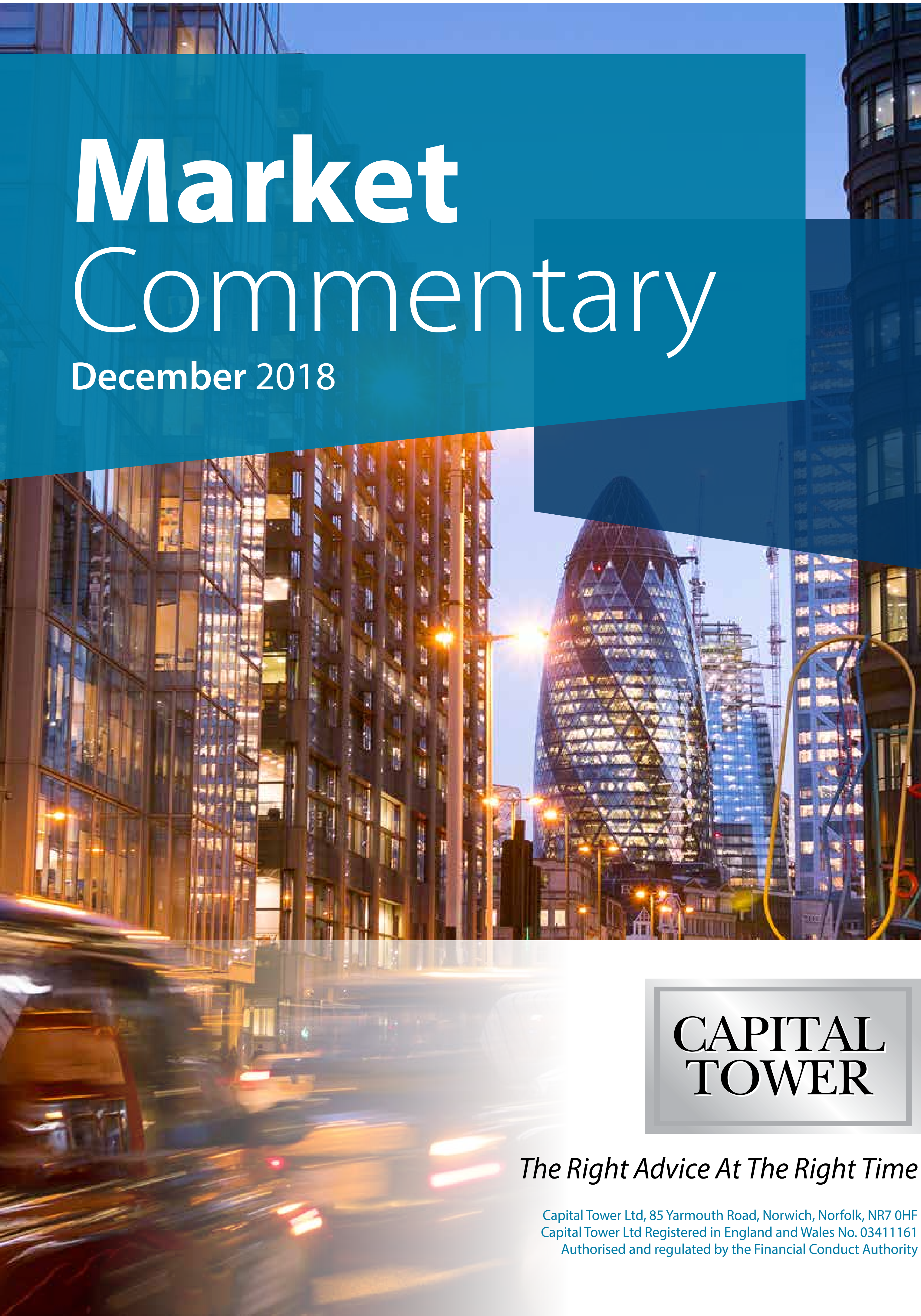
Market Commentary

December 2018



CAPITAL TOWER

The Right Advice At The Right Time

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December will be magic again.
Take a husky to the ice
While Bing Crosby sings White Christmas. He makes you feel nice.
December will be magic again.
Old Saint Nicholas up the chimney,
Just a-popping up in my memory.

Ooh, dropping down in my parachute,
The white city, she is so beautiful
Upon the black-soot icicled roofs,
Oh, and see how I fall.
See how I fall
(“Fall!”) [backwards]
Like the snow.

