BENTLEY REID

INVESTMENT VIEWS

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EQUITIES	:	Rate fears trigger the worst October since the financial crisis
BONDS	:	Treasuries fail to attract a bid as corporate debt spreads widen
CURRENCIES	:	The dollar firms at the expense of the euro and renminbi
COMMODITIES	:	Safe haven buying lifts gold in every major currency; oil slumps

For the second time this year, positive economic news sparked a sharp correction in global stock markets. October's 10% peak-to-trough fall in the MSCI World index echoed February's drawdown, with technical factors (like trend-following trading programs) exacerbating the move. It might seem perverse, but talk of robust US growth triggers fears of a rapid rise in interest rates, threatening to choke off the expansion. As we explore in greater detail in the markets section, we are now at a stage where good news can be bad for stocks.

We believe this validates one of our core concerns; namely, that we are at a tipping point where growth and asset prices are increasingly vulnerable to rising rates, given the profligate debt accumulation since the financial crisis. Using the US as an example, over the last 10 years, the value of investment grade (IG) corporate bonds in issuance has swollen from $1.8trn to $5trn. Worryingly, as investors ignored risk in their desperate pursuit of yield, quality has collapsed; the share of the lowest-rated IG bonds (BBB) has risen from about a third to a half. At the same time, the value of US high yield (junk) debt has nearly trebled. This does not augur well for default rates if this cycle ever turns.

Corporates are not alone. The US Government is forecast to run annual budget deficits of more than $1trn over the next 3 years as Trump's $1.5trn of tax cuts and $300bn of spending promises arrive; the government shortfall was $587bn in 2016. This will push US gross government debt towards 120% of GDP by 2020, even without a recession (source: IMF). To set that in context, markets are currently fretting about Italian debt of 130% of GDP.

Why does this matter? Primarily because there are clear signs that higher dollar rates are crowding out activity in the last engine of growth; the US. Indeed, the tech driven rally in American stocks earlier this year has arguably masked this reality. As base rates have risen, economically sensitive sectors have tumbled. The S&P auto index is 34% below its January peak; the homebuilding sector has retreated 40% and the Philadelphia semi-conductor index has lagged the S&P500 by 15% since March. Underperformance of such sectors has historically been a reliable recessionary portend.

Of equal interest, during the October equity sell-off, US treasuries failed to rally; the FTSE US treasury index ended October 0.5% lower. Given the scale of the equity market carnage, one would have expected sustained safe haven buying. Why didn't this happen? We would argue that concerns about US indebtedness are finally surfacing.

The US government net treasury issuance in the first 9 months of 2018 touched $769bn, $132bn more than all of 2017; it is set to rise to $1.4trn in 2019. However, the market is struggling to absorb this flood of new issues. The US Federal Reserve is selling $50bn of bonds a month as part of its QE withdrawal and Chinese holdings of US treasuries have stalled, falling 3% since August last year. US corporates also front-loaded treasury purchases for their pension funds due to a tax break that expired on the 9th September, dampening an important structural buyer for the next 6-12 months.

This explains why treasuries struggled in October and suggests that yields may well head higher; especially if the result of the US mid-terms heralds further fiscal easing. With the yield on corporate debt following suit, the cost of the accumulated debts is set to skyrocket. Congressional Budget Office models predict interest payments on outstanding treasuries to treble over the coming decade if the 10-year yield heads to (a modest) 4%.

Putting all this together, if one looks beyond the US, economies have been steadily slowing since late last year, as China deleverages and central banks moderate or withdraw QE. It is thus no surprise to see the MSCI World ex-US index 16% below its January peak; within a whisker of a formal bear market.

The US is now playing catch up and, as we look to 2019, expensive American equities look exposed. External demand is slowing, trade frictions are rising, the dollar is firm and the delayed impact of higher rates is a drag; signs of nascent real wage growth complete the picture. With issuers forced to refinance maturing debt at higher yields, the headwinds will grow; the yield on a 10-year treasury has more than doubled from the 2016 low. Finally, share buybacks are set to slow, diminishing the dominant marginal buyer of the last few years.

Unless the Fed reneges and re-starts QE (or a derivative thereof), our sense is that recent market rumblings are simply a trailer for the main event. As such, our enduring caution is finally paying off as the winter clouds gather.

