

Skerritts View – May 2018

Catalysts and Causes:

Many column inches have been written (including here) trying to work out why markets fell in February this year, and have generally struggled to reclaim the previously held territory that they had risen to occupy throughout December and January. Numerous causes have been suggested, including Trump and trade skirmishes, Trump and Syria, Trump's Twitter politics, Trump's style of diplomacy, Trump versus Amazon, Trump's hairstyle (to be clear, we have not actually seen this one mentioned but we're sure it's out there somewhere...). They are all wrong. These are not the causes; they are the catalysts.

In the same way as a strong wind blows the leaves off the tree in Autumn, it is not the wind that is the cause for the leaves to fall - otherwise the tree would be bare in Summer - it is the catalyst. The cause is that the leaves have reached a fragile state and are ready to fall because of their natural cycle.

So, in our opinion, markets had reached a cyclical high throughout the end of 2017 and beginning of 2018 and were ripe for a strong wind to allow them to fall - in this case a wind emanating from Washington DC and blowing through China and the Middle East.

The wind may not have stopped blowing just yet, but are the causes in place for a prolonged bleak economic Winter or will Spring come early? We think the latter.

Markets Peak 6 Months Before A Recession:

We've said it before, but we like to keep things simple. Historically, markets peak 6 months before a recession. So to answer the eternal questions, "but are we entering a bear market" and "was that as good as it gets", you need to answer the simple question, "are we at least six months from a recession?"

Absent a major economic shock, we can't see where a recession is coming from in the next 6 months (we're talking about the US in this instance - the UK may possibly be a different case while Brexit rumbles on). Looking further out to 2020 and we may come up with a different answer. But keeping it simple, if a recession is not likely within the next 6 months, yet markets peak six months before a recession, the rationale is that markets have not peaked yet. And if they haven't peaked, they've got another peak to find in the meantime. Conclusion? Stay invested.

Similarities To 1998:

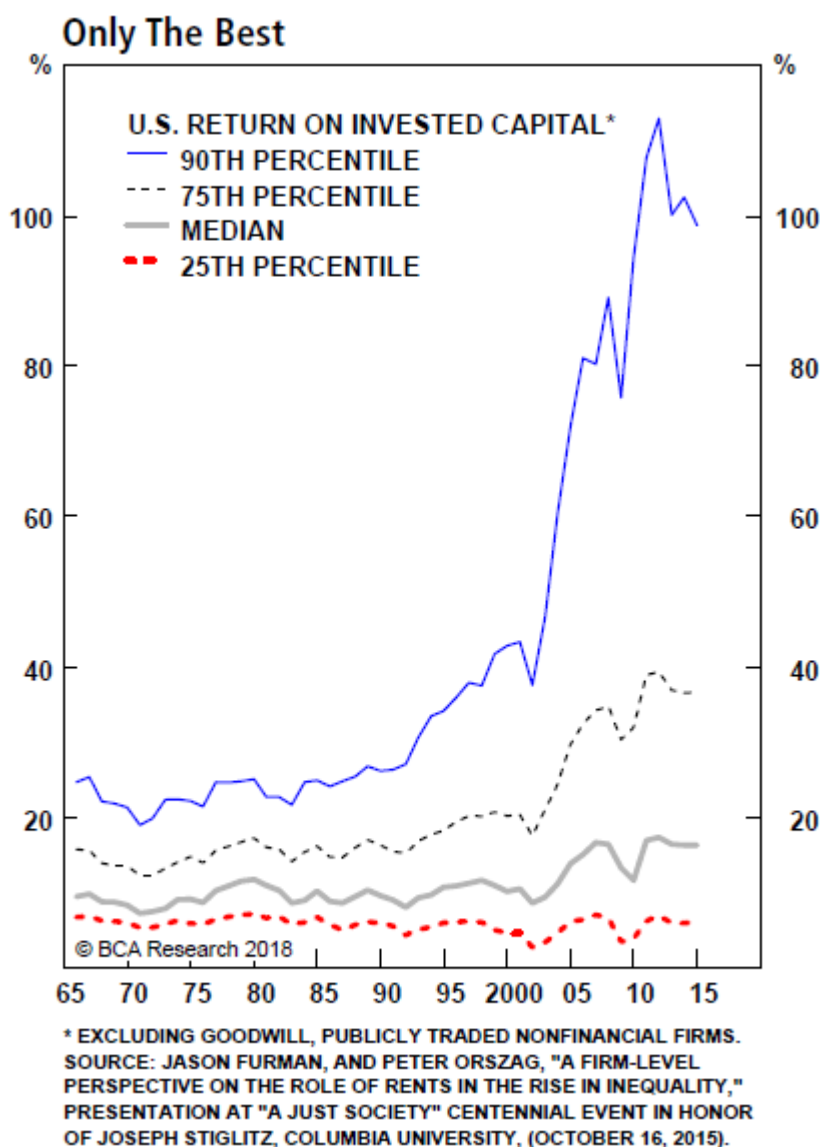
We always look for clues in what to expect from the future by inspecting periods in the past. Sometimes certain similarities align, yet never precisely. Today feels a bit like 1998.

The 90s were a prolonged bull market much like today's, with a steadily rising index interspersed by sharp sell-offs. As today, tech stocks were driving US returns and commentators were questioning how long the party could last, because it could not last for ever. **And if something can not go on for ever, it has to stop some time.** The similarity could even be extended to Neil Woodford's funds being written off after a period of extreme underperformance, as they were during the dot.com boom, as his value approach was left stranded by the ever-accelerating "stocks of tomorrow".

