BENTLEY REID

INVESTMENT VIEWS

MARCH 2018

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EQUITIES	:	Volatility returns pushing indices sharply lower
BONDS	:	Firm US wage data pushes bond yields higher
CURRENCIES	:	The US dollar and Yen are bid as equities roil
COMMODITIES	:	Rising rates undermine bullion as oil falls back

In 2015 global growth slowed as inflation slumped. US, UK and EU CPI touched zero. The global deflation sirens sounded. In hindsight the major culprit was a sharp slowdown in China, masked by massaged economic data. It scared the authorities into action. As we have noted before, the Chinese injected various forms of stimulus into their economy, equivalent to 25% of GDP; during the financial crisis the equivalent figure was 14%. At the same time, major Central Banks remained firmly committed to their expansionary QE policies and the oil price fell from $90 to $40 a barrel by January 2016. The world experienced “peak stimulus”.

Fast forward 18 months and it is unsurprising (in hindsight!) that this generated an uptick in global growth, from sub-par to average, with inflation rising towards target levels. Talk of incipient deflation has been replaced by nervous whispers of unruly inflation.

If we strip away the noise, so far we have seen a fairly orderly reaction in asset markets. US bonds have priced in modestly higher inflation, with 10 year Treasury yields doubling to 2.8%; real yields have actually fallen as inflation has risen faster, helping to explain the softer US dollar. This has shaken out some of the obvious excess in equity markets, as the prop of cheap money begins to be withdrawn. The question is what happens next?

The obvious observation is that the backdrop is less supportive. Major Central Banks, having increased their balance sheets by a combined US$3.8trn in 2016/17, are set to reduce their net asset purchases to near zero in 2018, with plans to drain about US$500bn from the system in 2019/20 (source: Central Banks and JPMorgan). Base rates are rising in the US and UK with both the ECB and Bank of Japan now openly discussing their path to monetary policy normalisation. As for China, post the 19th Party Congress, policy has re-focused on removing unproductive capacity, environmental concerns and reining in excessive credit creation; growth at any cost is no longer the party line. Finally, oil has risen over 50% from its 2017 low, an effective tax on economic activity.

All of the above argues against the more gung-ho 2018 growth projections favoured by some. It also creates some doubt over the accompanying earnings estimates. Though we do not see a precipitous slowdown, as we consider some slightly softer economic data during February, including a 19 month low in the Chinese Manufacturing PMI, we have sympathy for the more sanguine forecasts. Indeed, rate sensitive sectors argue for cool heads as base rates and bond yields rise. For example, applications to refinance home loans in the US fell 10% year on year during February, after the average 30 year mortgage rate rose from 3.8% to 4.3% over the last 3 months.

This more considered view of future growth does not rule out higher inflation. As we already noted, the oil price has risen sharply and various lead indicators, including US corporate compensation surveys, suggest that wages could continue to rise as we head through 2018. Indeed, with Trump's tax cuts and spending plans set to push the budget deficit over 5% of GDP by 2019 (source: Goldman Sachs), inflation pressures should mount. The US is arguably running close to full capacity with unemployment at 4%. As such, any fiscally induced increase in aggregate demand will probably be met by inflation and imports rather than a dramatic increase in domestic supply.

This is what has spooked markets. Investors are starting to anticipate much higher inflation later this year as the fiscal flood washes through the system. If this comes to pass, there is a sense that the US Federal Reserve could get (or is already) "behind the curve" with inflation rising faster than rates. Rising bond yields and inflation would erode margins and force equity valuations to reconnect with economic reality.

Indeed, one suspects that many Central Banks would like to see inflation modestly above target. After such a long period of depressed inflation, it would help dispel any whiff of a Japan-like deflationary mindset and would erode the real value of the vast accumulated debts (a form of stealth default). Finally, it would help repair the chronic underfunding of many pension schemes, a huge and growing problem for many countries and their ageing populations. Higher inflation would push bond yields up; this, in turn, reduces the present cost of future benefit liabilities as they are discounted back at a higher rate or factor.

Of course, the Federal Reserve may draw on the Volker play book and try to "get ahead" of the curve, raising rates aggressively if inflation starts to build. It might also achieve the same accidentally if it over-estimates inflation, lifting rates too far, too fast. If it did, one could expect rising real rates to choke off growth and general price inflation, with a wave of debt defaults pushing the US and the world into a sharp contraction. The US dollar would rise sharply.

For the very reason that this 1930s narrative seems so unpalatable, we firmly believe that Central Banks will favour a period of "above target" inflation and will adjust policy to support that outcome. Mindful of their record to date, with a near decade of sub-par growth and inflation, their success is not a given and the risk of policy error is high.

