Knightsbridge Wealth

update

Dear Friends and Colleagues,

Happy New Decade! Here come the 2020s. What will they hold for investors?

Once again politics looms large in the minds of investors. At this point in 2019, it was "hard Brexit" (not to mention the spectre of a Jeremy Corbyn-led Labour government). This year, it's an escalation in the temperature of the conflict between Iran and the US.

It's worth remembering that geopolitics often doesn't have the market impact that people fear. It's easy to over react, particularly when headline-writers have an incentive to grab our attention by being as aggressive as possible. Last year's big concern is a case in point – for all of the hysterical columns that talked about "cliff edges" and imminent recessions, following the election of Boris Johnson in December, we no longer need to worry about a Corbyn government and we should be heading for a relatively smooth Brexit (although there'll be plenty of overhyped ups and downs throughout the process).

Similarly, there have been tensions in the Middle East for as long as I can remember. The latest bout is hardly something to shrug off, but nor is it the worst, not by a long way. It's quite possible that by the end of this year we'll all have forgotten all about Iran. Remember when we were all worrying about North Korea in late 2017? At the time, that was going to turn into World War III as well.

However, the reaction to such incidents can be useful in terms of what it suggests about the market mood. This, I think, is where the real significance lies. Investors have been keen to shrug off the conflict, sending US stocks higher after an initial dip and continuing to act as if oil prices will remain capped by US shale production and frail economic growth. This is where they may be too complacent, particularly on the latter point. Markets seem to believe we've already hit "peak oil demand". Yet for all that the environment and climate change will increasingly provide interesting investment opportunities, I'm pretty sure we'll need fossil fuels for a while yet. Oil prices are one of the main things to keep an eye on this year.

I'm more interested in what has been done poorly over the past decade. Why? Well, when the market commentators of ten years ago were carrying out their post-mortems on the 2000s, one headline kept cropping up: "The Worst Decade for Stocks Ever". To be pedantic, it was the worst calendar decade (the worst ten-year stretch for US stocks ended in 1938, according to The Atlantic). But the point is, equities followed an extraordinary bad decade with a really very good one, even though, at the end of 2009, very few people were ragingly bullish about anything at all.

Today, the mood is practically the opposite – it's hard to find anything that people aren't incredibly bullish about. Hard, but not impossible. It's clear that the losers' list is dominated by one asset class – commodities. That's not too surprising. The bull market in resources peaked in 2011 and was followed by a vicious bear market. The bottom for both oil and commodities in general arrived in early 2016. But there's still a lot of catching up to do – commodities have lost 3.1% a year over the past decade.

Could they be due a rebound? Perhaps. But a decade in which commodities did well would also imply one in which inflation returned and knocked a market that's positioned for perpetually low interest rates.

For most investors, the best choice they can make in 2020 is to filter out the political noise and invest for the long term. The majority of investment performance is driven by choosing the right strategic asset allocation, and investment success is drive by ensuring this is well aligned with personal financial goals.

Meanwhile, from all of us at Knightsbridge Wealth, have a very happy New Year.

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Market Report

Bonds
Green Bonds emerging

After very strong returns in 2019, the outlook for 2020 is more muted, as bond yields have fallen. Still, against a backdrop of very easy monetary policy globally and mediocre economic growth, selecting the right carry assets remains a promising strategy. Emerging Market sovereign and corporate bonds look more appealing than high grade bonds.

Green bonds are emerging as a sound, sustainable alternative to global investment grade (IG) bonds. While an individual green bond usually performs in line with an otherwise identical non-green one, the green bond market has a more conservative sector and risk profile and benefits from demand for sustainable investments outgrowing supply. This should lead to outperformance during times when credit risk premiums rise, making green bonds an appealing late-cycle investment, following the recent recovery in credit risk premiums globally. To benefit from green bonds' less cyclical profile, investors should diversify broadly and in particular avoid issuer concentration risk.

Equities
US and Japan appeal

With a meaningful trade deal reached between US and China that includes the removal of tariffs on Chinese goods in stages and expectations that improved trade visibility may support economic growth in the coming months, emerging market equities look attractive versus high grade bonds.

