Levitas A and B
November/December 2018

Market background

- Following October's broad sell-off, markets stabilised in November as investors perceived some of the risks to the outlook to have lessened.
- In the US, the midterm elections ended with the democrats winning control of the House of Representatives, but the Republicans strengthening their grip on the Senate, a result which was taken positively by investors as it largely preserved the political status quo while adding expectations of slightly greater oversight of Trump's administration. Markets also anticipated a thawing in US-China trade relations ahead of the early-December G20 meeting in Argentina. Meanwhile, rhetoric from Federal Reserve policymakers turned slightly more dovish in the face of slightly lower inflation expectations and some weaker-than-expected housing market data; given that fears of higher interest rates had sparked October's broad market sell-off, this shift provided broad support to asset markets. US equities benefitted and outperformed their developed-world peers.
- The primary beneficiaries of the shift in US monetary policy expectations were the emerging markets, which outperformed strongly after lagging in recent months. The shift in expectations for the path of US trade policy also helped, with Chinese equities making some of the greatest gains.
- Japanese equities also made minor gains, benefitting from improved sentiment towards Asia.
- UK equities were the laggards, with investors predicting that the parliament will reject the government's Brexit agreement, potentially sending the UK towards a no-deal secession, and a number of Conservatives submitting votes of no confidence in Prime Minister Theresa May. Sterling also lost ground and remains near its 2018 lows.
- European equities were also weighed by political uncertainty, with fears that Italy's economy may fall into recession exacerbating concerns that its government's spending plans will cause friction with the EU.
- Within fixed income markets, corporate bonds underperformed as a result of concerns over valuations, the potential for a deceleration in growth and amid concerns about the quality and amount of leverage in credit markets as the monetary policy backdrop shifts further from quantitative easing towards tightening. Sovereign bonds made gains as expectations of the rising US interest rates were tempered.

Fund performance

Both the Levitas funds were ahead of their benchmarks over the month.

Risk assets performed better in November, although volatility remained elevated. In general, the funds' international exposure was boosted by a weakening of sterling, as concerns regarding the outcome of Brexit put pressure on the currency. This also affected UK equities as investors continue to prefer other markets, which meant that domestic UK equities underperformed, especially in the mid and small-cap markets. In Levitas A, positions in Japan, Asia and emerging markets were all positive over the month and themes such as technology, which bounced, and healthcare, performed well. The fund's exposure to City Financial was much more positive over the month as this holding tends to do particularly well in periods of higher volatility and market weakness. Similar to Levitas A, risk assets within Levitas B generally performed better, especially international equity positions, although UK equities lagged. High yield bonds broadly outperformed gilts and investment grade corporate debt. The performance of alternatives was a bit of a disappointment: having delivered some protection in October, two of the funds in Levitas B declined over the month.

Outlook

It has been a further volatile period for markets despite data showing the global economy continuing to expand, led by the US. However, there are some signs that US growth may have now peaked, with economic data showing that cyclical growth headwinds are building. This is being recognised by investors, with bond-market pricing showing concerns over slowing growth. Furthermore, US policymakers have softened their rhetoric regarding the pace of future US interest rate rises in recent weeks, which arguably reduces a key risk to markets given that the threat of higher rates catalysed October's market sell-off. However, the Federal Reserve continues to withdraw liquidity from asset markets by reducing the size of its balance sheet, thereby exacerbating volatility within asset markets.

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Despite building headwinds, we expect global growth to remain positive over the next twelve months and there are few signs that a US recession is imminent in the next year. Europe's economic expansion should also continue now that transitory headwinds that affected growth earlier in the year have lessened, notwithstanding a political shock. We are also encouraged by the fact that China's government is acting to prevent the country's growth rate from dropping too quickly by enacting stimulus measures to support growth; these have included a weakening of the renminbi in response to the implementation of US trade tariffs, cuts to banks' reserve requirement rates and income tax cuts.

However, various situations are contributing to a riskier investment backdrop. The global monetary policy backdrop continues to shift away from extreme accommodation. The threat of protectionist trade policy continues to weigh on global sentiment, despite the US and China having come to a ceasefire that will delay the implementation of tariff increases. In Europe, it appears that the new Italian populist coalition government is on a collision course with the European Union over its fiscal position; this situation will likely garner more attention as the publication of its budget approaches in the autumn.

In the UK and for UK investors, Brexit remains the key risk. Whilst the government came to an agreement with the EU, this faced stiff opposition within Parliament and in the event PM May cancelled the 'meaningful vote' as it was clear it would not pass. The PM then faced a leadership challenge which, as expected, she did win although the number of votes that went against her were higher than anticipated. Theresa May has now returned to the continent to try and obtain some concessions regarding the main issue which appears to be the Irish border situation. At present, the EU has rebuffed these efforts by May.

The situation with regards to Brexit remains highly fluid. As such, political uncertainty remains elevated and the situation is likely to catalyse further episodes of heightened market volatility in the coming months. We remain unable to rule out a no-deal Brexit scenario playing out, a general election, or another referendum, as it is proving very difficult to reach an outcome that will satisfy both the EU and a majority of MPs. However, we have positioned the portfolios so that elements will benefit from either outcome. Within both funds, we have a significant exposure to foreign currency, primarily US dollars, which should do well if sterling continues to weaken, which may happen if investors perceive a heightened risk of a 'no-deal' scenario. Equally, our UK exposure is overweight to mid and small cap positions, and these should perform well if a deal is passed.

Despite these risks, we remain constructive on risk assets, given valuation levels and the strength of corporate earnings. Indeed, the recent sell-off has presented an opportunity to acquire attractive assets at cheaper valuations. We favour equities over fixed income, with core regional equity earnings yields well above those of equivalent corporate bonds. Within equities, we are constructive on the US market as we believe its valuation premium is warranted by the strong consumer backdrop, earnings momentum and the pace of economic expansion. We have also focused portions of our equity exposure to specific themes where we believe companies should be able to outperform the broader market, such as technology and healthcare, and have used the recent market weakness to add to these positions within the portfolios.

We have also made some significant changes within our fixed interest exposure. We have become increasingly concerned about the degree of leverage within credit markets, particularly US smaller companies, although large cap US companies' debt levels have now surpassed 2008 peaks. As such, we have been active in reducing the risk in our international credit exposure, by selling high yield and corporate positions in favour of US Treasuries, either via trackers or by funds that have a high exposure to this asset class. We feel that this should protect the portfolio against pressure on the corporate bond market. We are also currently looking at our UK fixed income exposure and may look to carry out a similar change.

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The recent sell-off has highlighted the fact that market volatility is likely to remain elevated as we move into 2019. Given this, we will be monitoring businesses' operating margins closely for signs that shifts in the economic backdrop are beginning to affect corporate performance and, therefore, our broader asset allocation view. We believe the development of cyclical growth headwinds or inflationary pressures presents the major risks to the global economic outlook, alongside the potential for an escalation of global trade protectionism and political events in the UK and Europe. In light of risks, we continue to endorse a balanced approach to portfolio construction and have continued to make use of assets that have a low correlation to both fixed interest and equity markets.

Important information

The information in this document does not constitute advice or a recommendation and you should not make any investment decisions on the basis of it. Investors should be aware that the price of investments and the income from them can go down as well as up and that neither is guaranteed. Investors may not get back the amount invested. Past performance is not a reliable indicator of future results. Changes in rates of exchange may have an adverse effect on the value, price and income of an investment. Changes in interest rates may impact the value of fixed income investments within the fund.

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