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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

A poor final quarter for international equity markets left returns in negative territory for the year although currency effects resulted in the US market showing a small positive return in sterling terms. High quality bonds benefited from this volatility in international equity markets whilst, in currency markets, the Yen, US dollar and Swiss Franc were strong performers. In commodity markets, the collapse of the oil price was a feature whilst gold showed a useful rise, fulfilling its function as a store of value in uncertain times.

The tables below detail relevant movements in markets :

International Equities 28.09.18 - 31.12.18

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-7.9	-8.3	-10.4	-9.0
Finland	-13.1	-12.4	-14.4	-13.1
France	-13.6	-12.9	-14.9	-13.6
Germany	-14.0	-13.4	-15.4	-14.0
Hong Kong, China	-6.0	-3.9	-6.1	-4.6
Italy	-10.9	-10.2	-12.3	-10.9
Japan	-17.4	-12.4	-14.5	-13.1
Netherlands	-11.2	-10.5	-12.6	-11.2
Spain	-7.2	-6.5	-8.6	-7.2
Switzerland	-8.3	-7.0	-9.2	-7.7
UK	-10.0	-10.0	-12.1	-10.7
USA	-13.6	-11.5	-13.6	-12.2
All World Europe ex UK	-11.7	-10.8	-12.9	-11.5
All World Asia Pacific ex Japan	-8.5	-6.5	-8.7	-7.3
All World Asia Pacific	-12.2	-9.0	-11.1	-9.7
All World Latin America	+1.3	+3.1	+0.7	+2.3
All World All Emerging Markets	-6.4	-3.9	-6.1	-4.6
All World	-12.4	-10.5	-12.4	-11.2

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +1.9%

International Bonds - Benchmark Ten Year Government Bond Yields (%)

Currency	28.09.18	31.12.18
Sterling	1.46	1.26
US Dollar	3.06	2.72
Yen	0.09	0.02
Germany (Euro)	0.46	0.17

Sterling's performance during the quarter ending 31.12.18 (%)

Currency	Quarter Ending 31.12.18
US Dollar	-2.3
Canadian Dollar	+2.9
Yen	-5.6
Euro	-0.9
Swiss Franc	-1.6
Australian Dollar	+0.4

Other currency movements during the quarter ending 31.12.18 (%)

Currency	Quarter Ending 31.12.18
US Dollar / Canadian Dollar	+5.3
US Dollar / Yen	-3.4
US Dollar / Euro	+1.4
Swiss Franc / Euro	+0.7
Euro / Yen	-4.7

Significant Commodities (US dollar terms) 28.09.18 - 31.12.18 (%)

Currency	Quarter Ending 31.12.18
Oil	-34.8
Gold	+7.9

PERFORMANCE DURING 2018

International Equities 29.12.17 - 31.12.18

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-2.5	-6.8	-12.2	-7.8
Finland	+1.3	+2.4	-3.6	+1.3
France	-7.1	-6.1	-11.6	-7.1
Germany	-17.5	-16.6	-21.5	-17.5
Hong Kong, China	-10.1	-4.6	-10.2	-5.7
Italy	-12.7	-11.7	-16.9	-12.7
Japan	-15.3	-7.6	-13.0	-8.6
Netherlands	-9.7	-8.7	-14.1	-9.7
Spain	-11.8	-10.8	-16.0	-11.8
Switzerland	-7.6	-3.0	-8.7	+1.4
UK	-9.2	-9.2	-14.6	-10.2
USA	-4.5	+1.4	-4.5	+0.3
All World Europe ex UK	-10.4	-9.1	-14.4	-10.1
All World Asia Pacific ex Japan	-10.4	-8.5	-13.9	-9.5
All World Asia Pacific	-12.4	-8.1	-13.5	-9.1
All World Latin America	+4.5	-0.3	-6.2	-1.4
All World All Emerging	-8.8	-7.6	-13.0	-8.7
All World	-7.4	-3.4	-7.7	-9.5

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +0.6%

International Bonds - Benchmark Ten Year Government Bond Yields (%)

Currency	29.12.17	31.12.18
Sterling	1.23	1.26
US Dollar	2.43	2.72
Yen	0.05	0.02
Germany (Euro)	0.43	0.17

Sterling's performance during the year ending 31.12.18 (%)

Currency	Year Ending 31.12.18
US Dollar	-5.8
Canadian Dollar	+2.5
Yen	-8.2
Euro	-1.1
Swiss Franc	-4.9
Australian Dollar	+4.5

Other currency movements during the year ending 31.12.18 (%)

