INVESTMENT VIEWS

FEBRUARY 2018

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EQUITIES	:	The best January since 1987 then......
BONDS	:	Yields push higher as inflation concerns mount
CURRENCIES	:	"Team Trump" talk the US dollar lower
COMMODITIES	:	A soft dollar supports metals as agri prices firm up

After Trump's Christmas tax cuts, equity markets focused on the potential one-off fillip to 2018 US corporate profits and the growth impetus from this late cycle stimulus. Bullish investors forecast an acceleration of 2017's globally synchronised growth; they predicted an end to the post-crisis, sub-par muddle through. Inflation would rise, but growth would rise more. Resurgent economies would cast off the economic shackles of vast accumulated debts. The S&P500 had its best start to a year since 1987, adding 6%.

Bond markets took a different view. They focused on inflation. Trump's fiscal largesse would stimulate an economy that is running near full capacity. With US unemployment at 4.1%, American companies would struggle to increase output. Increased demand would thus be met by inflation. Indeed, the markets' prediction of future inflation began to stir. By comparing the yield on normal treasuries and their inflation-linked equivalents, the 5 year forecast for inflation has risen to 2.2% from a low of 1.9% in December.

This put pressure on US Government bonds. Having touched 2% in September, the yield on a 10 year treasury ended 2017 at 2.4%. With inflation expectations heading north of the Federal Reserve's 2% target, yields climbed further. Importantly, in mid-January, the 10 year treasury yield rose above 2.63%. This arguably ended a bond market rally that started in 1981; back then, inflation was 13% and a benchmark treasury yielded 16% pa. Treasury yields broke their downward trend and quickly moved higher, touching 2.85%.

This all unfolded in an orderly way until a 2nd of February US employment report that showed healthy job creation. More importantly, it also revealed that average hourly earnings increased at an annualised rate of 2.9%; the best gain since 2009.

This spooked (increasingly correlated) global markets as the prospect of rapidly rising wages suggested a more hawkish Fed, forced to accelerate its rate hikes to control resurgent inflation. For a world that is heavily indebted, the prospect of rapid rate rises and higher bond yields served to unsettle. To illustrate the point, the US 30 year mortgage rate spiked from 3.85% to 4.3% in January, surpassing the 2015 rate that precipitated an abrupt slowdown in US housing activity. For equity markets, the result was electrifying. Global equity markets tumbled, with the Nikkei registering an intraday fall of 7%; the US market gave up all its 2018 gains and more.

Of course, this could be viewed as a sagacious, if unsettling, outcome. Froth is being blown off over-exuberant equity markets and bond yields, artificially suppressed by years of QE, are reconnecting to economic reality. Indeed, even though yields have risen and equities have slumped, they have only (at the time of writing) given back a modest part of recent gains.

The problem is that the technical excesses that have accumulated over the last few years are now being laid bare; the pace of the moves, as well as the magnitude, is exposing frailties. As we noted in the lead article last month:

"…with many asset markets over-valued we are conscious that they could easily roil, if one of the "known unknowns" disturbs the current market calm and volatility surges. Interestingly, the cause of the disturbance is less important so long as it engenders rising market volatility. If this happens, the geared investment algorithms, that used low volatility as a pretext to buy, would rapidly become equally dispassionate and aggressive sellers."

After such an extended period of rising markets and low volatility, the scale of bets on this enduring have swollen to epic proportions. The rise in VIX is thus a concern. VIX is a measure of expected equity market volatility. It has skyrocketed; from a January low of 10, the index touched 50 during the 6th February trading day, the highest in 10 years. All the strategies that rely on a low VIX and an undisturbed trend are being tested; several to destruction. Many ETFs that provide returns that are the inverse of VIX (ie. they fall when VIX rises) look set to fold; some of the futures contracts that underpin these funds have clauses that make them worthless if their value falls by 80%.

For all this detail, the key question is obvious; do we buy the dip? This is particularly relevant given our enduring caution of the last year or so. At this time, the sell-off seems to be a healthy correction after a speculative run up. Markets remain orderly. Government bonds are bid and the yield premium on lesser quality debt (the spread) remains low; a 10 year BBB-rated US corporate bond still offers less than 1.25% more than the equivalent treasury, close to a decade low. For now, the equity market malaise is not spreading, even if technical factors make the pullback sharper and extend the period of correction.

