BENTLEY REID

INVESTMENT VIEWS

MAY 2018

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EQUITIES	:	The S&P500 trails as world markets bounce off March lows
BONDS	:	10 year Treasury yield breaks 3% as RMB bonds rally
CURRENCIES	:	The US dollar recovers as the HK dollar hits a 35-year low
COMMODITIES	:	Middle East tension and trade spats push oil & metals higher

At a recent client gathering and in various email exchanges before and since, there seems to be a growing anxiety that Brexit negotiations are about to collapse. A subsequent ‘hard Brexit’ would catalyse a Tory party implosion (or vice versa), with the Downing Street coronation of Labour’s Jeremy Corbyn to follow. The obvious alarm at what this might mean is fed by sensational coverage of all-things Brexit by a media bereft of calm, considered reflection.

Whilst we do not belittle the possibility that this may come to pass, we do not share some of the more extreme fears. Why? It really breaks into three parts; European and UK politics and the British electoral arithmetic.

Starting with Europe, the last 18 months has seen the rise of far-right, Eurosceptic parties. The AfD in Germany; the PVV in the Netherlands; Le Pen’s NF in France; ‘5 Star’ and the League in Italy. Whilst none of these parties has gained control of a national Government, they all dramatically improved their electoral standing during recent votes. They have achieved a prominence and influence that question whether French Prime Minister Macron’s EU integration proposals will progress smoothly. Indeed, a key fault line in Frau Merkel’s fragile ruling coalition is whether Germany will pick up the tab for an EU transfer union. We suspect the CDU/SPD alliance will focus on the extravagant, but less contentious, domestic social spending agenda. Germany is still the EU cheque-writer-in-chief; without their buy-in, significant further EU integration looks doubtful.

As regards Brexit, this step to the Eurosceptic right suggests that political dogma will give way to economic pragmatism at ‘le moment critique’. This belief is reinforced by the fact that German industry, faced by slowing economic momentum, does not want access to a key (UK) export market disrupted. Indeed, with President Trump’s threat of steel (25%) and aluminium (10%) import tariffs delayed but not cancelled, a proactive economic schism with the UK would verge on self-harm.

On the other side of the channel, the Conservative party remains structurally discordant. To quote Bloomberg, “before (Prime Minister May) can even start trying to sell a deal to the EU, she has to find a proposal that both her Cabinet and Parliament support. Both are fundamentally split, with each side strong enough to block a plan, but not to push one through."

This Tory party cold war, with each side facing mutually-assured destruction if they do not agree to compromise, contains the seeds of a solution. We question the bargaining power of the Rees-Mogg Brexiteers. If they insist on a binary outcome, in their favour, a Tory/Labour Remain coalition would likely unseat May's Government. Would a general election return a Tory Government with a reinforced Brexit mandate? We doubt it. Would Rees-Mogg et al be thanked for the uncertainty? Certainly not, especially if the vote returned a Labour administration. Indeed, if Corbyn won the vote, the Brexiteers would face a Labour party that favours staying in some form of customs union; an anathema.

We suspect that a deal on Brexit occurs before the end of 2018; this may well come after the current October timeline. It will be "fudged" and porous but will be sold (and accepted) as a basis for the EU nations to go back to their domestic Parliaments to ratify over the winter months. The deal will promise a two year transition. In reality it will take longer; 4, 5 or more years. Neither the EU, Remain or Leave cohorts could accept an extended timetable at this time. They need to get into the separation detail to be able to sell such a prolonged transition to their faithful. All sides will choke back delays if they have actual facts and figures (not conjecture) to hold on to as they acquiesce.

Of course, our sanguine (naïve?) view could be wrong. The risk of a 'hard Brexit', where the UK leaves the EU with no deal on trade access, is not de minimis. As noted above, if we get a disorderly Brexit, a Tory rupture and a national election seems likely.

Would this herald the arrival of Prime Minister Corbyn? In a YouGov poll, in June 2017, 35% thought Corbyn would be a better PM than May; that has sunk back to 26%. In the meantime, May has seen her approval rise from 34% to 39%. Even if the polls are woefully off-beam again, this does not suggest an imminent Corbyn landslide. Indeed, another YouGov poll puts the Tories at 43% and Labour at 38% to win the next election. Other indicators also question the likelihood of a Corbyn victory. Betfair betting odds favour 'no overall majority' for either side at the next election, with both May and Corbyn priced at evens to be the next Prime Minister.