Currency	Year Ending 31.12.18
US Dollar / Canadian Dollar	+8.8
US Dollar / Yen	-2.6
US Dollar / Euro	+5.0
Swiss Franc / Euro	+4.0
Euro / Yen	-7.2

Significant Commodities (US dollar terms) 29.12.17 - 31.12.18 (%)

Currency	Year Ending 31.12.18
Oil	-19.1
Gold	-0.9

MARKETS

A very poor fourth quarter put international equity markets into negative territory for the year. Looking at the final quarter of 2018, the FTSE All World Index returned -12.4% in local currency terms, -10.5% in sterling terms, -12.4% in US dollar terms and -11.2% in euro terms. Dealing with local currency performances first, the only positive performance came from Latin America where, spurred by the Brazilian election result, the FTSE All World Latin America Index returned +1.3%. In relative, but not absolute, terms, the FTSE All World All Emerging Markets Index, the FTSE All World Asia Pacific ex Japan Index, the FTSE Switzerland Index, the FTSE Spain Index and the FTSE Australia Index outperformed with returns of -6.4%, -8.5%, -8.3%, -7.2% and 7.9%. Underperforming were the FTSE USA Index, -13.6%, the FTSE Japan Index, -17.4%, and certain European markets including Germany where the FTSE Germany Index returned -14.0%. Moving to sterling adjusted returns, the positive return for the FTSE All World Latin America Index rose to +3.1%, whilst the negative return from the FTSE Japan Index improved to -12.4% because of the yen's strength. The return on the FTSE All World All Emerging Markets Index improved to -3.9% and the return on the FTSE All World Asia Pacific ex Japan Index improved to -6.5%. The FTSE USA Index's return of -10.8% still underperformed the FTSE All World Index.

In the international bond markets, government bonds benefited from the weakness in international equity markets and yields, as measured by the ten year government bonds in our table, fell sharply. The gross redemption yield on the ten year UK government bond fell by 20 basis points to 1.26%, on the US Treasury bond by 34 basis points to 2.72%, on the JGB by 7 basis points to 0.02% and on the German Bund by 29 basis points to 0.17%.

In the foreign exchange markets, the yen was the strongest currency. Against the yen, sterling fell by 5.6%, against the US dollar by 2.3%, against the Swiss Franc by 1.6% and against the euro by 0.9%. On the other hand, it strengthened against the commodity currencies. Sterling was up 2.9% against the Canadian dollar and by 0.4% against the Australian dollar.

In the commodity markets, the stand out feature was oil which, as measured by Brent crude, fell by an astonishing 34.8% over the quarter. On the other hand, gold, which has been a disappointing investment, did what it is supposed to do in time of uncertainty and rose by 7.9%.

If we turn to look at the year as a whole, we see that in local currency terms, the FTSE All World Index returned -7.4%, in sterling terms -3.4%, in US dollar terms -7.7% and, in euro terms, -9.5%. On the positive side, the FTSE All World Latin America Index returned +4.5% and, in Europe, the FTSE Finland Index showed a positive return of +1.3%. By themselves, these markets would have been unlikely to have made more than a marginal difference to overall portfolio performances by virtue of their low weighting in portfolios. Of the major areas, the FTSE USA Index showed relative strength, although negative in absolute terms. Its return of -4.5% was significantly less negative than the -7.4% of the FTSE All World Index. Moving to sterling adjusted indices, the FTSE USA Index showed a positive return of 1.4%, whilst the other major markets performed worse than the FTSE All World Index. The FTSE Japan Index, in sterling terms, returned -7.6%, the FTSE UK Index -9.2%, the FTSE All World Europe ex UK Index -9.1%, the FTSE All World Asia Pacific ex Japan Index -8.5% and the FTSE All World All Emerging Markets Index -7.6%. Despite the underperformance of the US market in the final quarter, for the year as a whole, the divergence of performance between the USA and elsewhere was striking. It follows that an important weighting in the USA was necessary to limit the negative returns for the year to a modest level, one which would hardly register in the context of the gains in previous years.

In the high quality section of the government bond market, using ten year government bond yields as a benchmark, there was a small rise in the gross redemption yield on the ten year UK government bond, 3 basis points to 1.26%. That on the US Treasury rose by 29 basis points to 2.72%. On the ten year JGB, the gross redemption yield fell by 3 basis points to 0.02%. On the ten year German Bund, it fell by 26 basis points to 0.17%. As we can see from our comments on the fourth quarter's performance of this sector, a lot of the action on yields occurred as share prices fell in the final quarter.