The reality is that, for now, global growth continues to improve and inflation, though rising, remains low by historic standards. If this endures, rates will rise but not by a huge amount. Fear will subside. Equities that benefit from reflation will rally. Japan, which was cheap even before the correction, is a prime example. However, if evidence of rising wages and inflation continues to mount, market participants will factor in additional rate rises to rein in resurgent prices. Bond yields will resume their upward march, the yield spread on lesser quality debt will widen and equities will struggle. Talk of a 2019 recession will grow.

For now, caution remains the watch word. That said technically-driven selling could throw up opportunities to buy assets on our "shopping list" at compelling valuations; we remain buyers at the right price.

IN OTHER NEWS…

Gary Oldman turns in an Oscar worthy performance as Churchill in the World War 2 movie "Darkest Hour". Even though the Chairman has his reservations, we'd encourage you to go and see it. To whet the appetite, a few quotes from the great man.

"A lie gets halfway around the world before the truth has a chance to get its pants on."
"Life is fraught with opportunities to keep your mouth shut!"
"We contend that for a nation to try and tax itself to prosperity is like a man standing in a bucket and trying to lift himself up by the handle."

And some advice for UK Brexit negotiators as they cross swords with their EU counterparts:
"Diplomacy is the art of telling people to go to hell in such a way that they ask for directions."

EQUITIES

Has the Trump Administration weaponised the US dollar? Whilst in Davos, US Treasury Secretary Steven Mnuchin declared "a weaker dollar is good for us", accelerating the slide of the greenback. Already buoyed by the pre-Christmas US tax cuts, equity markets reacted favourably, especially emerging markets, some of which are heavily reliant on US dollar borrowing. The S&P 500 gained 6% during January whilst the technology heavy Nasdaq added 7%. Even a brief three day government shutdown, as immigration policy differences derailed a funding agreement, was not enough to dent investor euphoria. Indeed, US retail investors are opening new stock-broking accounts at a furious pace, with passive funds and ETFs attracting a large portion of the inflows. In the US, State Street's giant S&P 500 ETF celebrated its 25th birthday by passing $300 billion in assets.

As noted above, emerging markets fared well this month. The MSCI EM index gained 7%, led higher by Brazil and Russia which were up 11%. In Brazil, an appeal court upheld the money laundering and corruption convictions of former President Lula. Although there remains talk of an appeal, given Lula's socialist agenda, the stock market and currency responded positively to the news. As the US dollar broke a key support level, mid-month, we added to our EM equity exposure across client mandates.

The UK stock market fared poorly by comparison; the FTSE 100 index lost 2%. Dominated by exporters, the index struggled against the headwind of a much firmer domestic currency. Sterling gained 5% against the dollar this month. Even the more domestically focused mid-cap FTSE 250 index lost 2%. Notably, construction firm Carillion collapsed under £1.5bn of debt, after it wrote down the value of several large contracts. The company is now in the hands of the liquidators, threatening the livelihoods of its 40,000 staff. It is a timely reminder of the vulnerability of over-leveraged balance sheets. As the Hemingway quote goes: "How did you go bankrupt?", "Two ways; gradually then suddenly".

Across the channel, European markets fared better. The German DAX gained 2% despite continued uncertainty over the make-up of the coalition government. After four months of political bargaining, a grand coalition between Merkel's CDU and the Social Democrats (SPD) still looks the most likely result. Peripheral markets such as Spain, Italy and Greece produced even better returns: the latter was up nearly 10% as a positive review of reforms paved the way for another €6.7bn of bailout funds.

BONDS

January saw bonds battered, as prices fell and yields moved higher. Prompted by signs of inflation and the mildly hawkish tone of Janet Yellen's valedictory meeting at the Federal Reserve, the 10 year treasury yield added 0.3% to end January at 2.7%. In doing so it broke a generational downtrend in yields, that started in 1981. Several bond market doyens were quick to call time on the 35 year bond bull market. To us, it is too early to tell if bond yields have found a multi-year low. However, if yields continue to rise apace and the spread on corporate debt widens, we may finally find out if the world can afford higher rates on its prodigious stock of debt.

UK GDP growth came in at 0.5% for the fourth quarter; the economy grew by 1.8% in 2017, slightly down from 1.9% in 2016 and the slowest pace since 2012. The Office for National Statistics (ONS) observed that domestic consumer facing businesses (such as retail and hospitality) were particularly weak; hardly a surprise when inflation continues to exceed wage growth.

UK Government bonds followed their American counterparts. The yield on 10 year Gilts rose to 1.5% from 1.2% in January; this remains a negative real yield given inflation (CPI) of 3% pa. Although sterling's recent recovery should have a dampening effect on inflation, the recent rise in oil prices will somewhat offset this. As the ONS noted, "it remains too early to say" whether inflation has peaked. Indeed, the RPI rate of inflation, that underpins the return from inflation-linked Gilts, increased to 4.1% from 3.9%. We continue to favour inflation-linked bonds over straight issues.