IN OTHER NEWS…

The actor, Burt Reynolds, died on September 6th. He was 82. A renowned womaniser with a quick temper, his acting career and his finances ebbed and flowed throughout a colourful life. After his breakout movie, 'Deliverance' in 1972, he became America's first male centrefold, posing nude for Cosmopolitan. The ensuing media storm distracted from his performance, arguably costing him an Oscar nomination. He subsequently had notable popular success with 'Smokey and the Bandit' and the 'Cannonball Run' before a period of artistic exile; the decent roles dried up after he hit and severely injured the director Dick Richards, during the filming of 'Heat'. A renaissance in the 1990's saw him nominated for a best supporting actor Oscar for his role in the 1997 film, Boogie Nights. A wry observer of life, we share….

"My movies were the kind they show in prisons and airplanes, because nobody can leave"

"My son said, 'If you go to an actor's house, there's a picture of the actor with other actors. If you go to a producer's house, there are Picassos. I think I'll be a producer'"

"There are three stages of an actor's career. Young, old and 'you look good'"

EQUITIES

The "red October" market turmoil resonated with our long-held caution as many equity indices suffered their worst monthly falls since the 2008/09 financial crisis; peak-to-trough falls of 10% were common place. Significantly, having defied gravity for the last 18-24 months, US equities slumped with the S&P 500 correcting by over 11% intra-month.

Multiple triggers have been put forward including the US/China trade-war, an Italian debt crisis and uncertainty around the US mid-term elections. However, a hawkish statement from the Fed at the start of the month, coupled to the softer tone of recent earnings announcements, seemed the chief culprits.

Whilst over two-thirds of S&P 500 companies have beaten third quarter (Q3) earnings forecasts, many are lowering expectations for Q4 and beyond. A strong dollar and slower global growth is weighing on revenues, whilst wage and resource cost pressures continue to bite. As of 26th October, the number of US large-cap firms issuing negative profits guidance outweighed those upgrading by almost 2-to-1 (source: Factset).

A couple of major earnings trends stand out. The first is that many of the industrial bellwethers, including 3M and Caterpillar, disappointed; this suggests that the US economy may not be as strong as headline data suggests. Most forward looking economic indicators (such as the ISM surveys and business confidence) remain benign. However, the US housing and auto sectors are struggling; historically a harbinger of a broader economic malaise. We note too that rising inventories drove almost two-thirds of Q3's 3.5% annualised GDP growth; recent growth has been flattered by one-off, pre-tariff stockpiling.

The second is that several technology behemoths missed growth targets. The likes of Amazon and Google warned that operating conditions were deteriorating as the festive spending season approaches. Given their rich valuations, it is understandable that even modest setbacks whacked their share prices; Amazon fell 24% over the month with Google tumbling by 15%.

The market falls began shortly after Jerome Powell, the US Federal Reserve Chairman, was surprisingly upbeat about the health of the US economy. Phrases like "remarkably positive," "extraordinary" and "particularly bright" were interpreted as signs that the Fed may supplement its planned rate hikes. Markets have now entered a stage of the cycle where "good news is bad" as growth triggers the withdrawal of the cheap QE money that has fuelled this bull market. Fearing the impact of rising rates on asset prices and the economy, President Trump claimed the Fed was "out of control" and had "gone loco".

After such a sharp correction, a pause or bounce is normal. The market direction thereafter will depend on the pace of US rate rises and whether or not they cause a US recession. If they do, a peak-to-trough decline in the S&P 500 of 40-50% would not be unusual, given starting valuations. That said, if the Fed acts pre-emptively to head off any significant market or economic weakness, this could reduce downside (but ignite inflation).

The FTSE 100 fared little better as sterling's slide failed to support the internationally-focused mega-cap listings. At one stage the index had tumbled 8%, but recovered to finish the month 5% lower. The most economically-sensitive bank and resource stocks led the downturn, pulling the FTSE 100 back to a level it first registered in 1999.

Amongst developed markets, Europe and Japan suffered most with high single-digit losses reflecting investor concern about trade and global growth. European worries were amplified by a controversial Italian budget and heavy losses for Merkel's coalition in German state elections (see the bond and currency sections below).

October saw the IMF lower its global growth forecast for the first time in 2 years, citing trade wars and emerging market (EM) stress. 2018 global GDP is now expected to increase by 3.7% in real terms, 0.2% less than the previous forecast. This helps to explain why cyclical sectors have been amongst this year's worst performers; financials, semi-conductors and house builders have all witnessed big losses.