In the currency markets, sterling was generally weak as political uncertainty took hold. Against the yen, sterling fell by 8.2%, against the US dollar by 5.8%, against the Swiss franc by 4.9% and against the euro by 1.1%. Against the two commodity influenced currencies in our table, sterling strengthened by 4.5% against the Australian dollar and by 2.5% against the Canadian dollar.

In the commodity markets, the substantial fall in the oil price during the last quarter meant it was also much weaker over the year, down 19.1%. Gold, despite its rise in the final quarter, was hardly changed over the year, down 0.9%.

ECONOMICS

Whilst economic growth in 2018 and corporate earnings have been supportive to stock markets, 2018 ended on a sour note with securities markets experiencing a very poor fourth quarter. A good deal of this was self inflicted. The issues which have unsettled investors so badly in the final quarter of 2018 have been present for most of the year but they have taken on a new dimension as politicians have upped the stakes in some instances and not in a good way.

In our last review of 2017 as we entered the new year, and given that the majority of our clients are sterling based, we emphasised the political risk that we felt attended UK markets. This was because of the possibility of a General Election before the scheduled one in 2022, as prescribed by the Fixed Term Parliament Act, which could bring into power a government with economic policies extreme by UK standards which would have a negative effect on UK securities markets and sterling. This risk would be addressed by maintaining our long standing policy of holding a substantial percentage of our clients' portfolios in overseas assets where the currency would be unhedged. We concluded our review by saying that equities remained our preferred asset class but that we must expect some setbacks from time to time in 2018. However, the setback in the fourth quarter of 2018 was larger than we would have envisaged, this because of political developments which were more damaging than we felt we could have anticipated at the time. In the final paragraph of that review there was no mention of Brexit. Whilst it has increasingly dominated the UK news, it is relevant to note that, in an international context and viewed from outside the UK and, to some extent, Europe, it is not a major issue. If we look at the sterling adjusted performances of different equity markets in 2018, we can see that the ones which performed least badly in sterling terms were the USA (actually a positive return), Japan and Switzerland. Where investment markets allow, our major overseas exposure has been to the USA and this has mitigated the extent of the negative returns from equities in 2018. Interestingly, in sterling terms, the performance of UK equities was very much in line with most European markets so, apart from Switzerland, an important market for us, diversification there did not add any value in 2018.

As the year developed, an increasing theme in our reviews, as we assessed how equities and bonds might perform, was the interaction of tightening monetary policy through interest rate increases and the start or continuation of a reversal of quantitative easing called quantitative tightening (QT) with securities markets. We felt that, for equities, it was important that central banks signalled their intentions as clearly as possible so that investors did not receive any nasty shocks. In terms of signalling, central banks generally did a pretty good job so that the tightening of monetary policy which has occurred or is about to occur did not come as an unpleasant surprise. For central banks to be respected they have to be independent, otherwise they themselves, in particular, and monetary policy, in general, become discredited and that is not good whether for economic management or the securities markets. In recent weeks, there have been two unwelcome developments. In India, the central bank governor stood down, largely it is believed because of political pressure from the government facing elections. In the USA, there have been increasingly bellicose noises from President Trump against the Chairman of the Federal Reserve, Jay Powell, with suggestions that the President might sack him, although whether or not he can do so is questionable. This further unnerved investors although, as this is written, the President says that he never considered firing Jay Powell over the "absolute terrible" increasing of interest rates by the Federal Reserve. Nothing could be calculated to upset financial markets more than overt political interference in the independence of the Federal Reserve. Although one can never be sure, it looks as if the influence of the Treasury Secretary, Steve Mnuchin, may have come to bear. After all, a President who claims credit when US equities reach an all time high has to have an answer when share prices are weak and there is no doubt that President Trump's musings on Federal Reserve policy have been deeply unsettling to investors. If markets can get over this latest self inflicted difficulty and the Federal Reserve emerges unscathed from this latest skirmish with the President, its signalling activities can once again reassure markets.