Come to cover the lovers.
(Cover the lovers,
But don’t you wake them up.)
Come to sparkle the dark up.
(Sparkle the dark up,
With just a touch of make-up.)
Come to cover the muck up.
(Cover the muck up,
Oh, with a little luck.)

December will be magic again.
Light the canDLe-lights
To conjure Mr. Wilde
Into the Silent Night.
Oh, it’s quiet inside,
Here in Oscar’s mind.

December will be magic again.
Don’t miss the brightest star.
Kiss under mistletoe.
I want to hear you laugh.
Don’t let the mystery go now.

Oh, dropping down in my parachute,
The white city, she is so beautiful
Upon the black-soot icicled roofs,
Oh, and see how I fall.
See how I fall
(“Fall!”) [backwards]
Like the snow.

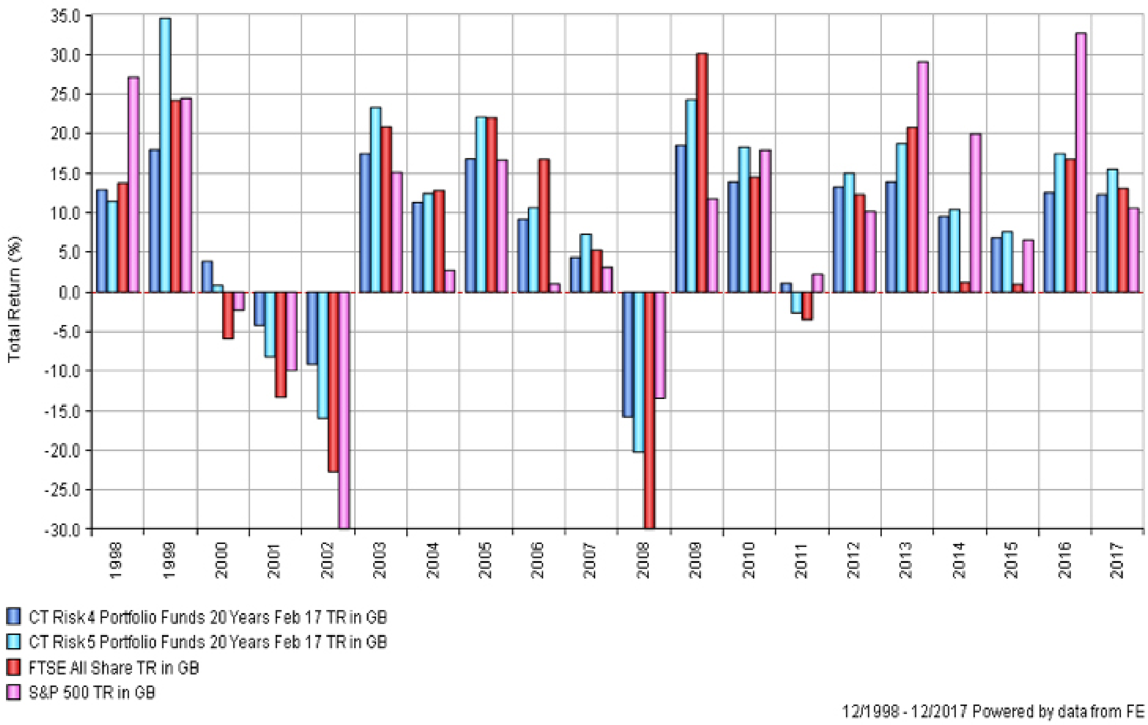
Come to cover the lovers.
(Cover the lovers,
But don’t you wake them up.)
Come to sparkle the dark up.
(Sparkle the dark up,
With just a touch of make-up.)
Come to cover the muck up
(Cover the muck up,
Oh, with a little luck.)
Oh, I’m coming to cover the lovers.
Oh, and I’m coming to sparkle the dark up.
Oh, and I’m coming to cover the muck up

Kate Bush – “December Will Be Magic Again”

> "Most people get interested in stocks when everyone else is. The time to get interested is when no one else is. You can't buy what is popular and do well."
>
> ***Warren Buffett***

It's worth reminding ourselves that December usually is magic on the markets, despite the current doom and gloom. A Santa Claus rally is a seasonal phenomenon, according to *The Stock Trader's Almanac,* a long-time provider of analysis of both cyclical and seasonal market tendencies. In 2018's edition, the almanac stated, "Since 1969, the Santa Claus rally has yielded a short sweet respectable rally in the last 5 days of the year and the first two in January. An average cumulative return over these days is 1.3%." Many consider the Santa Claus rally to be a result of people buying stocks in anticipation of the rise in stock prices during the month of January, otherwise known as the "January effect". There is also perhaps a more pragmatic and positive response to the often gloomy October that sees stocks fall sometimes indiscriminately and a gradual return to more reasoned approach during December.

