OCM Wealth Management

Independent Financial Planners | Discretionary Asset Managers | Tax Advisers

Market Commentary – 5th December 2018

Capital Preservation Mode Implemented

As I write, the instructions have been placed to sell down two thirds of our long equity positions, selling those positions where the fund manager can only buy equities or where they have a diverse mandate but have historically generated too much volatility. We have done this for various reasons, but the most fundamental reason is that as the CIO and caretaker of our client's assets, I no longer have any confidence that we are not staring down the barrel of a structural sell off as the global equity cycle comes to an end. Q1 2019 is looking like a significant risk-off period due to the slowdown in global growth and fears that excessive tightening in the US will result in a faster than expected slowing of the US economy. When I wrote last week, we were confident that Trump and Xi would agree a trade truce, and as a result of that we were expecting markets to rally up to 5% over this week before we entered into a chaotic week of Brexit debates, which would result in sterling depreciating giving the portfolios a further lift.

On Monday lunchtime it looked like the thesis was playing out, but as Monday continued, scepticism grew over what exactly Trump and Xi agreed. This coupled with some poor economic data resulted in a sell-off in US equities yesterday. Overall, China is talking positively today about implementing what has been agreed, however despite the suspension in the escalating trade war there is no forward momentum to take risk, and the undercurrent of bad news is getting stronger. In summary therefore as we see it, we are now at an inflection point and feel that we have to put in place the capital preservation mandate for the following reasons:-

1. When we look at the world from a risk perspective, returns available for remaining invested do not compensate for the associated risk and downside potential. Upside potential based on data slowing is only 1% - 2% against the downside risk of 10% plus for the coming quarter. The risk is therefore not worth the potential benefit.

2. We are also seeing widening credit spreads on corporate debt, which means that the default risk around corporate debt is increasing. This is typically a signal that we are coming to the end of the cycle and that forward looking profitability will be reducing, therefore impacting directly on the ability of a company to service its debt, making the risks increase and valuations drop.

3. The US and Chinese economies are slowing, and Europe has never really got going. We are therefore expecting the first quarter to be poor economically and for the slowdown to be delivering negative sentiment in Q1 which will drive down forward earnings and confidence in equities. This will make the selloff structural and will push equity valuations significantly lower than where they are today.

4. More and more commentators and fund managers are not able to explain what exactly is happening and are talking up the fact that investors should concentrate on long term performance and stay invested. This only ever happens when they are not optimistic about the short term and want clients to ride the roller-coaster. In my opinion, the herd is running itself off a cliff and by reducing our equity exposure we are lifting ourselves out of the herd and taking a different position to turn the risk into a potentially balanced opportunity.

5. Brexit is becoming increasingly chaotic and no one knows what the outcome will be. Based on the current discussions, the UK's withdrawal from the EU could be a disaster for both the UK and Europe and even if sterling fell due to the chaos, the indices could fall further due to potential negative impacts on corporate profitability. Over the past few years, when Sterling fell the FTSE 100 / 250 rallied because of marginal gains made by FTSE companies. That correlation will not repeat itself in a world where we have a hard Brexit.

6. Finally, it must be remembered that fund managers unless they have a mandate to invest in all asset classes cannot protect capital as they have to invest in whatever the mandate of the fund is. For example, a UK Mid-Cap Equity fund would have to invest 90% in mid-cap equities irrespective of what is going on. For most of our fund managers that can only be long equity exposure, therefore this is always a negative and is why we sit over them and let them manage the day to day.

Despite the trade wars, Brexit chaos and the end of a global expansion phase of the cycle creating a negative environment for anyone with investments in Q1 2019, as so many negative events are converging, no one is expecting this to be a repeat of 2001 or 2008, and the data does not suggest we are looking at a global recession. Employment should remain stable in the major economies and we are confident that we will end up with either no Brexit or a positive Brexit (as always, I am an optimist). Trump and Xi will do a deal eventually and the slowdown will prove to be just that and not a deep recession. Therefore, as we travel through this slowdown and the next quarter, we will start to get clarity and many of the issues we are facing today will cease or become quantifiable.