As expected, and as we discussed over the year in our reviews, the central bank in the forefront of monetary tightening is the Federal Reserve in the USA. Its policy may seem aggressive but it must be remembered that the base for tightening was extraordinarily loose in terms of interest rates. The target federal funds rate was moved to effectively zero in December 2008 (mid target rate 0.25%) and has been raised nine times since then to 2.5% (target range 2.25% to 2.75%). At the same time, the Federal Reserve has engaged in QT as it has reinvested an increasingly smaller amount of the bonds on its balance sheet as they mature. From a peak of US$4.5 trillion in January 2015, the Federal Reserve's balance sheet has been reduced to just under US$4.1 trillion. Back in August 2007 it was US$870 billion. It is desirable that the balance sheet shrinks. Too easy money can lead to asset price bubbles, banking problems and inflation, plus, importantly, there is a necessity to leave some meaningful monetary ammunition to counter the next economic slowdown. All this would be understood by investors and the challenge for equities was, and is, to withstand the competition of rising interest rates and for companies to produce increasing earnings. With the USA having produced some strong growth in 2018 and a sharp rise in corporate earnings, estimated to be for the third quarter about 28% higher than in the third quarter of 2017, the earnings requirement would seem to have been achieved (note that perhaps 8 points of that increase was due to the US corporate tax cuts). It was widely expected that the Federal Reserve would again raise interest rates in December, although the conviction had weakened a little following some indications of weaker economic growth. Nevertheless, on the day that the Federal Reserve announced the largely expected interest rate increase, the market, having been quite sharply higher, turned round completely to end up significantly lower. Had the atmosphere been less febrile, this might not have happened. Once can put this reaction down to various political actions which have not been well received.

In the background is the ongoing trade dispute between the USA and China. Although there is a ninety day truce until the end of February, meaning that the USA will not move to raise tariffs on US$200 billion of Chinese exports to the USA from 10% to 25%, the rhetoric is not good and, because protectionism is regarded as increasingly bad by most mainstream economists, markets have felt nervous, especially as President Trump is so unpredictable and seemingly oblivious to the dangers of protectionism. On the other hand, it is important to President Xi, having gathered ever more powers to himself, that he is not seen to have given ground to the USA. The USA and other developed countries have real grievances against China and, understandably, want them settled, but diplomacy does not seem much in evidence. One can only hope that some accommodation between the two sides can be reached. Secondly, we have talked about President Trump's view on interest rates. Whilst, like everyone else, he is entitled to his view, his position does not lend itself to publicly berating the Chairman of the Federal Reserve and trying to extend his influence over interest rate setting. Fortunately, he does not look as if he is going to have any success and, hopefully, he has been persuaded to draw back from his threats to try to remove Jay Powell. He only has to look at the effect on markets to realise how counterproductive such action is. The latest event to spook markets is a partial government shutdown in Washington over the Democrats' refusal to fund the US-Mexico wall, a key policy of the President. Nine government agencies have been affected so far. The chaos in Washington, as the President loses key advisers, whose advice has been overruled, is very unsettling for markets. This is particularly unfortunate because the President's tax cuts, which he manged to get through early in the year, plus some significant deregulation action, have been positive features. One can argue about the timing of the tax cuts in the economic cycle but, in principle, tax cuts are more desirable than tax rises. We conclude that, in the USA, a series of unnecessary "own goals" have damaged market confidence as we go into 2019. Our working assumption must be that the President, who took the credit earlier in 2018 when the US stock market reached new highs, will at least realise his part in unsettling investors' nerves towards the end of 2018 and adopt a less partisan pose.

Prior to the issues over the Federal Reserve's actions and the partial government shutdown, the focus had been on the trade negotiations with China. The President's unpredictability makes this a difficult one to call but a working assumption must be that recent volatility and weakness in share prices will have struck a chord with the President and alerted him (although as a businessman one would have expected him to know this) to the dangers of pushing this battle with China too far. The wider issue for President Trump is the battle for world influence with China. The country's "Made in China 2025" plan conflicts with his "America First" policy so it can be seen as a great wrestling match for world influence. "Made in China 2025" is a state led industrial policy which seeks to make China dominant in global high-tech manufacturing. The way that China seeks to meet these targets, using the power of the state, is unacceptable to the USA and other countries. By 2025, China aims to achieve 70% self-sufficiency in high-tech industries and by 2049 it seeks a dominant position in global markets. As the dispute with the USA has developed, China has downplayed this policy but, nevertheless, President Trump sees this as a threat to the industrial dominance of the USA. If one had to take a view on how this will develop over the next few months, as one has to from an investment aspect, one would say that President Trump, having claimed the credit for a strong US stock market performance earlier this year and presumably believing that this would help his election prospects, might reluctantly accept that the opposite is true, namely that a weak Wall Street performance would damage his prospects. From President Xi's point of view, whilst he has successfully accumulated extraordinary powers for himself, including having his thoughts included in the constitution, this dispute does not come at a good time as China tries to move the profile of its economy more towards consumption and services and away from fixed asset investment. This inevitably is likely to slow the rate of growth even though the result, if successful, should be higher quality growth. But China does not want the economy to slow too much, with the unrest which this might cause, so it is having to introduce stimulus measures on the monetary front, like reducing the level of reserves which banks have to hold. China has a high level of debt (corporate debt is 160% of GDP) which the authorities are trying to reduce by, amongst other measures, clamping down on the shadow banking sector. It is true that most of Chinese debt is held internally and, with strong central control, China might be able to work its way through any crisis caused by over indebtedness but, if international trade relations had been more settled, they would not at this stage want to pursue monetary easing as it goes against the policy of trying to reduce leverage in the economy. Whilst China will not want to be seen to bow to US pressure, and President Xi has made this clear, behind the scenes China is likely to want to try to see if tempers can be calmed. Two examples may be the downplaying of the 2025 aspiration just mentioned and signs that China is going to reduce tariffs on US auto imports into China.