Again, with the negative mood that prevails at the moment, it's worth looking at the longer picture and what value we can add as advisers. The bar chart below looks at the last 20 years and shows two typical Capital Tower portfolios, based on our investment process, for both a balanced investor and also one slightly higher in risk. These are measured on total 12-month returns each year against the FTSE All Share and the S&P 500 indices. The portfolios we are using here are simply what we would have chosen 20 years ago, and do not reflect changes along the way to introduce better funds. For example, there are many successful funds such as *Fundsmith, Lindsell Train Global Equity, and Baillie Gifford Global Discovery* which are not included here because they were not available 20 years ago.



"Think forwards and backwards — invert, always invert."

Berkshire Hathaway's Charles Munger

Speaking of **Lindsell Train**, fund manager Nick Train has turned to the staggering long-term performance of McDonald's (MCD.N) to justify why once again he has not made any changes to his high-performing portfolio. The star fund manager referred to a quotation an investor had sent him by one of his heroes, Peter Lynch, former manager of the US Fidelity Magellan fund.

Lynch, who made Magellan the best-performing mutual fund in the world with an average annual 29.2% return between 1977 and 1990, used McDonald's to illustrate why investors should not simply sell stocks on apparently high valuations, a subject close to the heart of the famously low-turnover Train.

Speaking about the burger bar chain's share price performance some time after its initial public offer (IPO) in 1965, Lynch said: *"McDonald's was up 10-fold after IPO, but it was only in 18% of countries. Then it gets to 30% and the stock is up 30-fold.*

"You have to know what innings you're in. There were more post offices in California than there were McDonald's restaurants. 'People missed the overseas potential too... Are you in the third innings of a ball game that might last 20 years?"

Train used the example to explain his buy-and-hold philosophy and justify his trust's long-standing holdings in alcoholic drinks company Diageo (DGE), PayPal (PYPL.O) and academic publisher RELX (REN). These represent 6.8%, 4% and 3.1% positions, respectively, in Lindsell Train investment trust.

Train said Lynch knew the difficulty of maintaining long-term conviction in holding so-called "baggers" – shares that multiply many times over their initial share price. "In addition, the truth is it was only obvious in hindsight that McDonald's was going to become a 100-bagger and more," said Train. "Every single trading day for 38 years someone could have offered a plausible reason to sell and probably did. What's more there was also plenty of extraneous market noise and volatility to unnerve you and shake you out of the stock."

By 1990, McDonald's shares stood at $8 and traded at a price-earnings (PE) ratio of 18 times historic earnings of $0.48 per share. Any doubts on its valuation at that time would have been "more or less irrelevant", said Train, given its value grew by 22 times between 1990 and 2018, three times more than the S&P 500 which rose 7.5 times in that period.

"And any quibbling about the valuation that actually encouraged a sale of the stock was downright ruinous," Train remarked.

Train said he intended to stick to this mantra in the hope of delivering his own "baggers" in the Lindsell Train trust, which had risen 12-fold in value since its launch in 2001, rather than selling out of companies on 'arbitrary' reasons.

Our portfolios are populated with many funds run along the same lines; buy and hold.

Research undertaken by Schroders shows how costly it can be when the timing is wrong.
Over three decades, mistimed decisions on an investment of £1,000 could have cost you nearly £18,000-worth of returns. This research examined the performance of three indices that reflect performance of the UK Stockmarket – the FTSE 100, the FTSE 250 and the FTSE All-Share.

If in 1987 you had invested £1,000 in the FTSE 250 and left the investment alone for the next 30 years,

"He who would leap high must take a long run."

Danish Proverb

it would now be worth £24,686. (Bear in mind, of course, that past performance is no guarantee of future returns).

However, if you had tried to time your entry in and out of the market during that period and missed out on the index's 30 best days the same investment would now be worth £6,878, or £17,808 less.