In late Summer of 98, Russia's default and the collapse of Long Term Capital Management (still gets the award for the most ironic fund name) led to a 22% sell-off of the S&P 500. The bell was rung on the bull market of the 90s. But it was rung too early. A rally ensued over the next 18 months that added a further 68% to annual statements.

When it did well and truly burst in March 2000, technology was decimated. Yet we had forgotten ourselves, until reminded by BCA Research that, outside the technology sector, the S&P 500 actually rose 9.2% between March 2000 and May 2001.

Today, it often feels like the S&P 495 is not doing that well, while the 5 megastocks at the top of the index surge ahead. The explosion of winner-take-all markets has allowed the most successful companies to dominate the stock market indices, while second-tier companies get pushed to the sidelines



Maybe the time is approaching for the much-maligned value stocks to start to be taken seriously once again. Value began to outperform growth in 2000, along with small cap. Today, value has massively underperformed growth for around 11 years. And Neil Woodford's being written off

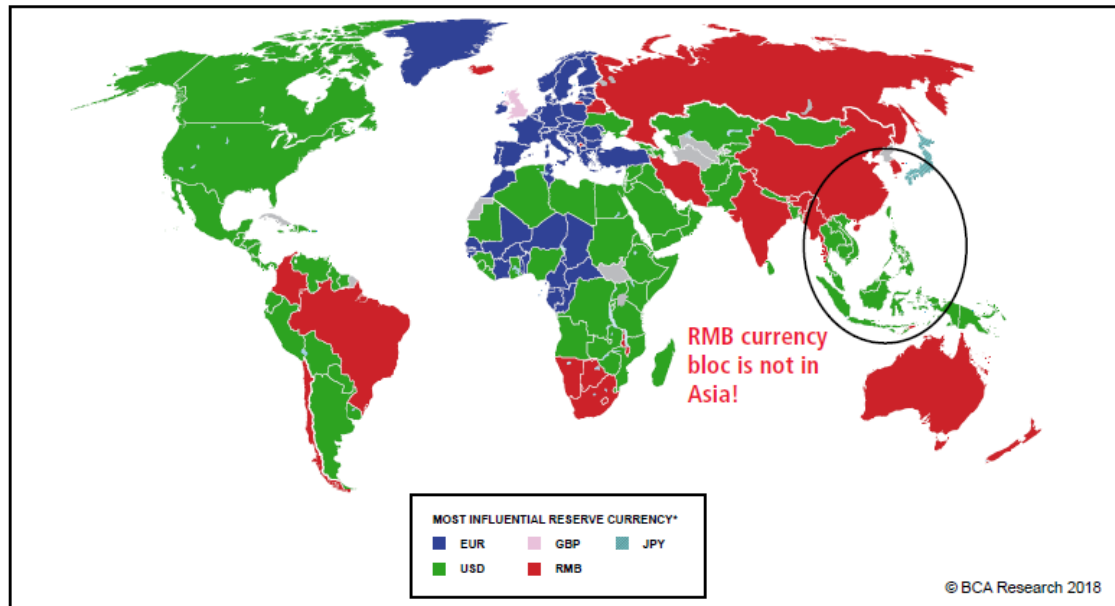
again. The first 6 months of 2016 saw a massive rotation from growth to value that saw value investors get very excited that their years in the wilderness had ended. That was short lived. Perhaps a slightly longer resurgence is due soon. Although, having seen the results from Amazon, Facebook, Microsoft and Intel in the past few days, we won't be deserting our thematic approach just yet with our growth bias.

Changing World Order, New Opportunities:

Multipolarity is back. With the decline in power of the US together with the emergence of China and the renewed nationalism of Russia, the era of the US hegemony is being replaced by....something else. In other words, so the Ancient Greek drachma, the Roman denarii, the Byzantium solidus, the Florentine florin and the good old British Pound have had their days as the global reserve currency, so the US Dollar is most likely beginning its decline. It'll take many decades though (hopefully), but as the process begins there will be opportunities within the currency markets for alpha to be generated in a diversified and balanced portfolio. The map below was one that we found interesting and surprising. If we could fast forward 100 years or so would that Asian bloc still be green we wonder?

It is hard to find a way to use currencies as an asset class, and in truth in recent years it was a case of finding the best looking horse in the glue factory. However, change brings opportunity and if we are to enter a new phase in the investment timeline, particularly if bond yields remain depressed yet slightly rising, currencies may provide an alternative to these in being able to deliver a positive return on capital.

...Renminbi's "Bloc" Is Not *In* Asia!



SOURCE: TOVAR, CAMILO AND TANIA MOHD NOR, 2018 "RESERVE CURRENCY BLOCKS: A CHANGING INTERNATIONAL MONETARY SYSTEM?," IMF WORKING PAPER WP/18/20.
*THE INFLUENCE OF THE RESERVE CURRENCY IS THE REGRESSION COEFFICIENT OF A REGRESSION OF THAT COUNTRY'S EXCHANGE RATE ON THE EXCHANGE RATE OF THE 6 MAJOR CURRENCIES. THE MOST INFLUENTIAL CURRENCY IS THE CURRENCY THAT HAS THE LARGEST REGRESSION COEFFICIENT WITH THAT CURRENCY.

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