With asset prices as elevated as the economic uncertainty, the aggressive pursuit of risk remains unwise. We are finally seeing QE fuelled complacency challenged as record asset valuations digest the withdrawal of Central Bank support. Volatility is back. Our defensive asset allocation has worked well for client portfolios this year; we see no urgency to change tack.

IN OTHER NEWS…

A friend from the US recently came to stay. A generous type, he bore gifts of a decent bottle of red and a book of "Usefully Useless" facts. The wine is long gone and the book awaits his return in the guest bathroom. We share a few mathematical curios from its pages…

To add the numbers from 1 to 10, simply divide the 10 by 2 and then write the answer twice = 55. This works for 1-100, 1-1,000, 1-10,000 and so on.

'Forty' is the only number that has all its letters in alphabetical order. 'One' is the only number with its letters in reverse alphabetical order.

1/1089 = 0.0009182736455463728 1…the numbers in the 9 times table are 9, 18, 27, 36…

19 = (1x9) + 1 + 9 and 29 = (2 x 9) + 2 + 9. The same goes for 39, 49, 59, 79, 89 & 99.

EQUITIES

February saw the MSCI World index finish 4% lower in dollar terms, with US equity market volatility experiencing a record surge, albeit from a low base. The VIX (a measure of expected market volatility) touched 50 during 6th February trading, a 5 fold increase. The index spent most of 2017 oscillating in a 10 to 15 range.

As we have noted before, last year's rally was unusually calm; by the end of January the S&P 500 index had gone 112 trading days without a 1% fall, the longest run in 3 decades. However, on 2nd February a strong US jobs number and the fastest wage growth since mid-2009 (2.9% y/y) prompted investors to price in a more aggressive rate-tightening cycle. The resultant higher bond yields acted as a brake on risk assets. The late January pullback morphed into the sharpest correction since 2016.

It is not unusual for Central Bank tightening to weigh on equity markets and, despite the subsequent rebound, the return of volatility often presages the top of an equity bull market. As Zero Hedge notes, 9 of the past 11 periods of rate tightening have subsequently resulted in recession as the removal of liquidity depresses activity.

Buoyed by steady economic data, the Federal Reserve is expected to raise the cost of borrowing 3-4 times this year under the guidance of the new Chairman, Jerome Powell. He spoke little during his first month in charge, possibly scarred by the 4% slump in the S&P500 during his first day in the job. From his initial comments he sounds committed to the established policy path. In his first Congressional testimony he was happy to talk up the "bullish" economic outlook and, in contrast to his predecessor, indicated he is willing to tolerate a degree of asset market volatility on the path to monetary normalisation.

As well as the rate hikes, the Fed remains committed to reducing its stock of bond holdings, purchased as part of QE; in January it cut U$18bn of US Treasuries, U$6bn more than planned. It is no coincidence that risk assets are wobbling as the Central Banks start to reverse a decade's worth of ultra-loose monetary support.

US and Chinese stocks were amongst the worst performers during the sell-off, but rallied firmly from their mid-month lows. The S&P 500 index fell by 4% overall, but the tech-based NASDAQ declined by just 2%. Surprisingly, expensive "growth" stocks outperformed despite cheaper "value" cyclicals benefiting most from the economic upturn. The MSCI World Energy sector slumped 10% last month with the Materials sub-index (miners, chemicals, construction & the like) down 6%.

The Q4 earnings season has been supportive with aggregate profits growth of 15% over the year. Just as importantly, 2018 profit forecasts are being raised across the board, with the breadth of revisions being the strongest since 2010. Interestingly, Apple and Google, two dominant drivers of the S&P 500's recent returns, both fell short of earnings expectations with a sharp decline in global smartphone shipments a notable factor. It seems that (iPhone) X does not necessarily mark the spot!

The 12% peak-to-trough drop in the Shanghai Composite was likely amplified by Chinese New Year disruption; the bulk of the fall came in the week before the break. The post-holiday rebound coincided with activity from the China Securities Regulatory Commission; this "plunge protection" team also stepped in during the 2015 market crash. This time around the remedial measures included more than 300 companies being forced to suspend share trading and all investors being warned against placing significant sell orders. The index finished the month 6% lower with HK 'H' shares falling by almost 9%.

Most other emerging markets held up relatively well, supported by huge capital inflows; foreign investors pumped U$30bn into emerging market assets (mostly in Asia), split evenly between equities and bonds. Such strong EM flows can often prove flighty if sentiment turns; a reality we are live to given our ongoing exposures. However, in this instance, most EM indices performed in line with their developed market counterparts.

