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SKERRITTS' VIEW – MAY 2019

It Looks Like We Called It Right This Time:

At least we've been consistent. For many months throughout 2018 we'd been repeating our belief that markets only peak between 6 to 9 months before a recession. Last September, this publication wrote, "if history can teach us anything, it is that markets don't peak until around 6 months before the next recession. We're edging towards the next recession every day by the very nature of cycles, but are we 6 months from the next one in the US and Europe? It doesn't feel like it, which means that markets have got a bit further to go" [*Professional's View* September 2018] and, after markets had been in a steep decline for a couple of months by November last year, "For some, the jury is out whether we've actually entered a bear market now, but we maintain what we have set as our "line in the sand" when it comes to peak cycles, which is that over the years it has been virtually unknown for a bull to phase into a bear if the next recession is more than twelve months away." [Professionals View November 2018].

Now, we can't pretend that our resolve hasn't been tested a little by the 20% decline in markets in Q418, but it was with a deal of satisfaction that we read the *BBC News* report for close of business April 29th that, "Wall Street ended slightly higher, with both the S&P 500 and the Nasdaq hitting record highs….the S&P 500 has hit an all-time high on open at 2,941.24, beating a previous record of 2,940.91 on 21 September 2018." So, markets had ***not*** peaked last September after all, which makes the timing of the next recession (we're talking about the one in the US) all the more important.

Economists are notoriously poor at forecasting recessions accurately but we like to try to keep things as simple as possible. So, assuming that Donald Trump wants to win the next US election in November 2020; and that he knows that no US President has won re-election in a "recession year" since 1860; our guess is that he will want to avoid the US from entering recession until after 2020 at all costs. This, to our simple minds, means that it is highly likely that trade war rhetoric is dialled down (as it has been from the start of the year) as a "deal" of sorts will suit both the US and China. Data is beginning to support the thesis that global growth is due for an uptick later in the year, although it must be borne in mind that data is backward looking by nature. We prefer to try to look forward, which is why we're happy, at this stage, to maintain a "risk on" stance with our portfolios, but will be prepared to reign back later in the year. What we don't particularly like the look of, however, is how this bull run may end.

We Asked, "Is 2018 1998 In Disguise?":

In September's issue, we also asked whether 2018 was 1998 in disguise. It turned out to be very, very like it. We had already noted that, apart from France winning the World Cup in both years, there had been currency crises in emerging market countries in each year too. What we said had happened in 1998, which had not yet happened by our September bulletin in 2018, was that the market had fallen by 20%. Well, by Boxing Day, it had in 2018 as well.

In 1998, the Federal Reserve had been on a rate rising cycle, but the correction in the markets had reversed this. Guess what? In 2018 the Federal Reserve had been forecasting 4 further rate rises by the end of 2019. By the beginning of 2019, after seeing the market fall by around 20%, it announced that no more rate rises were expected this year.

The good news is that, if we are rhyming with 1998/99 (remember that history rhymes, it doesn't repeat) then the year following the correction could be a good one. In 1999 the market rallied by over 60%. We're not expecting or forecasting anything of this magnitude, but as BlackRock's CEO, Larry Fink said recently, "There's still a lot of money on the sidelines, and I think you'll see investors put money back into equities. We have a risk of a melt-up, not a meltdown here."

It's What Comes Next That Worries Us:

Bearing in mind that the similarities between the two eras don't stop there – the 90s bull market in the US was driven by technology stocks, whereas the current bull market is largely being driven by, er, technology stocks – it's what comes next that worries us.

FE Trustnet published an insightful article on 18th April 2019 reminding us of how investing for the long term is not always profitable. They listed 11 sectors in the Investment Association universe that had made a negative return for investors over a period of at least 10 years. Of these, 7 saw their negative decade begin in the year 2000 when the 90s bull run that we've been referring to came to a juddering halt. It is noticeable too, that there was contagion between sectors and geographic areas. The seven sectors affected were IA Technology & Telecommunications, IA Japanese Smaller Companies, IA Global Equity Income, IA North America, IA Europe including UK, IA Global and the IA North American Smaller Companies.

What is even more eye-watering is the scale of the maximum drawdowns that these sectors witnessed. The Technology Sector saw a max drawdown of 85.50% (yes, ***85.50%***). The other drawdowns in the order that the sectors are listed above were 64.10%, 54.60%, 55.00%, 53.00%, 50.00% and 53.39%. It is difficult to comprehend what the reaction would be should we witness similar drawdowns today, but the question has to be, why shouldn't we?

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There are those who will scoff at the notion. “That’ll never happen” they’ll cry. Just as the Technology sector could never lose 85% in 2000; or the world’s largest banks couldn’t go bust in 2008; or Leicester City could never win the Premier League in 2016.

Today, does anyone really know what companies are truly worth? Money has been driven into the stock market on the back of QE and lower than low interest rates, bond yields and a stubborn refusal of inflation to make a prolonged reappearance. If bond yields rise, in which direction do equities head, and for how long, to re-establish the equity risk premium that should ordinarily exist over bond yields? As Dhaval Joshi of BCA Research reminds us, global risk assets are worth $400 trillion, five times the size of the global economy, yet if bond yields were to rise substantially “equity and other risk assets’ valuations would fall off a cliff”.

This is why we run our funds as we do, without being handcuffed to a benchmark and able to rotate between thematic, tactical and defensive elements in each portfolio.

We like being right, of course we do. Our investors like it when we’re right too. Sometimes though, we’d rather not be right if it means there’s something nasty to deal with, but we’d still rather deal with it if it comes instead of simply saying, “that’ll never happen”. We’ll let others take that route.

These are our views and are for professional use only.