December 2018

Quarterly Commentary

Aberdeen Standard International Equities

- Global equity markets, as measured by the MSCI AC World Index, had their weakest quarter since September 2011, and their worst annual decline in a decade.
- Global economic growth was mixed amid the gradual, yet persistent tightening of financial conditions.
- Market moves reflected ongoing trade tensions between the US and China and heightened political uncertainty in Europe.

Economic and Market Review

Financial markets swung wildly and volatility jumped during the final quarter of 2018. Global equities, as measured by the MSCI AC World Index, suffered their largest monthly fall in over six years in October, before stabilising, then falling sharply again in December. The Index declined 13% in US dollar terms during the quarter, the worst showing since the 3rd quarter of 2011. This poor end of year performance led to an annual decline of 11%, with 2018 representing the weakest year for global equities since the financial crisis 10 years ago.

The energy sector was extremely weak during the fourth quarter, tracking a steady decline in the oil price caused by fears of a supply glut and stuttering economic growth. Technology companies, which had led the charge for most of the year, also suffered heavy losses amid softer demand prospects and valuation concerns. Traditionally more defensive categories such as utilities, telecoms and consumer staples fared better although most still posted negative absolute quarterly returns. The US equity market changed course and underperformed during the period under review, wiping out gains made earlier in the year. The re-pricing of risk assets was widespread, with most regional equity markets posting declines, although emerging markets held up relatively well. Latin America, and Brazil in particular, performed well in the fourth quarter.

Other asset classes had an eventful quarter also. At the start of October, the US 10-year government bond yield rose sharply and traded consistently above 3% for the first time since mid-2011 before retreating in December. These market moves took place against mixed signals from global economic activity and the gradual, yet persistent, tightening of financial conditions. Market moves also reflected the ebb and flow of ongoing trade tensions and heightened political uncertainty in Europe and elsewhere.

These issues are a reminder of the narrow path that central banks are treading in their quest for policy “normalisation”, in a generally challenging policy environment.

Against this backdrop our portfolios performed relatively well versus the MSCI AC World Index. The underweight to the US market helped, as did the exposure to Brazil, plus good stock selection across several sectors.

In the United States, stock market losses were particularly sizeable for industrial and technology companies, with some of the largest technology stocks shedding more than a fifth of their market value during the quarter. The change in sentiment came from fears of slowing demand, plus a growing acknowledgement that some of these stocks had been on an incredible, momentum-fuelled run until recently, with valuations now being more widely called into question. A backdrop of stretched corporate balance sheets and weakening lender protection may well have compounded investor concerns. In the United States, corporate debt of non-financial companies stood higher, as a percentage of GDP, than at its Global Financial Crisis peak. Bonds with the lowest investment grade rating amounted to one third of bonds outstanding, while “covenant-lite” loans, which afford lenders fewer safeguards, represented c80% of the volume of the US leveraged loans issued in 2018.

This is set amid a backdrop of rising interest rates. December marked the fourth interest rate rise in 2018 by the US Federal Reserve, with two more currently lined up for 2019. This move prompted heavy criticism from President Donald Trump, who has repeatedly blamed the central bank for unsettling markets and potentially stifling US economic growth. He has dismissed those who cite other factors such as numerous spats with foreign governments and rising trading tariffs for causing general unease. The Federal Reserve’s continued resolve for “further gradual

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increases" in interest rates towards some theoretical point of normalisation proved unpopular with both dominant political parties. Having recently reclaimed the House of Representatives in November's mid-term elections, Democrats continue to push for higher infrastructure spending and a wider distribution of US corporate profits to workers in a tightening labour market. Republicans meanwhile, need economic growth to fiscally compensate budget shortfalls from tax cuts, deregulation and higher defence spending. Steadily rising interest rates appear contrary to both goals. With a Presidential election looming in 2020, austerity is unlikely to feature in any political manifesto for the foreseeable future. The US Treasury Department's recent release depicting a 17% year-on-year increase in the fiscal deficit for FY18 is a stark reminder of fundamental fragilities. To compound matters, as the year ended the US was in the grip of a partial government shutdown caused by President Trump's determination to secure funding for a wall on the Mexican border. It seems the US Federal Reserve may face continued political pressure going forward.

During the quarter, Europe was knocked by a number of political setbacks including Italy's budget row with Brussels, news that German Chancellor Angela Merkel would not seek re-election in 2021, "gilets jaunes" anti-government protests in France and renewed Brexit confusion.