Have we seen peak Corbyn? At the 2017 election he was fresh and people knew little about him; the Tory campaign failed to elucidate. He promised largesse to disaffected voters, most notably paying off tuition fees for students. Since then, as the harsh light of day-to-day politics has illuminated Corbynism, his popularity has fallen back; he has recanted on the student debt promise and his more esoteric foreign policy positions have caused many to pause and think.

Even if we are wrong and we do see a Prime Minister Corbyn, no-one is forecasting a sizeable majority. As such, his ability to enact some of his hard-left, 1970s policies will be curtailed; many in the parliamentary labour party are centre-ground Blairites who recoil from the more hard-left Corbyn policies. They would resist.

A final factor is who would lead the Tories if May was forced from office. If Ruth Davidson (young, articulate, female and alternative) took on the job, the Tories would become more relevant and appealing over-night.

So we see a period of prolonged uncertainty as all sides get used to compromise. The risks remain elevated throughout. However, if we do see a Tory collapse, the mere whiff of Prime Minister Corbyn would crucify UK assets. This would likely be the 'sale of the century' as extreme negative sentiment runs ahead of the probable actual damage. This is one of the scenarios we have gamed and we would see it as the chance to buy GBP assets in size.

IN OTHER NEWS…

Inspired by the New York & Boston races, the London Marathon was founded in 1981 by Chris Brasher and has been running every year since then. His son, Hugh, took on the role of Race Director in 2013. It is the largest annual fund raising event in the world; the 2017 race raised £61.5m for good causes, bringing the total since inception to more than £890m. The Reverend Steve Chalk holds the record for largest individual fund raise with £2.33m in 2011.

This year 386,080 applied to run in the 22nd April race; 54,685 got places. Starting at 3 separate locations in Blackheath and finishing in front of Buckingham Palace, the runners used 1,263 portaloos, 45 ambulances and 650,000 water bottles.

The race record was set by Eliud Kipchoge in 2016 when he ran a 2 hours 3 minutes and 5 seconds; Paula Radcliffe holds the ladies record at 2 hours 15 minutes and 25 seconds. To set that in context, Mr Kipchoge averaged 17.5 seconds per 100m. Usain Bolts 100m record stands at 9.58 seconds.

As the comedian Paddy Lennox observed, "I was watching the London Marathon and saw one runner dressed as a chicken and another running as an egg. I thought: 'This could get interesting'"…..

EQUITIES

Even by recent standards it was an eventful month with trade wars rumbling, a blockbuster corporate earnings season and a potential détente on the Korean peninsula just some of the issues that helped shape market moves.

Amidst this flurry of activity most equity indices staged a decent recovery from their February/March lows; US stocks lagged again with the S&P 500 finishing the month little changed despite resoundingly positive profit updates. The failure to rebound, despite good corporate news, adds weight to our view that a bull market top is forming.

Almost half of S&P 500 firms have reported their first quarter earnings with the vast majority comfortably beating forecasts. Aggregate profits growth of 23% year-on-year is stellar and reflects the past year's upturn in economic activity as well as the Trump cuts to corporation tax. Though welcome, it is not unusual for markets to run out of steam just as such positive profits figures are being announced; earnings are, after all, backward looking and a lot of good news is already priced into elevated valuations.

There were a few exceptions. Energy stocks outperformed by a healthy margin with the MSCI World Energy index producing a 9% dollar gain. US large-cap names saw their bottom line expand by 89% over the year (source: Factset) and several firms are now more profitable than when oil was priced at U$100/barrel. Recent efforts to clean up balance sheets and to enforce capital discipline have increased operational gearing. We retain an indirect exposure to mega-cap energy names via some of the dedicated "value" managers.