Whilst EM debt and currency prices have stabilised after their summer rout, the same cannot be said of the related equity markets, particularly in Asia. After last month's 8% fall, China has become this year's worst performing market with a 21% loss. Although profits growth is holding up relatively well, the economy is clearly slowing. The Q3 6.5% y/y expansion was the lowest in a decade. Domestic liquidity pressures have intensified with the clampdown on shadow-banking draining funds from the Chinese financial system (including the stock market). This negative flow is set to moderate after recent steps to ease monetary conditions and President Xi's "unwavering support" for the country's private sector. Whilst valuations look increasingly cheap, it seems too early to call a bottom in Chinese stocks.

Nearby, the Hang Seng's 25% fall from its January high pushed it into bear market territory (defined as a decline of 20% or more). The SAR's market was a reflection of the mainland woes, but also came under pressure from technical selling. Two key names, HSBC and Tencent, attracted sustained selling due to their use in various stressed structured products.

BONDS

It was interesting to see traditional "safe haven" government bonds rally during the more acute "risk off" moments last month. That said, US treasury prices still ended slightly lower; investors remain unsure as to whether the 10-year QE experiment will birth a deflationary episode or a multi-year increase in yields and inflation. The 10-year US treasury yield finished the month 0.1% higher at 3.14%.

US CPI inflation eased to 2.3%, from 2.7%, led lower by a 3% monthly fall in used car and truck prices. Core CPI (ex food and energy) continues to hover around its 2% target. This year's acceleration in wage growth means a period of rising inflation remains on the cards even if aggregate pay growth is struggling to rise above 3% y/y. With unemployment at 3.7%, the lowest since 1969, worker compensation should already be growing faster; a high underemployment rate, reflecting part-timers who want to work longer hours, means some labour market slack remains.

We suspect fiscal concerns are also undermining US treasuries. To help fund Trump's tax cuts and the country's huge social security obligations, the US government's net borrowing is set to balloon by U$2trn in 2018/19. With the Fed and other central banks moderating their treasury holdings (the Fed is a net seller as it withdraws from QE), the resulting flood of treasury issuance is swamping demand; text book "crowding out".

Gilts performed reasonably well last month with the 10-year yield falling 0.1% to 1.4%. With UK CPI inflation at an above-target 2.4% y/y, inflation-adjusted (real) yields remain negative. The Budget failed to dampen the enthusiasm for UK bonds, despite Chancellor Hammond declaring "the end of austerity". He took advantage of higher growth and tax receipt forecasts to bring forward personal tax cuts and to deliver the Prime Minister's £20bn NHS spending pledge (to mark its 70th birthday). Hammond also cautioned that he might have to renege on these and other spending commitments, in the event a "hard" Brexit.

The Italian bond market didn't react well to the populist government's debut budget. The League/5 Star coalition is honouring its election pledges to lower the retirement age, cut taxes and establish a basic income. The result is a fiscal deficit of 2.4% versus an EU-imposed target of just 0.8%. This caused Brussels to take the unprecedented step of rejecting a member state's budget. Italian 10-year bond yields spiked in response with the yield premium (or spread) over German Bunds rising to 3%. The coalition has said they will intervene if this premium reaches 4%, but has not explained how; they have few permitted tools at their disposal. The battle between EU fiscal orthodoxy and Italian fiscal populism is only just beginning and could pose existential questions of the Union, just as its strongest leader (Merkel) loses her grip on power.

As noted above, having sold off earlier in the year, EM debt held steady last month, but other riskier parts of the bond market universe are starting to crack. US high-yield ("junk") prices are falling with spreads over treasuries rising to a 12-month high of 3.8%. This was driven by a tumbling oil price and a sell-off in energy issues; the sector is a material component of high-yield indices.

CURRENCIES

October's turbulence saw the trade weighted dollar (or DXY) rise 2%. The euro bore the brunt of the losses with a 2.5% retreat. The Italian budget crisis caught the headlines, but the results of two German state elections were just as important as they signal the beginning of the end for Chancellor Merkel. The core coalition parties, including her own CDU, suffered major losses in Bavaria and Hesse as the Germans joined the long list of electorates losing faith in centrist politics. She has relinquished the chair of her party but hopes to remain as Chancellor until 2021. Given the fragile collation make-up, there is a good chance she goes earlier and that we see an unwelcome return to the polls.