In Europe, fourth quarter GDP grew at 0.6%, a firm print that allowed the Central Bank to start moderating QE. The ECB reduced its bond purchases from €60bn to €30bn a month during January, in line with its stated aims. Money supply growth is still likely to be positive but should reduce from 5% to 2% pa all else being equal (source: MacroStrategy). German 10 year bonds retreated, with the yield rising from 0.4% to 0.7% pa; the same issues offered -0.2% pa in the summer of 2016.

In emerging markets, ratings agency Standard & Poor's cut Brazil's credit rating to BB- from BB, three notches below investment grade; they cited less timely and effective policymaking. Whilst we sympathise with these political concerns, the downgrade fails to acknowledge positive economic news. The 2017 current account deficit was the lowest in a decade whilst foreign direct investment was over $70bn. CPI inflation came in at 2.95%, down from 6.29% a year ago and below the official target of 4.5% ± 1.5%. Many local currency emerging market bonds continue to offer highly attractive real rates of interest, in stark contrast to developed market bonds and dollar denominated EM debt.

CURRENCIES

As we discussed above, the weakness of the US dollar has been the most important factor in currency markets this year. The trade weighted dollar fell by another 3% in January and is now 14% lower than its December 2016 high. In addition to Secretary Mnuchin's comments at Davos, Commerce Secretary Wilbur Ross noted that "there have always been trade wars. The difference is the US troops are now coming to the ramparts". The first estimate for US GDP growth for the fourth quarter came in at 2.6%, bringing full year growth to 2.5%. Although a solid outcome, accelerating growth elsewhere has encouraged dollar investors to rotate into non-US opportunities; this lessens the demand for dollars. The Treasury Borrowing Advisory Committee estimated the Treasury would need to borrow net $955bn in the fiscal year ending September 30th, up 84% on the prior year (source: MacroStrategy). It would then rise above

$1tr in fiscal 2019 and $1.1tr in 2020. Trump's unfunded tax cuts will further endanger the health of US finances, absent a dramatic pick-up in domestic economic activity and productivity.

In the UK, sterling's 2017 recovery continued into the New Year. It gained 5% against the US dollar and 2% against the euro, finishing January at $1.42/€1.14 respectively. Though noisy Brexit negotiations grab the headlines, the underlying economic reality is of more import. In one FT annual survey almost a fifth of respondents predicted no further interest rate rise this year, whilst two fifths of people expected an increase of at least 0.5%. With inflation stubbornly elevated but growth slowing, rate expectations are diverging. To us, without real wage growth, we expect low nominal and real rates to prevail given the heavily indebted profile of the UK consumer. This suggests that the bulk of sterling strength may now be behind us. Other major currencies also rallied against the US dollar, with the euro and yen both up 3% this month. The ECB hinted that it may end, rather than taper, bond purchases after September if inflation and economic growth continue to improve.

The renminbi (RMB) also bested the dollar, gaining 3% to trade at RMB6.3 by the end of January. The currency is now approaching the level that previously prompted the PBoC to devalue in 2015. This is primarily US dollar weakness rather than RMB strength; indeed the wider RMB currency basket has risen far less, making an unsettling intervention less likely. In related news, Germany's Bundesbank announced that it will include the Chinese currency in its FX reserves, giving a further boost to the internationalisation of the RMB.

Emerging market currencies fared especially well as the dollar slumped and the reflation trade gained traction. The Mexican Peso gained 6% against the dollar, despite ongoing rumblings about NAFTA re-negotiation by the Trump administration. The Brazilian Real and South African Rand both gained 4%, whilst the Russian Rouble put on 3%. Even the Turkish Lira managed to firm up. Bucking the trend, one of the weakest EM currencies this month was the Indian Rupee. It was flat against the dollar on budget deficit worries. As expected, Modi's administration announced a budget with several populist measures designed to boost his party's popularity amongst poor rural voters. A general election is due in May 2019. We continue to view India as a secular growth story and would welcome a cheaper currency and stock market, as an opportunity to build exposures.