Further gains in the oil price, borne of geopolitical tensions in Russia and the Middle East, also helped. US WTI oil gained 6% last month, finishing at U$69/barrel. Firmer energy markets typically spell good news for the Russian stock market, given its large exposure to natural resources. But it fell by 8% last month (US$ terms) in response to the US administration imposing fresh sanctions following Russia's alleged involvement in recent Syrian chemical attacks. Seven oligarchs were targeted, including Oleg Deripaska. He is a close ally of President Putin and majority owner of HK-listed Rusal, the largest aluminium producer outside China. Its share price halved after the sanctions were announced.

Other economically-sensitive sectors also generated solid profits growth. The US banks posted better than expected earnings with the recent spike in market volatility boosting trading commissions, whilst the "tech titans" also surprised on the upside. In both cases there was a muted market response with share prices struggling to kick on to higher levels. The noise around data abuse at Facebook and Mark Zuckerberg's 2-day testimony to US lawmakers undermined sentiment; the Facebook founder avoided any major faux-pas, but the risk of an anti-trust/regulatory backlash against "big tech" is clearly building. However, the companies themselves seem unperturbed (for the time being at least) as record share buybacks were announced in the first quarter. Apple led the way, repurchasing U$23.5bn of its own stock and committing to buying at least U$100bn more.

Sectors that benefitted from QE, particularly consumer staples, continued to struggle in the face of rising US yields. The lofty valuations attached to income-focused, high yield stocks are vulnerable as the yield on cash deposits and bonds rises. The MSCI World Consumer Staples index fell a further 2% last month and is 8% lower for the year-to-date.

Unlike some of its peers the Federal Reserve seems committed (for now) to "quantitative tightening" (QT), whereby it raises the cost of borrowing and runs down its U$4 trillion balance sheet by effectively selling back some of the bonds purchased during "quantitative easing" (QE). It would be an exaggeration to say the Fed has turned hawkish but, as we opined in last month's lead article, the new Committee appears keen to normalise monetary policy. A recent acceleration of US inflation and positive business investment data provides good reason for rates to continue their gradual ascent.

Elsewhere, the monetary authorities in the UK, Europe and Japan have all hinted that they may backtrack on previous commitments to moderate QE support. This divergence between the Fed and its global peers caused rate-differentials to widen further last month, triggering a relief-rally in the US dollar. On a trade-weighted (DXY) basis, the greenback added 2%, recovering its 2018 losses.

The majority of gains came against the euro and Japanese yen. European stocks benefited from the single currency's falls with most bourses posting mid to high single-digit gains. Japanese equities followed a similar trend with the Nikkei index rising by almost 5%. Further currency weakness/relative equity strength in these markets is possible, given the Central Bankers retreat. ECB President Draghi last month acknowledged the "moderation" of economic growth and suggested QE purchases could be extended beyond September. In Japan, Governor Kuroda began his second term by promising more of the same vis-à-vis monetary support. The BoJ is still accumulating assets at a rate of ¥80 trillion per year and we hear rumours that it was aggressively buying equity ETFs during the first-quarter sell-off.

UK indices are also particularly sensitive to currency moves and, after a prolonged period of sterling strength, the stock market was granted a reprieve last month; the pound fell sharply back below U$1.40 on the back of weakener UK growth and inflation. Brexit-based political headwinds also resurfaced with the government losing a number of House of Lords votes over the EU withdrawal bill. Unsurprisingly, it was the export-focused FTSE 100 that performed best with a 6% gain, but mid and small-cap stocks also progressed.

BONDS

As noted above US yields continue to rise, but the bond market sell-off in most other sovereign markets stalled. The 10-year US Treasury (UST) yield finally broke above 3% for the first time since 2014. Such round number milestones have little fundamental significance bar their impact on short term sentiment. Last month's UST sell-off came despite a lacklustre first-quarter US GDP print. Output expanded at an annual pace of 2.3%, with the dominant consumer sector a notable slowpoke; household spending was soft across the board with auto consumption contracting by 15% annualised. Aggregate "big ticket" spending was poor, suggesting consumer activity is fragile despite robust survey-based confidence measures.

With inflationary pressures building in the US economy, the Federal Reserve is likely to continue lifting rates. US headline CPI has accelerated to 2.4% y/y, boosted by higher energy costs which rose by 7%. Core inflation, which excludes volatile food and energy prices, also inched higher to 2.1% y/y. Markets are starting to account for the possibility of up to three more 0.25% rate hikes this year, one more than was expected just a month ago. The current Fed funds rate stands at 1.5%.

