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J O Hambro Capital Management (JOHCM)

2019 outlook:

Party on or party over?

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Free from a house view on economies, markets or stocks, J O Hambro Capital Management's (JOHCM) fund managers invariably see the world in different ways. We asked a number of our managers for their thoughts on the outlook for their asset class next year, what they would like to see and the possible surprises that 2019 could bring.

Global equities:

No time to be recklessly chasing the Roadrunner

Ben Leyland
Senior Fund Manager

JOHCM Global Opportunities Fund

In the old Looney Tunes cartoon, Wile E Coyote would often be pictured frantically clawing at thin air having careered blindly over the cliff edge in pursuit of the elusive (and somewhat annoying) Roadrunner.

That's roughly how global equity markets look to us at the moment. With the rocket fuel of cheap money provided by QE and rock-bottom interest rates having run out, gung-ho price-insensitive momentum investors are finding that the ground beneath them has disappeared. This is at a time when the market can take its pick from a clutch of issues: a possible budgetary crisis in Italy and stand-off with the EU; a looming US budget crisis; the ongoing, mind-numbing, head-scratching Brexit shenanigans; and the prospect of an intensifying and highly damaging trade war between the US and China stoked by a highly unpredictable US president. Volatility is rising as perceptions of risk return to hitherto complacent financial markets.

We've been concerned about stock market valuations for a few years now, choosing to keep our powder dry and hold a high cash balance rather than potentially destroy capital by locking into valuations that are divorced from fundamentals. We bought a few new names in red October, taking our cash balance down somewhat, but in general we do not think the sell-off has created much of a buying opportunity yet. The declines were particularly pronounced in more cyclical areas (industrials, resources, technology), and having been very elevated to start with, the valuations of most stocks we monitor in these areas have yet to reach compelling levels. By way of illustration, the MSCI AC World Industrials index was, as at the end of October and in US dollar terms, c. 34% above its trough level in early 2016. Even looking outside of the US in order to ignore the impact of tax cuts on earnings forecasts, it was c. 29% higher (source: Bloomberg). We do not forecast the macro cycle, but there is still material downside in this market in the event of a recession. The time to be recklessly chasing the Roadrunner is over.

US smaller companies:

Keep an eye on wages – stock market booms don't die of old age

Thorsten Becker
Senior Fund Manager

JOHCM US Small Mid Cap Equity Fund

The bull market in US equities since the global financial crisis has been an unusually long one, but stock market booms don't die of old age. Instead, it's more often the case that they are killed off by the Federal Reserve raising rates to cool the economy.

The thing to watch with regard to Fed action this time is wage growth. Despite full employment – at 3.7% (source: Bureau of Labor Statistics), the unemployment rate is at almost a 50-year low – wage pressures have been more subdued than would be expected given the strength of the US economy. I'd offer two possible reasons for this. One is that paychecks are bigger after President Trump's income tax cuts, making employees more content. The other might be that there is a greater focus on benefits and overall job satisfaction on the part of many millennial and knowledge workers.

As long as wage growth remains contained, the chances of the bull market being strangled by Fed rate rises seem fairly low. Clearly interest rates have been rising and the yield curve has become flatter over the last few quarters, but neither

should yet be cause for major concern. Contrary to general opinion, the level of rates (still below historic norms) is much more important than the direction of rates. The yield curve has flattened recently as a result of global growth concerns. Yet a full inversion is not a given and history tells us that there is, on average, an 11-month lead until a recession might start.

Investors worried that the good times in the stock market are over should also consider the similarities to the situation in 1998. After turmoil in Asian and emerging markets, many investors exited the stock market entirely, but then missed out on a very strong run of performance for the rest of 1998, 1999 and a good part of 2000. Bull markets usually end with a bang.

For our asset class, US smaller companies, there remain compelling arguments why 2019 could see small and mid-cap stocks continue to outperform other parts of the market. As higher effective rate tax payers, smaller companies are benefiting more from the corporation tax cuts than large-cap multinationals who can readily shift profits to lower-tax countries. The reduction of red tape under President Trump also benefits smaller companies more. Additionally, I'd point to the fewer headwinds for smaller company stocks from trade tensions, given they typically generate 80-90% of their revenues from within the US. Next year offers more promise for the smaller end of the US stock market.