In terms of annualised returns, over the last 30 years you would have made:

- 11.3% if you stayed invested the whole time
- 9.3% if you missed the 10 best days
- 7.9% if you missed the 20 best days
- 6.6% if you missed the 30 best days

The 2% difference to annual returns between being invested the whole time and missing the 10 best days doesn't seem much but the effect builds up over time, as shown in the table below.

Brexit – Deal or No Deal

- The deal is largely as expected – but this is only the end of the beginning.
- It is apparent that the EU has broadly dictated the terms of Brexit from the beginning.
- We believe that the risk of a no-deal Brexit will focus minds and lead to cross-party support for May's deal
- The path ahead is politically fraught and sterling is likely to remain very volatile
- Failure to sell the deal risks a no-deal Brexit, and a higher risk of a UK recession next year

The UK government and European Commission have announced that the broad terms of the UK's Withdrawal Agreement have been finalised. This lays the path for completion in the next few weeks, and the UK entering a transition period following its exit from the European Union on 29 March 2019. The 585-page draft agreement follows most of the key points from the UK government's previous white paper, but with a few significant compromises about the Irish border.

UK stocks investment returns since 1987

Index	Return on £1,000 over 30 years	Less the 10 best days	Less the 20 best days	Less the 30 best days
FTSE 250	£24,686	£14,456	£9,750	£6,878
FTSE All Share	£13,320	£7,124	£4,637	£3,168
FTSE 100	£12,989	£6,691	£4,238	£2,833

Source: Schroders. Thomson Reuters Datastream. Data shown is for total return indices, which include dividend payments, between 23 October 1987 and 23 October 2017. Past performance is not a guide to future returns.

The UK will enjoy all of the benefits of EU membership during the transition period, which may be extended beyond December 2020 for a set period (yet to be specified). This includes ongoing single market access, remaining in the customs union and free movement of labour. However, it will also need to make ongoing budgetary contributions and will not be able to finalise any new trade deals until it leaves the customs union. Of course, the UK will no longer have representation at European institutions or the European Commission.

What does it mean for Northern Ireland?
During the transition period, Northern Ireland will largely face the same rules as the UK with regards its relationship with the EU (including the Republic of Ireland). However, when the transition period comes to an end, if a solution has not been found to avoid a hard border and maintain the Irish peace deal, then Northern Ireland could be tied into the EU for longer. The so-called "backstop" is not the desired outcome for the UK government or the EU and the idea of regulatory differences with the rest of the UK has angered the Northern Ireland Democratic Unionist Party (DUP), who happen to be supporting the Conservative Party to achieve a majority in parliament.

The backstop would only be temporary until a solution is developed to maintain an open border, and Northern Ireland would have greater access to the single market than the rest of the UK. The British government has stated that Northern Ireland would not face any barriers to exporting to Great Britain, but goods arriving from Great Britain (and the rest of the non-EU world) would face checks as they enter Northern Ireland. Essentially, Northern Ireland will become a special economic zone, which from an economic standpoint seems to be the best of both worlds. So much so that ministers in Scotland are demanding the same arrangement, or threatening another attempt at separation from the UK

The end of the beginning
As a reminder, this is only the end of the beginning. The future relationship beyond Brexit, and beyond the transition period has yet to be decided. The EU has always insisted that negotiations on trade and security amongst many other issues would not start until after Brexit has been completed. Trade negotiations are likely to take many years, possibly beyond the end of the transition period. Uncertainty for companies will therefore remain. The relief in the near-term will be that an agreement in principle reduces the chances of a no-deal Brexit.

Brexiteer backlash
The deal has been met by anger and accusations of betrayal of the original Brexit referendum result. Of course, nobody can claim with any authority that they know what form of Brexit people voted for, because that question was not on the ballot. After the details of the agreement were revealed, Theresa May announced that she had the full backing of her cabinet. The next day, several senior and junior ministers resigned in protest. She is likely to survive, as even if there are enough unhappy Conservative MPs to force a vote of no confidence, it is doubtful that they have a majority in the parliamentary party.

What next?
Now that the UK and EU have finalised the agreement, the Withdrawal Agreement will be debated in the House of Commons for about a week before a vote on 11th December. This is the next major risk to an orderly Brexit.

The same significant number of Conservative Brexiteers that are seeking to challenge the leadership of May are also threatening to vote against the deal in parliament, preferring no deal at all. The DUP has stated that it will vote against the deal too as mentioned earlier, while the Scottish National Party (SNP) and the Liberal Democrats have also said they would not back the deal in the hope of avoiding Brexit altogether.