US stocks continue to look more appealing than the Euro-zone. Should economic data weaken, the Federal Reserve has more leeway to act than the European Central Bank (ECB). Consensus expectations for earnings growth look more realistic in the US than in the Eurozone. Both US and Japanese equities are geared toward global growth and exports, whilst Eurozone stocks have outperformed and are already pricing in a significantly better outcome compared to the Japanese market.

Commodities
Focus on specific opportunities

Broad commodity indexes have risen 5-7% from their August lows. With industrial activity still soft, a sharp price rise into this quarter looks unlikely. Positive demand surprises beyond weather-induced heating demand are unlikely. More support is likely from the supply side – the spread of African swine fever, for instance, has tightened global protein markets and lifted livestock prices. So, any focus should be on commodity-specific investment opportunities, either with outright longs or by selling downside risks, in addition to hedging with gold.

Prospects of slower US growth, the Fed cutting rates again and the USD weakening broadly still provide a very favourable backdrop for gold and precious metals in 2020.

Oil
Second half of the year looks attractive

Oil prices are predicted to weaken in the first half of the year on strong supply growth from non-OPEC states amid weak global demand growth, with Brent prices testing $55 a barrel by the middle of the year. Any dip below should offer an opportunity to add exposure.

Substantial capital expenditure cuts by energy companies between 2014 and 2016 should constrain supply growth in the coming years, resulting in a tight market. In addition, emerging Asia will continue to fuel oil demand growth, as the region accounts for roughly half of the world's population but just one-quarter of global oil demand.

Hedge Funds
Useful source of stability

Hedge funds are a useful source of return and stability in a multi-asset portfolio, especially during times of market volatility. They can offer superior risk-return compared to many other asset classes and access to uncorrelated investment opportunities, which provides downside protection and diversification benefits.

With potentially tougher times ahead, investors should consider holdings in this asset class. Heightened stock dispersion, volatility, rising interest rates and a maturing cycle more broadly should be conductive of performance. UBS anticipates average annual returns of between 3-6%.

Foreign Exchange
Political clarity supports Sterling

Euro/US Dollar rates have bene frozen in a narrow range recently. The Euro is likely to rise as trade discussions are expected to calm even further in the run up to the US elections. In addition, the growth differential between Europe and the US is likely to narrow.

Political clarity is supporting Sterling, expected to trade in a 1.30-1.40 range until June. Sterling is looking attractive as a long-term investment, whilst the risk of the UK to reverting to trading with the EUU on World Trade Organisation rules by 2021 could still drive Sterling lower.

Greece: Rebuilding its economy

Days after winning power in July, Greek Prime Minister Kyriakos Mitsotakis gave every one of his ministers a blue envelope. Each contained a list of policy targets and deadlines to complete them by. Failure to do so would mean the responsibilities would be stripped from the minister and taken back under Mitsotakis's control.

The leader of centre-right New Democracy hopes this style of governance can instil a competitive accountability that will fast-track an ambitious pro-business agenda and kick-start the Greek recovery.

Despite the huge challenge facing Mitsotakis, the capital's stock market was one of the strongest performer globally last year, and the cost to the government of borrowing money (bond yields) fell to levels unimaginable during the 2015 market chaos.

Mitsotakis (the son of a former Prime Minister and Harvard graduate) pushed more than 30 bills through parliament in his first 150 days in power and a queue of legislation is waiting for the green light. He inherited an economy clawing out of the worst economic depression in modern history but still lacklustre. Greek GDP is still a quarter below pre-2008 levels, unemployment is at 17% and growth is unspectacular. Its recovery has been left in the shade by other Euro-zone countries bailed out in the debt crisis, such as Ireland, Portugal and Spain.

After spurning the populist leftist Syriza and the kamikaze policies that brought the eurozone to the brink, Greece has undergone a remarkable political realignment by handing New Democracy a majority. Mitsotakis has a mandate for a radical overhaul of the economy, including tax cuts, privatisations, lifting capital controls and slashing red tape.

Two main economic ills are plaguing Greece: the lack of foreign investment and a banking sector hamstrung by bad loans. A flood of investment from overseas is crucial for the government to hit its growth targets.

Net foreign direct investment recovered to 2% of GDP in 2018 but remains around half the eurozone average. The government expects growth to accelerate to 2.8pc this year and is targeting a punchy 4pc rate in 2021, all while the world economy is slowing.

