest opportunity. If the UK avoids No Deal, we expect this to provide the catalyst for small- and mid-cap UK stocks to perform strongly and for the pound to strengthen. This led us to add a new fund in this area in March, as our portfolios had little exposure to this part of the market.