Meanwhile, the main opposition Labour party have also stated that they would not back the deal, and instead, have called for a general election. They believe they have the ability to achieve a "better" deal for the UK, but without outlining in any way how such a deal would be achieved.

Indeed, this is the problem at the heart of UK politics. The belief that the UK has negotiating power is misguided, when in reality, the EU has dictated the terms of Brexit from the beginning. While politicians widely state that there is no majority to support May's deal, they also state that there is no majority for a no-deal Brexit. Yet, in the absence of a deal being ratified, or a delay to Brexit being requested and backed unanimously by other EU states, the UK will be leaving the EU on 29 March 2019 without a deal or transition period.

We believe that the risk of a no-deal Brexit will focus minds and eventually lead to cross-party support for May's deal (60% probability on this outcome). There are many Labour MPs that take a more pro-Europe centrists approach, which we believe would defy their hard-left leadership in order to avoid a chaotic Brexit. Passing the legislation would complete the path to the transition period, which could see the pound rising to 1.40 against the US dollar

If parliament rejects the deal (a 40% probability), then a number of scenarios are possible:

1. A general election could be called following a successful attempt by the opposition parties to pass a vote of no confidence in the government
2. If the vote of no confidence fails (this is more difficult to achieve following the introduction of the Fixed Term Parliament Act) a three-way referendum could be called which would include an option to remain in the EU
3. The government continues but starts to prepare for a no-deal Brexit.

We doubt the first two options would yield a materially different outcome from the previous referendum and general election, and so our central view would shift to a no-deal Brexit. This would trigger a sell-off in sterling, which could take the pound down by 10–15% against the US dollar.

The path ahead is politically fraught and sterling is likely to remain very volatile in the days and weeks ahead. The UK's immediate outlook depends on the prime minister being able to sell her deal to parliament and the public.

"Sometimes the questions are complicated and the answers are simple."

Dr. Seuss

Much has been said about the economic consequences of a no-deal Brexit. In trying to take an impartial view, we would suggest that a no-deal Brexit does not mean that there will definitely be a UK recession next year, but it probably does increase the risk of a recession occurring, primarily as a result of the negative sentiment that a no-deal Brexit could create.

market commentary

SUMMARY
It feels like the market has moved from an optimistic footing to a cynical one and it is important to look at the underlying factors which may have caused this shift in sentiment.

There is a consistent correlation between the direction of equity markets and credit spreads. Credit spreads reflect the bond market's perception of future economic activity and corporate profits, and are therefore a key indicator for equity markets

Long term relationship of US equities and credit spreads

Source: Bloomberg, 24/11/2000 - 21/11/2018.

Credit spreads have risen year-to-date (as circled in the above chart), and the equity market has had a volatile and generally unprofitable year. However, most economic indicators remain positive although pointing to lower growth going forward than the current year.

The gradual withdrawal of European QE, which started in October, combined with ongoing interest rate rises in the US, is giving rise to the long expected normalisation. The last ten years have seen misallocation of capital, reflecting ultra-low interest rates and high levels of liquidity, notably in the bond markets with companies servicing their interest payments by borrowing further money, but also in equity markets where share buybacks financed with borrowed money have become common. Higher interest rates will make these strategies less attractive and quite possibly lead to an increase in the number of failing borrowers.

It is therefore wise for investors to avoid highly indebted companies and lower quality borrowers, a philosophy evident with many of our preferred fund managers such as Terry Smith and Nick Train.

> "I will honour Christmas in my heart, and try to keep it all the year."
>
> ***Charles Dickens***

Credit spreads have risen because of the fear of interest rates being raised more quickly by the Federal Reserve than markets had previously anticipated. However, on a longer-term basis, credit spreads remain well within normal ranges and are certainly not at levels which would imply an imminent recession.

This would argue that current events are more financial market related than real economy driven.

To evidence this, after Federal Reserve Chair Jerome Powell recently announced that the US interest rate is now "just below" estimates of a level that neither brakes nor boosts a healthy economy (indicating a limited number of future interest rate increase) the Dow Jones and the S&P 500 posted their biggest percentage gains in eight months…

We remain….

Finally, all of us at Capital Tower Ltd wish you, your family and friends a very Happy Christmas and we look forward to advising you in 2019.

market commentary

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