A sweeping policy package has been put together to lure in about €100bn (£830m) of foreign investment in the coming years. Corporation tax has been cut to from 28% to 24%, dividend tax has been halved to 5% and rich foreigners will be enticed by a flat tax of €100,000 in a "non-dom" programme. The government will also speed up the privatisations.

Visitors' first steps on Greek soil will be symbolic of this change. A 30% stake in Athens International Airport is on sale, while the much-delayed Hellinikon Project (at the old airport) has been heralded by government officials as the centrepiece of the plan. This huge €8bn redevelopment of part of the capital: including hotels, shopping centres, offices, museums and a marina; will contribute to the country's GDP by 2.4%.

Some remain sceptical about the ambition of the privatisation plans given how slow it has taken to come to fruition. A pipeline of further privatisations need time to 'mature,' in other words being improved to a reasonable state to attract interest.

Greece is also not fussy over where the investment comes from. China has become a key investment ally, prompting the US ambassador to Greece to accuse its rival of preying on 'cash-starved' economies.

Fixing the ailing banking system will be the second key pillar of the growth strategy. Greek businesses are still heavily reliant on the still struggling banking system to access finance. Its four main players are burdened by a mountain of non-performing loans (NPLs) left over from the crisis – bad debt where the borrower has failed to make scheduled payments for a specified period. The proportion of bad loans at Greek banks is 39% compared to an EU average of 3%.

Plan Hercules, which packages up this debt to be sold on to investors, also known as securitisation, aims to reduce the amount of NPLs. The plan is based on a successful scheme in Italy but banks will take an initial hit to profit. An industry source says this could lead to some of the weaker banks needing to raise more money from investors. "All securitisation schemes burn some capital but the problem now is not capital for Greek banks, it is the very high percentage of NPLs, so this is the priority," argues Yannis Stournaras, governor of the Bank of Greece, the Central Bank.

Mitsotakis will not just have to persuade investors of the Greek comeback story. His government wants to renegotiate the stringent budget targets set by the country's creditors. Giving Greece more space could be difficult in prudent Northern Europe but attitudes on public debt are starting to shift in Germany and the Netherlands. Despite the optimism, Greece's fate will, as always be steered by its creditors in Brussels.

Trump Curbs Iran

Donald Trump wants to curb Iran. He may have deterred conventional attacks, but goaded Iran to build a bomb faster. Ultimately, it may be Iran's feeble economy that prevents an escalation.

The Islamic Republic is a big player in regional geopolitics, but its economy is weak, its people in revolt and its enemies growing bolder. In 2017, the last year for which it has published final figures, the World Bank put Iran's GDP at $448bn, making its economy the second biggest in the Middle East and North Africa (after Saudi Arabia). It is also the second biggest country in the region in terms of population (after Egypt) with about 83 million people. Iran's GDP is about the size of Thailand's, Venezuela's or Austria's. But in terms of GDP per head (about $5,400) it's less well off: Iran's population is around ten million more than Thailand, 50 million more than Venezuela and ten times as many as Austria.

Iran has a well-educated population and it scores highly on many global development indicators. But compared with similar largeish countries in the wider region, Iran is notably poorer.

Turkey has about the same size population as Iran, but GDP per head is twice as big. Saudi Arabia's population (about 33 million) is less than half the size of Iran's, but its GDP per person is about four times as big. And although it currently dominates Iraq politically, Iran is only level-pegging with it in terms of GDP per person.

Broadly speaking, Iran is relatively rich (in terms of GDP per head) compared with Egypt and other North African countries, or compared with its eastern neighbours Pakistan and Afghanistan. But it is quite a bit poorer than Lebanon, much poorer than Saudi Arabia, and massively poorer than, say, the UAE or Israel.

Oil was first discovered in Persia in 1908, and since the 1950s Iran has emerged as a hydrocarbon superpower, with around 10% of the world's proven oil reserves and 15% of gas reserves (according to US official estimates). Other sizeable sectors are agriculture and services, plus manufacturing and finance, with a high degree of state ownership and control (both direct and indirect via a web of religious foundations known as bonyads).