Global income:

Tread carefully across asset classes

Giorgio Caputo
Senior Fund Manager

JOHCM Global Income Builder Fund and Head of Multi-Asset Value team

Income investors looking across asset classes must remain careful. Rising US 10-year Treasury yields created an opportunity in early 2018 to buy interest-rate sensitive equities (in defensive sectors such as REITs and utilities) that had sold off in response to the rise in rates. However, recent market volatility has led 10-year yields to pull back from their highs and lifted valuations for defensive equities. As a result, these traditional income investments are once again more vulnerable to rate increases and offer lower returns.

We continue to believe the traditional income sources of longer-duration fixed income and defensive, income-generative equities should be balanced with some more cyclical equity exposure, as well as allocations to credit investments, where one can earn attractive income without being as exposed to the risk of increases in long-term interest rates.

Fixed income:

Favouring US high yield debt

Lale Topcuoglu
Senior Fund Manager

JOHCM Global Income Builder Fund and Head of Credit, Multi-Asset Value team

Within fixed income, we continue to favour US high yield. Without additional stimulus, US GDP growth is expected to dip from a recent average of 3.9% to around 2% in 2019 (source: JP Morgan). US growth also faces a lot less political and geopolitical uncertainty relative to Europe and emerging markets. That said, continued rhetoric around trade, tariffs, Fed rate hikes and broader global central bank policy, combined with relatively tight levels of spreads, is likely to dampen sentiment in the fixed income markets.

Our expectation is that 2019 will see modest spread widening both in investment grade and high yield, making spread duration a critical element of returns. As such, modest GDP growth in the US can support low single-digit returns in the US high yield market and offset the negative impact from higher rates and spreads, while longer duration fixed income asset classes, including investment grade, may deliver another year of negative returns.

Continental European equities:

Eyes remain on Rome; a recession not inevitable; and the euro could be a winner

Paul Wild
Senior Fund Manager

JOHCM Continental European Fund

After a difficult 2018, it is hard to see 2019 being any easier for global stock markets. The rise in volatility, after a long slumber, is here to stay and will be driven by the likely continuation of monetary tightening, particularly in the US. The debate on the timing of the end of the cycle will continue to rage and have crucial implications for sector positioning. The likelihood is that market consensus will stay bearish on growth and will seize each and every opportunity to call for the next recession. We think it is more likely that we see a muddle through scenario, where growth is slower than in previous years but doesn't necessarily turn negative. A recession is by no means inevitable in the next year or two.

The flaws in Europe's construct have again been highlighted in 2018, this time by the tensions between the recently installed Italian government and the EU over the former's budget plans. What happens here is important for the wider European market outlook. At the moment all cards are on the table, with the populist coalition in Rome empowered to push fiscal stimulus as far as it can. Meanwhile, it is not as if the leaders of Germany or France don't have their own domestic political issues. Germany has clearly been hurt by recent trade tensions, and it's quite possible its export dependency remains a short-term weakness.

The European Central Bank should be ending quantitative easing this month. Ultimately, it needs to get interest rates up to provide ammunition for future economic firefighting when eventually growth really does slow. With core inflation rising, there remains an outside possibility that the central bank becomes more hawkish. This could lead to the euro performing strongly in 2019. Finally, we have a change in ECB President next year, which is currently a wide open race.

Emerging markets equities:

Attractive valuations based on largely unwarranted negative sentiment, but any gains more likely to come in H2 2019

James Syme
Senior Fund Manager

JOHCM Global Emerging Markets Opportunities Fund

The external environment remains difficult, but one legacy of 2018 for emerging markets (EM) has been the extremely attractive valuations appearing in parts of the asset class, particularly in those areas exposed to domestic demand. The dominant benchmark, the MSCI Emerging Markets Index, is about one standard deviation cheap relative to its history, despite the rise of the (comparatively expensive) internet sector in the index. Many parts of the asset class now trade on single-digit forward earnings multiples. We believe that there is substantial opportunity in EM equities, but that this will need an improvement in the external environment before that opportunity can be realised.

The catalyst, we feel, will be the feedback of weak EM economic conditions back into the developed world (particularly the US), causing central banks there (especially the Federal Reserve) to pause the monetary tightening process, allowing EM equity markets to rally, potentially quite powerfully. According to the IMF, emerging market and developing economies (including South Korea, Taiwan, Greece and the Czech Republic) represent 42.8% of global GDP, and weakness here will affect demand for US goods and services, ultimately influencing US monetary policy. A recovery in China would be an additional support, but we are less convinced that China will revert to credit-led growth in 2019.

Finally, the political calendar looks far more benign in 2019, with Argentina, India, Indonesia, South Africa and Greece the key elections to look out for, although the effects of 2018's elections must also be watched, notably in Brazil and Mexico.