The domestic US issues of rising interest rates, which have irked President Trump and caused him to criticise the Chairman of the Federal Reserve so publicly, and now the partial shutdown of the US government because of his dispute with the Democrat controlled House of Representatives over funding for the Mexican wall may well create most attention now but things have not been so cosy in Europe. In recent reviews, we have discussed the implications of the Italian government's budget challenge to the rules of the EU's Stability and Growth Pact and, by implication, the euro, but, suddenly, from nowhere a further threat has emerged from events in France where the gilets jaunes have forced a major economic climbdown by President Macron. Initially caused by a rise in diesel (in particular) and petrol taxes which badly affected those in rural areas, it developed into a general complaint about the cost of living and taxes in France, one of the highest taxed developed economies. The violence in parts of France and the economic damage to the country forced a climbdown by President Macron which will be expensive with the tax increases abandoned and minimum wages increased, which the government will effectively underwrite, together with other concessions, such as on police pay. The result is that France's budget deficit in 2019 will exceed that allowed under the Stability and Growth Pact, though it is not likely that France will be sanctioned for this in the same way that Italy was threatened. As it happens, and so often the way in the EU, a compromise was reached which the EU says led to a "not ideal" solution. Instead of a 2.4% budget deficit for next year which the coalition Italian government has proposed, the agreement now envisages a 2.04% deficit. Italy will postpone the launch of a minimum basic income programme which will be rolled out during 2019 instead of January. The coalition will also delay unwinding part of previous pension reforms by a year. There are other clauses in the agreement as well, but one of the original objections to the proposals was that the deficits were predicated on rather optimistic growth rate estimates and this could well cause the deficits to exceed what was agreed, especially as the Italian economy is showing signs of weakness at the moment.

Back to France, and the problems for the EU have suddenly mounted as a result of recent events. Most independent commentators would agree that France suffers from excessive taxation (one of the complaints of the gilets jaunes), too large a public sector and overregulation, something about which President Macron has had some success in reducing and thereby restoring some French competitiveness. Major reforms on pensions and social security are planned but it seems highly unlikely that he will be able to achieve anything significant now that he has had to back down in the face of protests, in which case he will suffer the fate of previous French Presidents who have tried to introduce reforms. The budget deficit in 2019, as a result of the concession made to the gilets jaunes, could reach 3.4% of GDP, well over the allowed limit of 3%. Allowing France to exceed the limit of the Stability and Growth Pact without sanctions, as has been indicated by the EU, will make it more difficult to sanction Italy and this lenience threatens to challenge the credibility of the euro. Admittedly, France's outstanding public debt as a percentage of GDP is well below that of Italy (over 130%), but the original aim of the Stability and Growth Pact was to reduce the level to 60% at maximum.