Oil and gas are not just vital to the economy, accounting for the vast bulk of exports, they also account for the overwhelming bulk of government income – a dependency that makes the country vulnerable. Iran's economy picked up strongly following its 2015 nuclear accord with global powers. But since Donald Trump pulled the US out of the deal and reimposed sanctions in mid-2018, the economy has tanked.

Sales of crude oil have fallen from 2.8 million barrels a day to less than 500,000, gutting the country's foreign-exchange earnings and driving up prices of staple goods. Inflation has soared to around 50%. Food prices have doubled in the past two years.

The value of Iran's currency, the rial, has plunged by around 60%. Since mid-2018 Iran's central bank has stopped publishing macroeconomic data, but the IMF estimates that GDP shrank by 9% in 2019, following a contraction of almost 5% in 2018. People are leaving the cities in search of a cheaper life in smaller towns. And crime is soaring, fuelling popular anger and a sense of national crisis.

The government is desperately trying to stabilise the economy and keep the government finances more or less afloat. President Rouhani has vowed that Iran can withstand the "great psychological, political and economic warfare" he believes is being waged on the Islamic republic by the US, and has announced a range of measures aimed at doing just that.

In essence, Tehran plans to muddle through by cutting its reliance on oil exports, increasing taxes, borrowing more money (selling Islamic bonds in the domestic market), selling off some state-run companies and slashing subsidies on fuel. At best, it's a strategy that can only work for so long.

Iran's government says things began improving in the second half of 2019, and that the "storm" was passing. The rial has been back on an upward path, the Tehran stockmarket has been rising strongly, and there was a small increase in industrial production and agricultural output. Compared with the 2019 collapse in GDP, the IMF is forecasting zero growth in 2020, chiming with the government's claim to have got through the worst of the crippling effect of sanctions.

However, the situation in Iran remains highly volatile. In November, the government's move to slash fuel subsidies – in effect raising petrol prices by 50% overnight and drastically limiting the quantity available for purchase at subsidised rates – sparked the worst civil unrest since the 1979 revolution, and a ruthlessly brutal security crackdown in which hundreds were killed.

In the past, the theocratic Iranian state has proved resilient in the face of popular anger. This time, nothing is guaranteed, and much depends on how the geopolitics unfolds from here and how this affects the economy.

In terms of geopolitics, Iran is looking extremely vulnerable, despite its strong relationship with China, its biggest trade partner. Whether you believe the US was reckless and provocative – or just ruthlessly opportunistic – in eliminating the Iranian general Qasem Soleimani, what made President Trump's action possible is a crucial new economic reality. Four months ago, in September 2019, the US became a net exporter of oil for the first time since the 1940s. That's a dramatic and defining moment for the Middle East and the Gulf. As of now, higher oil prices are a net positive for the US economy. That means Washington has been granted armour that deflects what was once a favourite economic weapon in Tehran – oil price shocks.

US energy self-sufficiency marks the start of new geopolitical era, and for Iran the killing of Soleimani could be merely its opening salvo.

Property in the Doldrums

House prices barely rose in 2019. The average house cost £211,966 in January and £215,734 in November, according to figures from Halifax. That's a gain of just 1.8%. London, which during upswings often outperforms the rest of the country, is now underperforming it. By October the average cost of a house in the capital had slipped by 1.6% year-on-year to £472,232, says the Land Registry.