With US inflation prints set to come in higher as the year unfolds, UST yields may continue to rise. Set against this, we note that sentiment and speculative positions in favour of further UST price falls (higher yields) have become extreme. A recent Bank of America Merrill Lynch fund manager survey showed 80% of respondents expect higher UST yields over the next 12 months, whilst there is a record bet against US government bonds in the futures market. Given the concentration of this positioning, any dovish news could trigger a sizeable "short squeeze", pushing yields lower in the short term.

Elsewhere, reflationary pressures are easing. The slowdown in China is probably most significant as it was rising prices in the Middle Kingdom that kick-started the global inflation trend back in 2016. Produce price inflation (PPI) has slipped to just 3.1% y/y from last year's 8% peak due to softer food, transport and tourism prices. Chinese consumer prices (CPI) have also drifted back to 2.1% y/y, which has boosted demand for RMB-denominated bonds. April saw the yield on 10-year Chinese Government bonds fall 0.3%, to 3.7%.

Although euro area CPI nudged up from 1.1% y/y to 1.3% y/y in March there was a limited reaction in the Bund market; the German 10-year yield was little changed at just 0.6%. The fact that most of the CPI increase was driven by food and energy costs, rather than "core" price pressures meant that most investors believe (rightly in our view) that the inflation threat in Europe remains very low.

UK growth and inflation also disappointed last month. First quarter GDP slumped to 0.1% q/q, down from 0.4% q/q; the weakest level since 2012. Construction and manufacturing activity were notably subdued, with consumer facing industries struggling too. This slowdown in domestic demand is cooling inflation with CPI down to 2.5% y/y from a November 2017 peak of 3.1%. Falling prices for clothing and footwear were evident, but the disinflationary, lagged impact of sterling's impressive 2017 rebound was also a factor. This is why the pounds recent fall bears watching; a pronounced sell-off would renew our inflation/stagflation concerns. For now, the UK gilt market has found a bid with the 10-year yield settling around 1.4%.

CURRENCIES

Softer economic data from the likes of China, Europe and the UK helped the US dollar regain some lost ground last month. It rose by 2% against sterling and the euro and by 3% against the yen. The widening gap between US interest rates and "the rest" is supporting the dollar, but we wonder how far it can rise given the parlous trajectory of the US fiscal and trade deficits. As 13D (a research firm) notes, a tightening cycle isn't always good news for the greenback; 4 of the past 5 rate hike periods have seen the dollar index weaken.

The Chinese renminbi depreciated by almost 1% last month, bucking several months of gains. With the authorities cracking down on the use of debt, liquidity conditions are tightening in China and across Asia. This has had implications for a host of assets including China/HK shares, which have struggled of late. Last month the People's Bank of China (PBoC) offered some relief by reducing the reserve requirement ratio (RRR) by 1% for most commercial banks. This was initially seen as a reversion to looser policy, hence the currency's pullback, but on closer inspection it looks like pre-emptive support for the banking industry, ahead of another round of deleveraging in the shadow-banking sector. Great strides are being made to clean up "off balance sheet" banking activity, which is estimated to total U$16trn; there remains a long way to go. The clampdown is contributing to weaker growth and inflation trends in China and elsewhere.

The most interesting currency development in Asia was the HK dollar falling to a 35-year low. As we highlighted last month, the managed exchange rate and the widening gap between US dollar interest rates (LIBOR) and the HK dollar equivalents (HIBOR) has encouraged a "carry trade"; investors have sold HK dollars to buy the positive yield differential in other currencies. This negative flow pushed the HK dollar to the HK$7.85 trading floor and forced the HKMA to intervene for the first time since this iteration of the peg was introduced in 2005. The HK dollar ended the month just shy of HK$7.85, as 3m HIBOR rose from 1.2% to 1.9%. Rates look set to rise further.