Short term fear will give way to medium term optimism

As a continuation from the above most commentators and economists are looking at Q1 being a risk-off period and the end of this cycle coming to us quicker than anticipated only a few weeks ago. We see these forward-looking economic events like a car crash we can see and cannot totally avoid, but we can navigate it carefully and slowly which ultimately reduces the risks. As we are navigating the car crash and a path forward becomes clearer, we will speed up again and take risk as normal or even as we sometimes do, go faster than normal for a short period of time, when the risks are behind you and the road ahead is abnormally clear.

It is key that we must be able to speed up and again and put back the risk when we see either a balance between upside and downside or more upside than downside. These opportunities generally present itself when the data is at its darkest and the market is oversold. That would be a threat and an awful ride if ridden, but if not, it becomes a significant opportunity and that is what we are trying to create as we did in 2001, 2008 and again in 2011 when the US was downgraded. The only difference with today is that we are not going to get 5% from being in cash and being defensive as we did in 2001 and 2008. There is no guarantee that our thesis will work or play out positively but if we are wrong this way we miss a few percent on the upside, but if we are right then we will protect your wealth and then turn the threat into an opportunity, making 2019 a year to celebrate rather than a year of losses and then gains and a repeat of 2018, but far worse.

What will we do next?

Step 1 is to sell the positions and that will happen today, and we will then hold a very high cash position once the positions settle. We have built a defensively positioned portfolio but a number of positions that we want to open cannot be implemented until we have clarity over the direction of Brexit (UK commercial property or other property related assets for one) and others we are waiting to implement once we see the market reaction to what Xi will say next week when China celebrate 40 years since they opened the market to the world in 1978. We are therefore expecting that by the end of December the full defensive portfolio will be implemented and if the market does capitulate in Q1 the worst that should happen is we flatline or even see the portfolio go up. As stated above we will have therefore achieved and had a positive outcome from decision 1 being our aim of turning a threat into an opportunity.

To get the decision right, we have to make two decisions. We have done the first which is the decision to go defensive and only history will tell us we are right, but if we are, for this to be an opportunity we at some point in the coming months have to invest in equities again and when we do, it is likely to be at a time when the markets are looking awful. If we reinvest when the upside is again significant and downside almost negated, then accepting short term volatility, 2019 should be a successful year. If we wait until all is lovely again and markets are stable then all we will have done is take the volatility out of the market and protected capital, which is in itself a benefit, but I want to deliver more, and we strive to balance the delivery of outcomes with preserving capital. Once we have finished preserving capital, and the risks are worth taking which will be before the market bottom hopefully, we then have to get back to what everyone wants and that is, delivering the outcomes and strong positive returns, which we have not in the last 12 months, but we are confident that we will over the coming cycle.

For anyone who wants further data to substantiate the global economy is not falling off a cliff and is still in relatively good shape looking at what has happened not what is happening, please review the attached Global Economic News Document. Also we have added a section on US government bond rates and the inversion that is about to happen which is always a signal of an impending recession.

Model Portfolios & Indices

Over the last week we have seen most of the indices that we track edge slightly higher and the delay in performance feeding through last week has also come through and we have had a positive week. The data below has as yet not reflected the upturn in markets we had on Monday but then again also will not reflect the downturn we had yesterday so all in next week we are looking at it being relatively flat. Overall though the week was positive and was a welcome relief, we just hoped the momentum would be greater and returns higher before we implemented capital preservation mode.

Please also note that there is still risk in the portfolios and we will still see some volatility, but by taking out the positions we are reducing the level of risk significantly and the volatility we experienced at the beginning of October should not feed through if that level of pull back happens again in the equity markets.

Global Indices Performance - YTD to close 04th December 2018				
Indices & Country		As at close YTD 27th November 2018	As at close YTD 04th December 2018	Indices Variance Change %
Indices	Country			
S&P 500	USA	0.32%	0.99%	0.67%
Dow Jones Ind Avg.	USA	0.12%	1.25%	1.13%
NASDAQ	USA	4.76%	6.23%	1.47%
Stoxx 600	Europe top 600	-8.17%	-7.90%	0.27%
FTSE 100	UK Top 100	-8.73%	-8.65%	0.08%
FTSE 250	UK Top 250	-9.77%	-11.37%	-1.60%
DAX	Germany	-12.45%	-12.25%	0.20%
CAC	France	-6.20%	-5.65%	0.55%
IBEX	Spain	-9.54%	-9.78%	-0.24%
FTSE MIB	Italy	-12.37%	-11.44%	0.93%
NIKKEI 225	Japan	-3.57%	-3.20%	0.37%
S&P ASX 200	Australia	-5.55%	-5.80%	-0.25%
CSI 300	China	-22.17%	-18.93%	3.24%
Hang Seng	Hong Kong	-11.99%	-8.89%	3.10%
Source - Reuters 05/12/2018 - Data to close 04/12/2018				