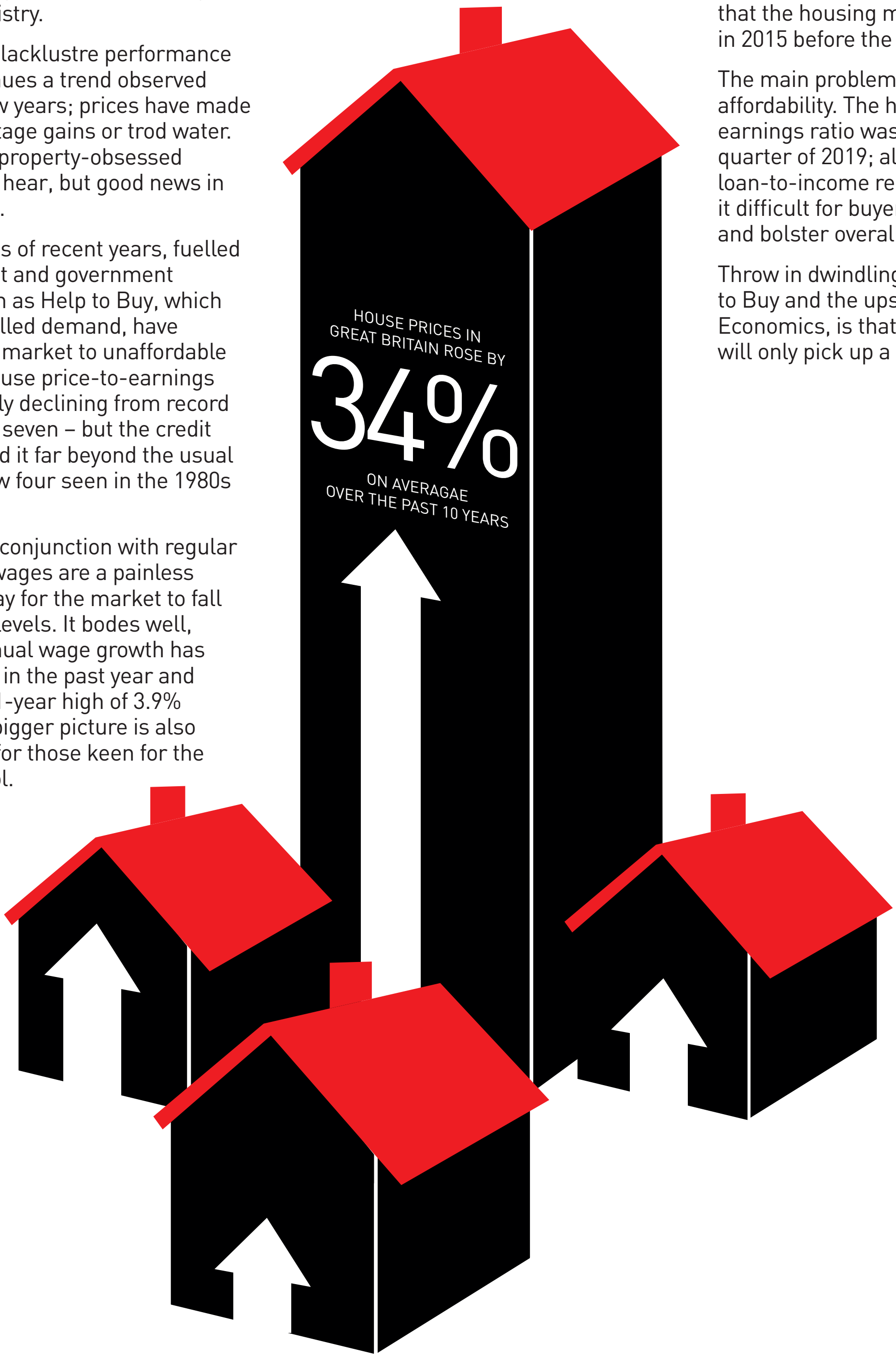
The market's lacklustre performance in 2019 continues a trend observed in the past few years; prices have made small percentage gains or trod water. Not what the property-obsessed British like to hear, but good news in the long term.

The price rises of recent years, fuelled by loose credit and government tinkering such as Help to Buy, which artificially fuelled demand, have propelled the market to unaffordable levels. The house price-to-earnings ratio is steadily declining from record peaks of over seven – but the credit bubble pushed it far beyond the usual levels of below four seen in the 1980s and 1990s.

Flat prices in conjunction with regular increases in wages are a painless and steady way for the market to fall to affordable levels. It bodes well, then, that annual wage growth has strengthened in the past year and reached an 11-year high of 3.9% in June. The bigger picture is also encouraging for those keen for the market to cool.

House prices in Great Britain rose by 34% on average in the past ten years.

But once the figures are adjusted for inflation, they have fallen 0.3%, according to a Savills report using Nationwide data. The subdued 2010s followed a 67.1% real-terms increase in the 2000s and a 13.9% slide in the 1990s.