Although there are some excellent European companies, the relative market performance of those companies within the EU compared to those in Switzerland tells a story about some unease at the economic policies being followed within the EU. Suddenly, things do not seem so bright. We have made the point on a number of occasions that such growth as we have seen will have been in part due to the very loose monetary policy followed by the ECB in terms of interest rates and QE. Growth now seems to be tailing off. If we look at the eurozone's purchasing managers' indices, we note a marked deterioration compared with the beginning of 2018. The latest composite index for the eurozone stands at 51.1, barely suggesting any growth, whereas in January 2018 it stood at 58.8. If we look at the PMIs for the three largest eurozone countries, we see a fairly unpromising picture. The index for Germany stands at 51.6 (59.0 in January 2018), that for France at 48.7, indicating economic contraction, (compared with 59.6 in January 2018) and, for Italy, the most recent index, stands at 50.0 (compared with 59.0 in January 2018). During the year, monetary policy within the eurozone has been tightening, not in terms of official interest rates but in terms of QT as the ECB has gradually reduced the amount of QE each month from an original level of €80 billion a month to €15 billion and now from the end of the year to eliminate it. The size of the ECB's balance sheet has now started to contract and this can be expected to act as a constraint on economic growth as it leads to tighter monetary conditions. The ECB will reinvest the proceeds of asset maturities but will not create money electronically to buy more assets. So, returning to Italy, it will increasingly have to market its debt as an attractive option to purchasers of debt securities without the backdrop of the ECB buying securities in the secondary market, which has helped to suppress yields. If the eurozone economy is slowing down, one might ask if it is sensible for the ECB to stop its QE programme. The answer is that a central bank balance sheet increasing at the rate it has been (total assets of the ECB have risen from about €2 billion in 2008 to about €5.3 billion now) risks creating significant asset bubbles and distortions of economic activity and, although it does not seem like it now, inflation at some stage. The ECB is also coming up against limits in what it can purchase. Generally, the ECB is limited to buying no more than 33% of a securities issue and no more than 33% of an issuer's outstanding securities. So, with Germany running a budget surplus with projections from the Finance Ministry indicating one of 1.75% in 2018 and 1% in 2019, it is not going to be a big issuer of government debt. This is relevant because capital keys (roughly translated as the relative size of a particular eurozone economy) limit the amount of debt which the ECB can buy for each eurozone country and, if German debt is limited, it could create pressures elsewhere on the issuer constraint mentioned above.

Into this background comes Brexit. Whilst many column inches are devoted in the UK to risks from a "no deal" or WTO outcome, it is relevant to note that the EU is a much larger exporter to the UK than an importer of UK goods and could face a difficult situation if the EU economy is weakening of its own accord as, for example, the purchasing managers indices suggest. In 2017, the UK recorded a £95 billion deficit on goods, only partly offset by a surplus of £28 billion on services. Common sense suggests, looking at these figures, that, in the event of an agreement on Brexit not being reached, the EU economy would suffer, as well as that of the UK. If that is on top of slowing economic conditions now apparent, although these may be a temporary blip, and tightening monetary policy, conditions could become difficult in the eurozone and the wider EU in 2019. Just by looking at market movements in the eurozone, one can sense a weakening of confidence, quite the opposite to what was expected at the beginning of 2018.

An issue which has captured attention, because of the dramatic fall in price, is oil. At the time of writing, the price of Brent crude has fallen about 37% from its peak in 2018 as recently as the beginning of October. Then the concern was that the 28% rise since the end of 2017 would have an impact on economic growth. Now the concern is that demand weakness has caused the world economy to be over supplied with oil and that this could be a sign of recession. However, the positive interpretation is that consumers will be left with more money in their pockets and business will benefit from lower costs which should be positive for economic growth. We would be in the optimistic camp on this issue.

A further issue which has attracted the attention of pessimists is the shape of the yield curve. At the time of writing (7th January), the following table represents the gross redemption yields on respective 2 year, 10 year and 30 year government bonds :

	2 years **%**	**10 years** **%**	**30 years** **%**
U.S.A.	2.486	2.646	2.943
U.K.	0.717	1.235	1.774
Germany	-0.607	0.194	0.843
Japan	-0.175	-0.026	0.668
China	2.663	3.144	3.807

The normal expectation is that the longer the maturity the higher the yield on the basis that, if one lends for longer periods, one expects to be rewarded for the risks that short term interest rates might rise on the back of economic growth or that inflation may increase and erode the real value of the bonds. As we can see from the above table, the yield curve does steepen as one moves along the maturities, but not dramatically in the case of the USA and UK. If the yield curve inverts with longer term rates (typically the relationship between the 2 year and 10 year bond yields) lower than short term rates, then a recession may be on the horizon. The rationale for this is that short term rates may then be lowered so that the 10 year bond may seem, at least, temporarily attractive on yield grounds. It is not infallible but it does have a good predictive record and the yield curve bears attention. What makes the current position more difficult to evaluate is that QE has caused considerable yield compression. Medium and long dated yields have probably been suppressed by central bank bond purchases but it could be argued that 2 year bond yields have been artificially low (not so much now in the case of the USA) because of the aggressive action of the central banks in setting policy rates so low, or effectively negative in some cases, so the yield curve starts off from a very low or negative basis, translating itself to the 2 year yields, as we see in the case of Germany and Japan and other countries, like Switzerland, not on the table. The table is at its relative flattest in the case of the USA where monetary policy is most advanced in the Federal Reserve's quest for normality.