OCM Portfolios - YTD to close 04th December 2018								
Portfolio	Benchmark	2018 YTD Return to Close 27th November 2018	2018 YTD Return to Close 04th December 2018	Change	1 Month Performance	3 Months Performance	6 Months Performance	12 Months Performance
OBI Active 3	AFI Cautious	-3.48%	-2.95%	0.53%	-0.33%	-3.35%	-2.52%	-2.11%
OBI Active 4		-3.64%	-2.94%	0.70%	-0.15%	-3.53%	-2.61%	-2.10%
OBI Active 5		-3.61%	-2.70%	0.91%	0.06%	-3.82%	-2.60%	-1.72%
Benchmark = AFI Cautious		-1.86%	-1.50%	0.36%	-0.37%	-3.70%	-2.56%	-0.41%
OBI Active 6	AFI Balanced	-3.76%	-2.72%	1.04%	0.07%	-4.29%	-2.86%	-1.59%
OBI Active 7		-3.59%	-2.35%	1.24%	0.32%	-4.41%	-2.64%	-1.07%
OBI Active 8		-3.84%	-2.44%	1.40%	0.44%	-4.76%	-2.73%	-0.94%
Benchmark = AFI Balanced		-2.62%	-1.89%	0.73%	-0.05%	-4.98%	-3.62%	-0.33%
Source - FE Analytics 05/12/2018 - Data to close 04/12/2018								
Performance has been detailed on a Gross Return calculation, which is before fees and charges after the fund manager's charges								

Important Information

The data above will not directly correlate to the indices as there is always a delay in pricing because the US markets close significantly later than the European markets and the Asian markets. The data set above reflects the last close and much of the days movements will not yet be reflected in the portfolios due to pricing delays. You cannot therefore directly correlate indices to the portfolios. The value of investments may fluctuate in price or value and you may get back less than the amount originally invested. Past performance is not a guarantee of future performance. Performance figures quoted include the fund manager charges but exclude other fees such as adviser, custodian, switch and/or discretionary investment management fees. Unless otherwise instructed and accrued, income is reinvested into the portfolio.

This Day in History

At 2:10 p.m on the 5th December 1945, five U.S. Navy Avenger torpedo-bombers comprising Flight 19 take off from the Ft. Lauderdale Naval Air Station in Florida on a routine three-hour training mission. Flight 19 was scheduled to take them due east for 120 miles, north for 73 miles, and then back over a final 120-mile leg that would return them to the naval base. They never returned.

Two hours after the flight began, the leader of the squadron, who had been flying in the area for more than six months, reported that his compass and back-up compass had failed and that his position was unknown. The other planes experienced similar instrument malfunctions. Radio facilities on land were contacted to find the location of the lost squadron, but none were successful. After two more hours of confused messages from the fliers, a distorted radio transmission from the squadron leader was heard at 6:20 p.m., apparently calling for his men to prepare to ditch their aircraft simultaneously because of lack of fuel.

By this time, several land radar stations finally determined that Flight 19 was somewhere north of the Bahamas and east of the Florida coast, and at 7:27 p.m. a search and rescue Mariner aircraft took off with a 13-man crew. Three minutes later, the Mariner aircraft radioed to its home base that its mission was underway. The Mariner was never heard from again. Later, there was a report from a tanker cruising off the coast of Florida of a visible explosion seen at 7:50 p.m.

The disappearance of the 14 men of Flight 19 and the 13 men of the Mariner led to one of the largest air and seas searches to that date, and hundreds of ships and aircraft combed thousands of square miles of the Atlantic Ocean, the Gulf of Mexico, and remote locations within the interior of Florida. No trace of the bodies or aircraft was ever found.

As always have a wonderful week and stay safe.

VBW

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