One laggard was the Indian Sensex. It fell back 7% during the global sell-off but has so far struggled to rebound. The government's recent imposition of a capital gains tax on stocks and bonds held for more than 1-year is unhelpful as is the revelation of a U$1.8bn fraud at one of the country's largest state owned banks, Punjab National. Along with rising inflation, this challenged sentiment despite signs of accelerating economic growth.

UK stocks continue to lag with the FTSE 100's 4% monthly drop leaving it 5% lower for the year to date. Sterling's recovery to an early February peak of $1.43, alongside signs of economic weakness, have been headwinds. However, the currency has failed to hold above U$1.40 and looks increasingly vulnerable to a testy Brexit negotiation.

Across the channel, a softer euro could not help European share prices last month; the MSCI Europe ex-UK index also fell 4% despite German GDP growth of 2.9% y/y, the strongest in 6 years. Political noise, stemming from protracted German coalition talks and the upcoming Italian election, compounded investor nerves.

BONDS

The US budget was at the heart of a global bond sell-off with Trump's deficit-busting tax cuts and government spending plans fuelling renewed inflation and debt-servicing concerns. In early February, after months of short-term fixes, Congress approved a 2 year budget of spending "giveaways" that, combined with the recent tax reforms, are projected to push the country's net borrowing requirement to around U$1trn this fiscal year. "Tea party" fiscal hawks fell silent as looming mid-term polls prompted political pragmatism.

A deficit of this magnitude is unprecedented outside of recessions or times of war. With growth already trending higher and unemployment touching 4%, the possibility that fiscal largesse generates higher inflation and a marked increase in bond yields cannot be discounted. The 10 year Treasury yield finished the month 0.2% higher at 2.9%.

For lesser quality bonds, we are monitoring the credit markets intently as we feel wider spreads (the yield premium that corporates pay over sovereign issuers) could portend a more protracted period of equity market stress. Spreads held up well last month with the average US high yield premium staying around 3-3.5%; an historically low level. However, elevated corporate gearing cannot be ignored; Standard & Poors warned that 37% of global issuers are now "highly leveraged", meaning that their debt to earnings ratio exceeds 5 times. This compares to just 32% shortly before the 2008 financial crisis.

Emerging market debt would also be vulnerable to a prolonged spike in risk aversion, but performed steadily last month. Indian bonds sold off the most after the government announced a largely populist budget to help secure votes in next year's election. Spending on agriculture, education and healthcare will increase with the target 2017/18 deficit being revised from 3.2% to 3.5% of GDP; we suspect the outcome will be worse. Annual inflation has already climbed above 5% and the government's pork barrel politics raises the potential for higher inflation and rates; the 10 year Indian government bond now yields 7.7% compared to 6.4% a year ago.

UK short dated gilts (those with maturities of 5 years and less) saw yields rise consistently over the month, but the 10 year yield finished broadly where it began (around 1.5%). This "curve flattening", where short-term rates rise by more than longer-dated equivalents, reflects signs of mild "stagflation". Inflation is stuck around 3%, despite hopes that a stronger sterling would act as a dampener, whilst consumer led growth appears under pressure. VISA, the credit card provider that accounts for £1 of every £3 spent in the UK, said household spending fell in January for the first time in 5 years. High street and recreational spending were notably weak.

CURRENCIES

The "sticky" UK inflation backdrop is forcing the Bank of England (BoE) to talk up the potential for rate increases despite these signs of frail growth. The Central Bank last month signalled its target rate may "rise faster and harder" than previously forecast. We question their resolve, particularly if inflation pressures ease as the year-on-year effect of sterling's strength filters through. Governor Carney has shared his concerns about the economy's sensitivity to higher borrowing costs and Gavekal, a research firm, estimates 39% of all UK mortgages are still floating rate.

The BoE's hawkish tone kept sterling well bid for most of the month before a late pullback, borne of renewed Brexit doubts. It is pointless trying to parse the day to day noise emanating from Westminster and the EU Brexit combatants. February alone saw a Labour U-turn on a customs union, PM May enjoying a "unifying" Cabinet gathering at Chequers (shortly before Jacob Rees-Mogg threatened a coup) and the UK reject the European Commission's draft Brexit treaty. Though arguably cheap on a real effective exchange rate basis, at around $1.40 further sterling strength seems limited absent genuine Brexit progress or signs of a recovery in real growth rates.

The US dollar remained under pressure with the DXY trade-weighted basket appreciating by only 2% last month; its failure to rise meaningfully during the "risk off" phase evidences how seriously investors are taking the US's twin deficits. With both the trade and budget deficits set to increase sharply, the dollar looks vulnerable as we look out 6-12 months.