Sterling faced a perfect storm last month with the softer growth and inflation prints encouraging Governor Carney to dampen expectations of a May rate rise. Before his dovish comments at the IMF in Washington, markets had priced in a 90% probability of an increase in the UK base rate from 0.5% to 0.75%. The pound came under pressures as soon as Carney admitted that the Bank of England has little reason to raise the cost of borrowing. Its losses were compounded by Amber Rudd's resignation over the Windrush immigration scandal. The now former Home Secretary was one of the Cabinet's more vocal "Remainers" and her departure is a boost to those favouring a "hard Brexit". Having peaked at $1.43 mid-month, sterling finished April at U$1.38.

Rising US rates and Trump's protectionist proclivities are having far-reaching effects. Argentina and Turkey were two emerging nations forced to raise rates aggressively last month in an ultimately unsuccessful attempt to prop up their currencies. In Iran, the rial hit an all-time low in response to the President's warning that he is likely to pull the US out of the 2015 nuclear weapons deal; the joint comprehensive plan of action. Back then, economic sanctions were lifted in return for Iran limiting its nuclear capabilities. Trump is no fan of the deal and even his bromance with President Macron (which was one toe-curling display during the latter's 3-day state visit to Washington D.C.)

is unlikely to change his mind; Macron and other members of the UN Security Council continue to advocate the merits of the plan. Capital is fleeing the Iranian economy ahead of a possible reimposition of draconian sanctions.

GOLD/COMMODITIES

The sanctions imposed on Russia and the US/China trade spat were a major influence on commodity markets in April. With the operations of Rusal (the Russian owned aluminium producer that generates 6% of global supply) heavily impeded, the price of aluminium spiked. At one stage it had risen by almost a third before ending the month 14% higher. The oil price also benefited from the Russia/Iran tensions; a Trump tweet, which blamed OPEC for artificially raising energy costs, provided further support. With gasoline prices increasing 6% in April, consumers are feeling the pinch just as they ponder who to vote for in the November mid-term elections.

Finally, gold bullion slid 1% to U$1,315/oz last month with the increase in US yields triggering most of the weakness. The nominal yield on a 2-year US Treasury is back up to 2.5%, leaving inflation-adjusted (real) yields effectively flat. Negative real yields are better for bullion, as they reduce the cost of carry. Events in Korea also weighed on the gold price, a marked change from the support it received when North Korea was sending nuclear missiles through Japanese air space last year. Kim Jong-un’s conciliatory tones appear almost too good to be true and his pledge to denuclearise the rogue state may have something to do with the rumoured collapse of its nuclear test site. The forthcoming meeting between the US and North Korean leaders is unlikely to be a dull affair.

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.

	30-APR-18	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.3763	−1.8%	−3.0%	+6.3%
CHF	1.0094	−3.7%	−6.0%	+0.4%
AUD	0.7530	−1.9%	−6.5%	+0.6%
JPY	109.34	−2.8%	−0.1%	+2.0%
EUR	1.2078	−2.0%	−2.7%	+10.9%
BOND YIELDS (10 yr)				
UK	1.42	+0.07	−0.09	+0.33
US	2.95	+0.21	+0.25	+0.67
Germany	0.56	+0.06	−0.14	+0.24
Australia	2.77	+0.17	−0.04	+0.19
Japan	0.05	+0.01	−0.03	+0.04
EQUITIES				
US. S&P 500 (USD)	2,648.05	+0.3%	−6.2%	+11.1%
UK. FTSE 100 (GBP)	7,509.30	+6.4%	−0.3%	+4.2%
MSCI Europe ex UK (EUR)	1,343.08	+3.6%	−2.3%	+2.1%
Japan. Topix (JPY)	1,777.23	+3.6%	−3.2%	+16.0%
China. Shanghai Comp (RMB)	3,082.23	−2.7%	−11.5%	−2.3%
HK. Hang Seng (HKD)	30,808.45	+2.4%	−6.3%	+25.2%
Australia. All Ords (AUD)	6,071.61	+3.5%	−1.2%	+2.1%
MSCI Pacific ex Japan (USD)	1,395.79	+2.9%	−5.4%	+7.1%
MSCI World (USD)	2,086.51	+1.0%	−5.7%	+11.1%
MSCI World (GBP)	1,515.81	+2.9%	−2.9%	+4.5%
COMMODITIES				
Oil (WTI)	68.57	+5.7%	+7.2%	+35.5%
Gold	1,315.35	−0.7%	−2.2%	+3.7%

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