Euro area banks suffered heavy stock market falls as the standoff between the European Union and the Italian government over the latter's 2019 budget proposal became increasingly fraught. The newly elected Italian government is formed by political parties seeking tax cuts, a guaranteed basic income for the poor, renegotiation of Italy's debt and a rejection of EU austerity, so confrontation with the European Commission was inevitable. Italy's ambitious, high-spending plans were eventually revised and a head on collision with the EU was averted for the time being. Adding to Italian woes will be the end to quantitative easing in Europe. Adamant that monetary policy in the Eurozone cannot be managed around the particular interest of any one country, the European Central Bank has confirmed its net asset purchase programme to stimulate the Eurozone economy will finish in December. The full extent of Europe's debt ridden governments and corporates will now be laid bare and credit quality issues are likely to dominate the European backdrop in 2019.

In the UK, Brexit continued to dominate the headlines and cause political upheaval. During the quarter there was a fresh round of cabinet-level resignations within government and Prime Minister Theresa May was forced to defend her position as leader of the Conservative Party following bitter division within her own ranks never mind the opposition. Small UK businesses in particular have been urged to plan for the possibility of a "hard Brexit" whereby the UK could leave the EU in March without a withdrawal agreement in place. With only a few months now until the deadline for a deal to be reached, there is remarkably little visibility as to the shape or practical consequences of Brexit.

Politics dominated the financial landscape in Latin America over the quarter. In Brazil, October's Presidential election proved to be a battle between Jair Bolsonaro of the Social Liberal Party and Fernando Haddad of the incumbent Workers Party. Bolsonaro emerged victorious with 55% of the popular vote. Elected on a mandate to restore growth, reform social security and root out corruption, the retired military officer may be many things but a "social liberal" he is not. Brazilian financial assets welcomed the election result with expectations of policy orientated towards fiscal austerity, privatisations and pro-growth legislation, however long term success will depend on the President's ability to obtain the political support within Congress to approve his reform agenda.

In Mexico, the political landscape became somewhat clouded as new President Obrador sanctioned the suspension on construction of Mexico City's new international airport and appeared to give tacit approval to proposed banking reform before actually taking office. Neither event was truly unexpected, but financial markets fretted over the timing given the re-negotiation of NAFTA was at a critical stage and provisional legislation to end Pemex's monopoly on oil and gas was due to be ratified around the same time - additional uncertainty proved unsettling for the local market.

The third quarter deceleration of Japanese economic growth significantly dampened the outlook for current macro-economic policy in Japan. Prime Minister Shinzo Abe's stated intention to increase the national sales tax in 2019 already carried significant risk. Raising the unpopular levy has shown to send the economy into reverse and incite political revolts. Consumption slumped four years ago when the tax was lifted to 8% from 5%. Desperate to boost revenues in an attempt to restore credibility in addressing government debt, Abe and his supporters are of the opinion that now is the right time for a further increase to 10%. It is reasonable to assume that growth could come under further pressure as the end of the Olympic construction stimulus coincides with a global downturn that dampens demand for Japan's exports. Against this backdrop, Japanese equities underperformed the wider global equity market in the final quarter of the year.

Elsewhere in Asia, the economic outlook for China remained a concern. The economy gradually decelerated throughout the year as authorities pressed ahead with a deleveraging policy aimed at keeping financial stability concerns at bay. During both the quarter and throughout 2018, escalating trade tensions between China and the United States, together with any signs of a possible truce, had a huge impact on market sentiment, with other markets within Asia also affected given the integration of regional trade. The external backdrop is important for future performance. Operational leverage within our Asian holdings has generally remained robust as witnessed by better than expected cash flows and dividend growth, but to restore calm in Asian foreign exchange markets and provide an environment for an upward revaluation in asset prices, trade tensions have to abate. Patience is required for the time being.

Outlook

Politics and national self-interest look set to remain key themes going into 2019, but from a business perspective, no one wins over protectionism. Global barriers to trade are likely to result in companies experiencing lower growth and higher costs, and while rationally and intellectually bankrupt as a policy, until common sense prevails, it will continue to weigh on financial markets.

We have been generally cautious on global equity markets in terms of the expansion of earnings multiples ascribed to corporates given the still fairly muted backdrop of economic growth despite until more recently, ultra-loose monetary policy within the developed world. As debt burdens continue to grow in absolute terms, there is a risk that increased funding costs will ultimately lead to further budgetary pressures. Trade tensions are perhaps just a different dimension of sluggish domestic conditions, but, whatever the reasons, increased trade barriers are another obstacle in the way of economic growth.

Global Equity markets have until very recently surprised by their ability to overlook some significant headwinds but following the recent tightening cycle in the US, back on the agenda come the topics of rising debt, rising interest rates, stretched valuations, combined with increasing political risk and potential disruptions to global supply chains. These present a challenging environment to navigate. During this recent period of heightened volatility we have made some portfolio changes. It is important to stress that these are in line with our process and philosophy, very stock specific, aiming to use periods of market volatility to invest in strong businesses at attractive valuations. Hence why we return to the binding themes at our core - diversification, business strength, discipline and focus on risk at the company level.

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AU-240119-81281-7 (240119)