Indeed, the greenback's gain was almost exclusively borne of euro weakness; it makes up 57% of the DXY. The single currency fell 2% ahead of a critical period for European politics. On 4th March, the Italians go to the polls (again) with right-wing parties and Eurosceptics set for an improved showing. Though the '5 Star' movement is highly unlikely to gain a ruling majority, the fractured political scene makes an unsustainable grand coalition likely. The election looks like the start of, rather than an end to, recent political vacillation. On the same day the German SPD votes on the terms of their proposed coalition with Angela Merkel's CDU. The SPD's youth wing is campaigning against the deal, which could foster renewed political instability in Germany and the wider EU.

GOLD/COMMODITIES

The rising rate environment proved a drag on bullion. Over the last 6 months, 2 year US Treasury yields have risen by 1%, to 2.3%, giving "safe-haven" investors a credible, yield producing alternative. That said, US annual inflation is running at 2.1% and seems set to rise, making real yields somewhat less compelling. Gold is currently trading at U$1,318/oz after a 2% fall, but with markets now pricing in several more rate hikes, we believe gold exposure remains merited. If the Federal Reserve slows its rate rises (or reverses course) because of weaker growth and/or cooling inflation, bullion should be bid. Likewise, any upside inflation surprise, pushing real rates lower, should prove equally beneficial.

China's producer price inflation (PPI) eased to 4.3% in January, the lowest since November 2016. This comes despite the authorities shutting down 115mn tonnes of steel capacity in 2016/17 and allowing a record RMB 2.9trn of new loans in January. At face value this credit surge contradicts the government's plan to de-lever, but the data was distorted by banks shifting loans away from the shadow banking system and back onto their "official" balance sheets; the debts simply became visible. Total broad credit growth was the lowest in 31 months, tallying with a slowdown in other China growth indicators, including property prices and freight volumes. Chinese economic momentum remains critical, givens its role as a key driver of global growth and inflation metrics.

Oil prices fell 5% over the month. A muddied supply picture makes it difficult to judge just how tight the energy markets are. The return of shale output growth has taken US crude production to an all-time high of 10.25mbpd, making it a top 3 producer with Saudi Arabia and Russia. Offsetting this US expansion is continued supply discipline amongst OPEC members and a collapse in Venezuelan output; WTI is currently trading at U$62/barrel.

Finally, adverse weather conditions have been driving up soft commodity prices since the turn of the year. Bloomberg reports that Indian wheat imports are surging due to winter crop stress, whilst droughts in South America are supporting soybean prices. China/US trade rhetoric is also having an impact. President Trump told China its heavily subsidised grain is too cheap, whilst removing some related US subsidies. The recent US budget proposals reduce crop insurance subsidies, which incentivised domestic farmers to overproduce. Talk of steel and aluminium tariffs are also gaining credence, a move that would mark a dramatic escalation from rhetoric to action.

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.

	28-FEB-18	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.3760	-3.0%	+1.7%	+11.1%
CHF	1.0587	-1.4%	+4.1%	+6.5%
AUD	0.7762	-3.6%	+2.6%	+1.4%
JPY	106.68	+2.3%	+5.5%	+5.7%
EUR	1.2194	-1.8%	+2.4%	+15.3%
BOND YIELDS (10 yr)				
UK	1.50	-0.01	+0.17	+0.35
US	2.86	+0.16	+0.45	+0.47
Germany	0.65	-0.04	+0.29	+0.45
Australia	2.81	+0.00	+0.31	+0.09
Japan	0.05	-0.03	+0.01	+0.00
EQUITIES				
US. S&P 500 (USD)	2,713.83	-3.9%	+2.5%	+14.8%
UK. FTSE 100 (GBP)	7,231.91	-4.0%	-1.3%	-0.4%
MSCI Europe ex UK (EUR)	1,325.36	-3.6%	-2.1%	+7.1%
Japan. Topix (JPY)	1,768.24	-3.7%	-1.3%	+15.2%
China. Shanghai Comp (RMB)	3,259.41	-6.4%	-1.7%	+0.5%
HK. Hang Seng (HKD)	30,844.72	-6.2%	+5.7%	+29.9%
Australia. All Ords (AUD)	6,117.34	-0.5%	+1.0%	+6.2%
MSCI Pacific ex Japan (USD)	1,420.75	-3.7%	+3.6%	+11.7%
MSCI World (USD)	2,117.99	-4.3%	+2.0%	+15.2%
MSCI World (GBP)	1,536.45	-1.5%	-0.1%	+3.8%
COMMODITIES				
Oil (WTI)	61.64	-4.5%	+7.6%	+11.8%
Gold	1,318.38	-2.0%	+3.4%	+5.6%

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