There has been widespread talk of a 'Boris bounce' for the property market as well as for shares. There is now certainty over the UK's departure from the EU and a clear majority in Parliament reduces political uncertainty. However, the removal of some Brexit-related uncertainty doesn't necessarily mean that the market will rocket. It is worth knowing that the housing market began to slow in 2015 before the referendum.

The main problem remains affordability. The house price-to-earnings ratio was still 6.8 in the third quarter of 2019; along with mortgage loan-to-income restrictions, this makes it difficult for buyers to muster deposits and bolster overall prices.

Throw in dwindling support from Help to Buy and the upshot, reckons Capital Economics, is that house-price growth will only pick up a little next year.

Is the Dollar doomed?

A puzzle is preoccupying the world's currency dealing rooms. The global economy is beset by tariff wars and political instability, yet we are living through unusually low foreign-exchange volatility. The US dollar has not had a weekly swing of more than 2% against other developed-market currencies for two years. The last time this happened was in the mid-1970s. A market truism is that "financial stability generates instability". This period of curious tranquillity might portend a new long-term trend: the arrival of a weaker US dollar.

High-yielding American bonds and modish technology stocks have made dollar assets the go-to place for global savers in recent years. The world's reserve currency has been riding high relative to others since 2015. Yet the scales are tilting. Talk of a synchronised pick-up in global growth this year should prompt investors to move money out of expensive US assets to places where stocks and bonds are cheaper, particularly in emerging markets. The dollar's stint at the top of the currency pile is looking tired.

The Federal Reserve is back in easing mode. A US-China trade truce could stoke risk appetite and encourage investors to venture out of dollar assets. In America, the bursting of the start-up 'unicorn bubble' and talk of a left-wing Democratic presidential candidate are also bearish for the greenback. A weaker dollar would be good news for the world economy. It would mean cheaper financing costs for companies in emerging markets. It would also help US exporters and boost corporate earnings.

There are more alarming reasons to believe that a weaker dollar is coming. The US federal deficit recently rose above $1trn for the first time since 2013, and that doesn't include America's mountain of unfunded pension liabilities. At this rate, we could spend the latter part of the 2020s going through a kind of worldwide bankruptcy. Politicians will never raise taxes or cut spending enough to close the gap, so the Federal Reserve is likely to find a convenient excuse to fire up the printing presses in a process known as 'debt monetisation'. That could rapidly undermine confidence in the global dollar-based currency regime. Consider slowly increasing your allocation to physical gold. Don't think of it as an investment so much as central bank 'insurance'.

'De-dollarisation' is already afoot. China is doing more business in euros and recently issued euro-denominated bonds. De-globalisation is upon us and history shows that asset-price falls in the country associated with the 'old order' usually follow.

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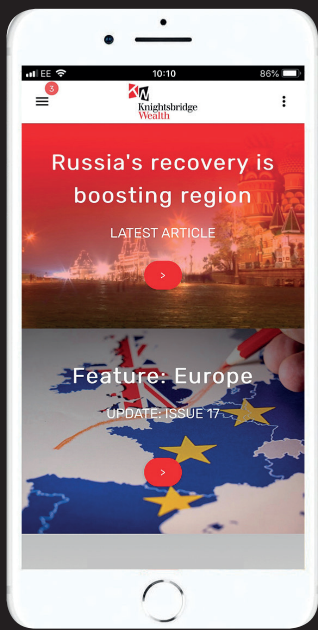

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Alexander Wade

Alexander is one of the most experienced London advisers in the international market, specialising in this field over the last 20 years at HSBC, consistently recognised as one of its most accomplished advisers. He has over 24 years' experience in financial services. He is particularly interested in the Middle East market and understands the specific issues which are relevant there.

Stuart Poonawala

Stuart has worked in financial services since 1998. In 2003, he helped to found HSBC's specialist London arm advising international clients which quickly became one of the bank's most successful UK divisions. In 2009, he launched Kubera Wealth, our sister company, focussing on providing quality advice to the UK market.

Graeme Cowie

Graeme is responsible for building our professional connections with international lawyers and accountants, as well as co-ordinating our relationship with key fund managers at a number of international Private Banks and Discretionary Fund Managers. He has spent over 20 years in financial services and investment management, most recently spending more than six years at UBS where he led the Strategic Partnership team.

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