Yet one feels a recession in the USA is unlikely unless, as is not impossible, there are serious missteps such as allowing the trade tensions with China to run out of control. Protectionism on a worldwide scale would most likely kill off economic growth. Domestically, whilst tax cuts must be welcomed, and they certainly helped Wall Street to reach its peak levels in 2018 as corporate earnings, already strong, were enhanced by tax cuts, the timing was not optimal as it added to pro cyclical forces at a time when the US economy was performing quite well. In these circumstances, one would expect inflationary pressures to strengthen and interest rates to rise along the curve but not necessarily to invert. Inversion would be more likely to occur if monetary policy had to be tightened so much that it brought about a recession rather than brought inflation down in a measured way without causing a recession.

We always make the point that investors should not be intimidated by markets. In this febrile atmosphere, the media will nearly always emphasise the negatives because that is what attracts more attention. Good economic news rarely makes headlines but, for most of the time, stock markets rise, but not in a straight line. It is true that market setbacks can feel very painful, but to be frightened out of the markets by negative sentiment can risk significant opportunity costs when markets recover. The loss of profit can often never be recovered given markets' tendencies to rise over time. Confidence may only return to the investor when markets have risen and sentiment is better but, by then, it can be too late. With the long term trend in mind, investors should value the fact that dividends are still coming in, especially at times like the present when, in some markets such as the UK, Continental Europe and Japan, dividend yields are much higher than the returns from cash and bonds. Clearly, there are some circumstances when prospects look so bad that a different view might be taken, but we certainly do not feel that this is the case now.

Against the current background of unsettled markets, it is worth looking at the latest OECD Economic Outlook published in November. It is entirely possible that current market turbulence might trim a small amount off growth but the orders of magnitude of its projections suggest that the world economy is not in a bad place. The OECD now forecasts a reduction in growth from a projected 3.7% in 2018 to 3.5% in 2019. If this is the case, this is not an unsatisfactory outcome and not one which can justify the extraordinary gyrations in markets now. For the G-20 nations, there has been a slight downgrade and it now sees growth in 2019 of 3.7% against its expectations of 3.8% for this year. Its forecasts for the following countries or areas in 2019 (2018 expectations are in brackets) are: the USA 2.7% (2.9%); the eurozone 1.8% (1.9%) and, within that, Germany 1.6% (1.6%), France 1.6% (1.6%) and Italy 0.9% (1.0%); Japan 1.0% (0.9%); Canada 2.2% (2.1%) and the United kingdom 1.4% (1.3%); China 6.3% (6.6%); India 7.3% (7.5%) and Brazil 2.1% (1.2%). These forecasts were released in November, after October's stock market weakness but before the turbulence of December. Since the November publication, negative factors have been the French political unrest leading to extra spending which will raise France's budget deficit and probably put paid to any further meaningful reforms and the US budget showdown which will have a short term impact on the US economy, assuming there will be some sort of resolution. On the positive side, although it is at best a compromise, the Italian budget stand off with the EU has been avoided, at least for the time being. Nevertheless, any deterioration in the economic outlook since the OECD produced this report on the information we have so far is unlikely to change prospects dramatically but it does depend on the satisfactory resolution of certain issues, notably, but not exclusively, the USA/China trade dispute, the US budget stand off and the end of President Trump's criticism of the Federal Reserve, which weakens investors' confidence in US monetary policy. Signs of an accelerating weakening in the Chinese economy, as evidenced, for example, by Apple's iPhone sales weakness in Greater China will also be monitored closely by investors.

Although on an international stage Brexit does not feature highly as a concern, in the UK it obviously does, together with, in our opinion, the greater risk of a change in government with radical economic policies which, if implemented, would almost certainly adversely affect UK markets and sterling. If a "no deal" or WTO Brexit occurs, this will inevitably lead to short term economic dislocation but the flexibility of the UK economy should lead to those dislocations being overcome in time. However, if these dislocations cause a political crisis in the UK which somehow leads to a change in government, that, in our view, would be the likely greater threat than Brexit. This seems to be borne out by surveys of international investors who are quite negative about the UK, mainly for political reasons. As we have emphasised in our reviews, we consider it of vital importance that we do have portfolio protection against such a possibility which we take by holding overseas assets.