Another month of Brexit uncertainty saw the pound slump back below U$1.30. Sterling fell by 2% as the UK and EU struggled to define a post-Brexit border between Northern Ireland and Eire. For all the histrionics, we still see a last minute deal emerging. Indeed, as we write, there are rumours of an Irish border solution and a wider deal on EU access for the vital UK service sector. In the meantime, sterling is acting as a Brexit barometer and, whilst any agreed deal will surely be construed as positive, the soggy UK economic reality argues against a resurgent pound.

The Chinese renminbi suffered a 1.5% loss last month and is inching towards the symbolic level of RMB7 per dollar. A raft of monetary support has helped to stem a slowdown in domestic credit growth, which in turn should stabilise economic activity. However, with the Federal Reserve still hiking, the widening base rate differential suggests the renminbi will remain pressured. Elsewhere in Asia, the Indian rupee hit an all-time low as the Reserve Bank of India unexpectedly kept its target rate at 6.5%. A clash between the Prime Minister and the Central Bank, over the latter's independence and use of the bank's reserves, served to unsettle. Any signs of escalation could lead to further rupee weakness.

In Latin America, it was left to Brazil to offer some respite. The real surged by 7% and the stock market by 10% in response to the election of Jair Bolsonaro as President. A right-wing, self-professed outsider, the former Army Captain won 55% of the second round vote by promising a mix of "Trumpian" nationalism and market-friendly policies that include greater independence for the Central Bank and the privatisation of state-run enterprises. For Brazilian assets to sustain this momentum he must now deliver; easier said than done given the fractious make-up of the National Congress.

GOLD/COMMODITIES

Gold finally caught a bid last month, finishing 2% higher at U$1,215/oz. It was one of the few occasions in recent years when bullion has rallied in all major currencies. Trading volumes spiked and speculative positions are returning to "net long"; large investors are starting to bet on further price gains. With central bank buying at a 3-year high (led by the Russians and Chinese), we remain constructive on gold as a core element of our cautious asset mix.

In energy markets WTI oil fell 11% to U$65/barrel despite mounting concerns over a supply/demand imbalance. The murder of Jamal Khashoggi, a US-based Saudi Arabian national who was tortured and killed whilst visiting the Kingdom's consulate in Istanbul, sparked calls from the international community to punish the Saudis.

The timing couldn't have been worse for President Trump. He is relying on the Kingdom to keep the oil market well supplied as US sanctions on Iranian oil exports could remove up to 2 million barrels per day. The threat of retaliatory action against Saudi could have caused prices to spike but the slowdown in global industrial demand and evidence of higher OPEC supply have so far prevailed.

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, Japanese Australian High Yield Healthcare Resources	US, Australian	
–	EQUITIES BONDS	US, European Technology	UK, European Japanese Corporate High Yield	

MARKET PERFORMANCE

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

	31-OCT-18	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.2766	−2.0%	−2.7%	−3.9%
CHF	0.9917	−2.6%	−1.8%	−1.1%
AUD	0.7073	−2.1%	−4.7%	−7.6%
JPY	112.94	+0.6%	−1.0%	+0.6%
EUR	1.1312	−2.5%	−3.2%	−2.9%
BOND YIELDS (10 yr)				
UK	1.44	−0.14	+0.11	+0.10
US	3.14	+0.08	+0.18	+0.76
Germany	0.38	−0.09	−0.06	+0.02
Australia	2.63	−0.04	−0.02	−0.04
Japan	0.12	+0.00	+0.07	+0.06
EQUITIES				
US. S&P 500 (USD)	2,711.74	-6.9%	−3.7%	+5.3%
UK. FTSE 100 (GBP)	7,128.10	-5.1%	-8.0%	-4.9%
MSCI Europe ex UK (EUR)	1,250.21	-5.6%	-7.7%	-9.3%
Japan. Topix (JPY)	1,646.12	-9.4%	-6.1%	-6.8%
China. Shanghai Comp (RMB)	2,602.78	-7.7%	-9.5%	-23.3%
HK. Hang Seng (HKD)	24,979.69	-10.1%	-12.6%	-11.6%
Australia. All Ords (AUD)	5,913.31	-6.5%	-7.1%	-1.1%
MSCI Pacific ex Japan (USD)	1,222.39	-8.8%	-12.1%	-9.8%
MSCI World (USD)	2,021.98	-7.4%	-6.1%	-0.7%
MSCI World (GBP)	1,585.37	-5.3%	−3.3%	+3.3%
COMMODITIES				
Oil (WTI)	65.31	-10.6%	−2.5%	+23.2%
Gold	1,214.76	+1.9%	−0.8%	-4.4%

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