Overall, we are very positive on the outlook for emerging market equities in 2019, as we feel the current negativity towards the asset class (as expressed through valuations) is unwarranted, but we feel the gains may be loaded into the back end of the year.

Emerging markets equities:

Whilst the headlines look glum there are still reasons for measured optimism

Dr Ivo Kovachev
Senior Fund Manager

JOHCM Emerging Markets Fund

Global stock markets including emerging equity markets (EM) have suffered a tumultuous year. Trade tensions as well as political populism emanating from western democracies have dominated news flow, while rising US interest rates and the strong US dollar have particularly hit emerging economies, especially those countries with persistent and significant current account deficits.

Whilst the headlines look glum, there are good reasons for measured optimism towards the asset class as we look ahead into 2019. Firstly, real interest rates in emerging markets and the differential with developed world rates again favour EM. This provides important economic support.

Secondly, whilst perhaps not all of the negativity is priced in across the asset class, risk/reward profiles are asymmetrically skewed to the upside. With investor sentiment towards EM equities at a nadir as political noise and trade war worries reduce risk appetite, the equity risk premium is currently extremely high. That means even small improvements in the macroeconomic picture could result in a strong rally across EM stock markets. As we have seen recently, all it takes is an upbeat trade tweet or a dovish comment.

As long-only equity managers, we have to be open-minded and spot the opportunities in any given market environment. From a low and pessimistic base for the asset class, any relative improvements next year could result in tangible gains. Recovery may well be the word of 2019 when it comes to emerging markets.

Asia ex Japan equities:

More headwinds ahead for Asian economies

Samir Mehta
Senior Fund Manager

JOHCM Asia ex Japan Fund

With pronounced weakness in Asian stock markets this year, valuations broadly now look relatively cheap versus history. Looking ahead to 2019, earnings downgrades are likely to intensify. Slowing trade and hence slowing growth, deleveraging, higher interest rates and tighter liquidity due to a stronger US dollar will be the headwinds. There is a high chance that we see a change in market leadership from 'growth' to 'value', albeit not 'value' in a traditional cheap price-to-book sense, rather defensive value with earnings upgrades.

Possible surprises for next year? On the positive side, a financial accident – which will be quite negative for markets in the near term – that pushes the Federal Reserve to hold off on rate increases. In the US, the Trump administration proves hampered and softens its rhetoric against China. Both these actions would take pressure off Asian currencies. Oil prices falling as global growth slows would be an effective tax cut for individuals and provide relief for governments in Asia.

Possible negative developments include a hardening geopolitical stance between the US and China leading to skirmishes and head on confrontation. That could lead to further US dollar strength and a financial accident, perhaps in China where leverage is still very high.

Japanese equities:

A changing of the guard; taxes and elections; and (hopefully) overdue recognition by investors that the recovery has roots

Ruth Nash
Senior Fund Manager

JOHCM Japan Fund & JOHCM Japan Dividend Growth Fund

Probably the big issue for Japan in 2019 will be the increase in the consumption tax, which is scheduled for October. Last time the tax was raised, the impact on the economy was severe and there are concerns that companies might refrain from investing in anticipation of a slowdown. However, the tax hike this time is only from 8% to 10% (the last increase was from 5% to 8% in 2014) and there will be exemptions for categories such as fresh food. Moreover, the government has promised a big programme of fiscal stimulus to help offset any negatives. We believe that the impact will not be significant this time around.

There is also an Upper House election due next July. The ruling Liberal Democratic Party (LDP) did very well the last time these seats came up for election, and it is possible that it struggles to retain all of them. If the LDP loses its two-thirds majority in the Upper House, that would mean that Prime Minister Abe's aim to push through constitutional reform would become more difficult. Expect to see the LDP focus on the economy ahead of the elections to try to boost its chances.

Next year will also see the abdication of the current emperor and the coronation of his son. This will be the first time in modern Japanese history a Japanese emperor has abdicated and will mark the end of more than 30 years of the Heisei era. It will probably lead to much reflection about how Japan has changed over the past 30 years, given that Emperor Akihito took office just as the Japanese bubble collapsed. There are a number of commentators who hope that the new era will see Japan finally turn the page and embark on a new chapter of economic and stock market recovery. At the very least, the events around the coronation will likely provide a boost to the economy.

We believe that Japan is in the midst of a powerful and prolonged period of expansion. Capex is recovering. Domestic construction demand is robust. There is an ongoing recovery in the real estate market. And consumption is growing steadily, boosted by increased revenue from the ever increasing numbers of tourists visiting the country.