As we start 2019, we can attempt to line up the issues both negative and positive which investors will have to consider. To summarise, they are the USA/China trade negotiations which, if they are not resolved, could lead to an elevated level of protectionism which would slow down the world economy. Whilst there is always a temptation when markets are behaving as they have done in the final quarter of 2018 to take the pessimistic view, it is possible to construct a more positive argument that, if negotiations do succeed, they will resolve some of the long festering complaints about China's trade policy to the benefit of both sides of the argument. Whilst President Trump's actions and statements since coming to office have always been unpredictable, they have reached a new level recently in both domestic and foreign policy which largely explains the US market's extreme gyrations. It is concerning how many experienced advisers he has lost and how little notice he appears to take of some of their advice. An optimistic view is that he will be influenced by the movements in markets, perhaps the strongest constraint on any politician who goes too far from the mainstream. At one's most optimistic view, one could see him reaching an accommodation with China, stop attacking the Chairman of the Federal Reserve and coming to an agreement with the House of Representatives over the budget. Markets would certainly welcome such a combination of positive news. Developments in the EU, particularly the eurozone, could be important. Will the unsatisfactory truce between the EU and Italy unravel? What will happen in France if President Macron tries to press ahead with social security and pension reforms and meets the type of resistance shown by the gilets jaunes? How will the EU cope with a "no deal" Brexit? Will that put some countries into recession? Then there is the issue with emerging markets which we have not touched upon in this review. If US interest rates continue to rise will they come under financial pressure if this rise adversely affects their currencies? There is a high level of US dollar indebtedness in emerging markets. Will China's monetary easing, meant to offset US trade sanctions, help the economy to offset the resulting problems? China is important to the world economy, so a significant slowdown would be negative for it.

But we should perhaps reflect most of all on monetary policy and its interaction with markets. We have noted that growth appears to be slowing down in some countries and this at a time when monetary policy is becoming more restrictive, albeit from a mostly easy basis. It is more normal in the USA than elsewhere, yet we have seen how badly Wall Street reacted to the Federal Reserve's interest rate hike in December, even though it was expected. Two further rate hikes are expected in 2019. Although probably unfounded, some have expressed fears that the President's pressure on the Federal Reserve will cause it to be more stubborn about implementing rate rises for fear of being seen to accede to the President's criticism of interest rate increases. It is important for interest rate determination to be independent. At least, having raised interest rates nine times in the current cycle, the Federal Reserve has some latitude in staging any further increases or, in an unexpected downturn, actually reducing them, aside from any decisions on QE or QT.

Perhaps the most interesting place for questions of monetary policy is the eurozone. We have noted that economic growth appears to be slowing down there and, in some countries, has turned negative. For example, in the third quarter of 2018, there was negative growth in Germany, Italy and Austria whilst quarter on quarter annualised growth in the eurozone was just 0.6%. The ECB does not plan to raise interest rates but it is stopping QE, but what will it do if growth stalls? The interest rate weapon has surely disappeared given that the policy rate is at zero at present. The ECB can provide liquidity to the banking system and start QE again, but one would expect the outcome to be fairly weak. Obviously, individual countries can take fiscal action, but they are, theoretically, constrained by the Stability and Growth Pact and, if fiscal rules are repeatedly breached, the credibility of the eurozone is undermined. It is a big policy dilemma. It looks as if the ECB could be tightening at the wrong time.

Elsewhere, the UK has a little more room to ease monetary policy if the UK economy has a more difficult time than expected over Brexit. Whilst interest rates can be reduced marginally, they are so low anyway that lower rates are unlikely to have much effect. QE can be restarted but, overall, tax cuts and/or higher public spending are the more likely tools to be used in any difficult post Brexit situation. In Japan, which has unsuccessfully tried to move inflation to around 2%, it looks as if some subtle monetary tightening may be occurring, but the world does not, with its other preoccupations, spend too much time these days on Japanese monetary policy. China, on the other hand, as we noted earlier, has already been loosening monetary policy through reducing the banks' reserve requirements and it has just done it again. The central bank may be happy continuing to do this even if it makes its plan to reduce the shadow banking sector's influence more difficult. It could also allow the renminbi to weaken further to reduce the effect of US import tariffs and loosen economic policy, although this may make President Trump even more angry. In normal circumstances, we would say that the course of monetary policy would be an important determinant of stocks' performance in 2019.

Whilst there many uncertainties which are having more effect on markets now that they did for much of 2018, we do not consider that they justify a change in policy. Shares do not look expensive and their relative income attraction compared to fixed interest securities and cash remain appealing. Although high quality bonds have attracted support in the recent equity market volatility, absolute levels of yield are highly unattractive. As we have repeatedly emphasised, for sterling based investors diversification of assets by geography is essential because of the particular political risks in the UK. We must expect some continued volatility but, in the absence of some significant deterioration in the issues which are worrying investors, we see scope for equity prices to recover on the back of continued modest economic growth and any offsetting action which central banks may take in the face of deteriorating economic data. Volatility is not pleasant and there will be some negative quarters, but the far greater danger for long term investors is to be out of the market when share prices resume their rise and do not fall back. That is when the opportunity costs can be painful.