GOLD/COMMODITIES

Broad based US dollar weakness was a tailwind for most commodity prices this month, as it has been for the past year. The price of oil touched a three year high as robust demand offset surging US production. US WTI prices rose by $4 per barrel to $65, whilst European Brent prices were up $3 to $69. US crude oil production is now approaching 10m barrels per day, just shy of Saudi Arabia and Russian output (source: EIA). The overhang of supply which has kept a lid on prices is starting to diminish. Inventories at Cushing, Oklahoma have fallen by nearly half from 69m to 37m barrels. Global oil production has also been eroded by collapsing output from Venezuela; production at state-owned Petroleos de Venezuela fell to 1.7m barrels per day in December, a 28-year low. With the IMF predicting inflation of 13,000% this year, relief looks someway off.

Precious metals performed well in January. Gold was up 3% to $1,345 whilst Silver added 2%. Gold miner Randgold Resources reported increased production for the seventh year in a row and doubled its dividend to investors. Gold mining shares have been left behind by this equity bull market and the recent uptick in bullion; they look increasing attractive. Company management are running more disciplined, conservative balance sheets as the industry has been starved of capital for a number of years. This is good for profitability and cash generation and suggests profits are increasingly geared to the bullion price. In our growth mandates we have been adding exposure to gold mining shares this month. In more conservative portfolios we continue to favour bullion.

Base metal prices were a mixed bag. Evidence of a globally synchronised expansion continues to mount, with Chinese growth holding up well. The latest China manufacturing PMI of 51.3 remained in expansionary territory, albeit at a slightly lower rate than December's reading of 51.6. With signs of less productive capacity being shuttered, zinc and nickel prices were up by 7% this month. Copper and aluminium prices fell by 2%, pausing after a strong run.

Grain prices enjoyed a positive month with corn, soybean and wheat prices all rising by at least 3%. Whilst global inventories remain high by historical standards, short sellers reduced their bets last month as drought conditions expand in Argentina and the US Great Plains. Conversely, sugar prices were soft, falling 13%; they are 37% down from an October 2016 peak. EU production and export restrictions are being lifted as part of Common Agricultural Policy reforms. As a result, EU production is expected to grow from 16m tons to 20m tons this year, the first of liberalisation, with exports up by 2m tons.

POLICY SUMMARY MATRIX

The matrix set out below is a summary of our current policy stance on the various equity and bond markets which we monitor. It is not intended as anything other than a guide on where we stand and we will change the content as our views alter. Cash exposure is a residual and will tend to be high when negatives outweigh positives and vice versa.

6-12 Month View	OVERALL	EQUITIES	BONDS	ALTERNATIVES
+	ALTERNATIVES	Asia Latin America	Inflation Linked Emerging Market	Uncorrelated Strategies, Gold
O		UK, European Japanese Australian High Yield Healthcare Resources	US, Australian	
–	EQUITIES BONDS	US, Technology	UK, European Japanese Corporate High Yield	

MARKET PERFORMANCE

All performance numbers show % changes except for bond yields which show yield changes.

	31-JAN-18	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.4191	+5.0%	+6.8%	+12.8%
CHF	1.0738	+4.6%	+7.1%	+6.2%
AUD	0.8055	+3.2%	+5.2%	+6.2%
JPY	109.19	+3.2%	+4.1%	+3.3%
EUR	1.2414	+3.4%	+6.6%	+15.0%
BOND YIELDS (10 yr)				
UK	1.51	+0.32	+0.18	+0.10
US	2.71	+0.30	+0.33	+0.25
Germany	0.70	+0.27	+0.33	+0.26
Australia	2.81	+0.18	+0.14	+0.10
Japan	0.08	+0.04	+0.02	+0.00
EQUITIES				
US. S&P 500 (USD)	2,823.81	+5.6%	+9.7%	+23.9%
UK. FTSE 100 (GBP)	7,533.55	-2.0%	+0.5%	+6.1%
MSCI Europe ex UK (EUR)	1,375.31	+2.2%	-0.2%	+14.0%
Japan. Topix (JPY)	1,836.71	+1.1%	+4.0%	+20.7%
China. Shanghai Comp (RMB)	3,480.83	+5.3%	+2.6%	+10.2%
HK. Hang Seng (HKD)	32,887.27	+9.9%	+16.4%	+40.8%
Australia. All Ords (AUD)	6,146.47	-0.3%	+2.8%	+8.3%
MSCI Pacific ex Japan (USD)	1,475.49	+3.8%	+8.9%	+19.1%
MSCI World (USD)	2,213.24	+5.2%	+8.7%	+23.5%
MSCI World (GBP)	1,560.38	+0.3%	+1.7%	+9.4%
COMMODITIES				
Oil (WTI)	64.73	+7.1%	+18.3%	+16.7%
Gold	1,345.15	+3.2%	+5.8%	+11.1%

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