It would be nice to think that 2019 might be the year in which global investors recognise that the economic recovery in Japan is self-sustaining and not dependent upon the level of the currency or demand from China. And that, instead of buying stocks which benefit from global trends, they start to buy some of the very undervalued Japanese companies which actually benefit from this positive economic backdrop.

As for a potential surprise: Japan, as the host nation, to win the Rugby World Cup!

Global equities:

US equity market outperformance appears stretched; Japan looks attractive

Chris Lees
Senior Fund Manager

JOHCM Global Select Fund

Even allowing for recent market weakness, the US equity market has significantly outperformed the rest of the world year to date. This outperformance is beginning to look statistically stretched and due a period of mean reversion. The problem is we do not know if this will be because the US equity market falls to catch up with the rest of the world on the downside, or if the rest of the world rallies to catch up with the US. What we do know is that our process continues to prefer Japan over Europe or emerging markets, and this remains a non-consensus portfolio position with which we are very happy.

UK equities:

A Brexit deal to end the two markets in one?

James Lowen
Senior Fund Manager

JOHCM UK Equity Income Fund

The UK stock market is effectively two markets in one at the moment: domestic and overseas-facing. The profound uncertainty created by Brexit means few investors have wanted to own domestic-facing stocks, like consumer and financial names. This has left valuations in these parts of the market at very modest levels by historic standards. In contrast, sterling's weakness since the June 2016 EU membership referendum has inflated valuations of the large-cap defensive overseas-earners, like consumer staples, to elevated heights we deem unsustainable. For those invested passively since June 2016, the strength of these large-cap overseas-earners within the FTSE 100 has been good news, even allowing for this autumn's market weakness.

If, as we do, you believe successful investment starts with the price you pay for an asset, you should be interested in the significant valuation distortion now at work in the UK stock market. Many investors have been focused on the downside of owning UK domestics. With valuations where they currently are, we believe that if anything the downside risks to being overweight overseas-earners and underweight domestics are far greater. Certainly investors need to be more discerning in their capital allocation towards the UK market. The worst outcomes from Brexit are already largely priced into UK equities and the currency. Almost any kind of Brexit deal could trigger a rapid recovery in sterling and a re-rating of up to 20% in UK domestic equities, in our view.

I am writing this comment on 10th December, the day before what was scheduled to have been the 'meaningful' vote in Parliament on Theresa May's Brexit deal. With the prime minister having seemingly been set for a substantial defeat, this has now been postponed. Currently we are at peak uncertainty, and quite how events over the coming weeks pan out is anyone's guess. What we can say with a good degree of confidence, though, is that both sterling and UK domestic equities are now at table-thumpingly cheap levels. Any kind of resolution to the Brexit saga should light a fire under UK assets.

Turning away from the stock market towards the real economy, 2019 might also see the UK economy perform better than the current overly gloomy consensus and media narrative suggest. Real wages are finally growing, helped by an incredibly tight labour market. Meanwhile, boosted by much healthier public finances, the UK government has signalled an end to the policies of austerity. With the consumer and government spending outlook stable to improving, and the potential for a Brexit deal to dispel the uncertainty holding back business spending and investment, the UK economy could be a surprise package next year.

UK equities:

More political earthquakes

Michael Ulrich
Senior Fund Manager

JOHCM UK Opportunities Fund

Expect to see more political earthquakes in 2019. The need to address the grievances of those who have not benefited from decades of financialisation will result in a redistribution of wealth away from the owners of assets. Investors should stay away from companies reliant on government support or sectors that are in the crosshairs of public policy. Don't expect returns in highly regulated industries to rise. And, yes, that includes the banks. Over the last year we have increased our exposure to large, diversified businesses with multi-products and multi-geographies and backed companies with more business-to-business activities to help protect our fund from the random shots being fired by politicians.

What we would like to see next year is a return to running businesses for the long term, including strong balance sheets, re-investment rather than cost gouging, and a preference for organic growth over M&A. We'd also love to see a reduction in the use of margin targets and share buybacks that serve to starve companies of investment. A removal of management

incentives that reward all of the above would be welcome, too.

We'd also like to see a return to some prudence in corporate lending. Corporate bond funds have ballooned in size over the last decade. A reversal in the flows in this very illiquid market will surprise investors and finance directors. Credit, like other commodities, is a function of supply and demand. Credit spreads will need to widen significantly to compensate for the risks being taken. Investors who sought refuge in BBB-rated bonds may be surprised at their capital losses.

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