INVESTMENT VIEWS

DECEMBER 2018

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We wish all our readers a very Happy Christmas and a prosperous New Year

EQUITIES :	A 'dovish' Fed pushes US, Asian and EM indices higher; tech names lag
BONDS :	Core Government bonds rally as spreads widen on corporate credit
CURRENCIES :	The Aussie dollar bounces as other major currencies drift sideways
COMMODITIES :	Oil crashes as Iranian supply concerns wane and bullish bets sour

In late November we finally got a draft Brexit agreement between the UK and the EU. It came in two parts. A 585-page draft withdrawal agreement (DWA) and a 26-page draft political declaration (DPC).

The DWA sets out the terms for the separation. It covers the UK's divorce bill (approx. £39bn) and the reciprocal rights of UK and EU citizens during a 2-year transition period; freedom of movement remains for all intents and purposes. During this phase, as the terms of future relations are negotiated, the UK will remain integrated with the EU. It will obey the Union's rules but relinquish any control over the related laws. Non-EU trade deals can be negotiated but not enacted.

The biggest bone of contention remains the border between Northern Ireland and Eire. The DWA provides a backstop, that keeps the UK in the customs union, if a trade deal that avoids a hard border has not been agreed by the end of the transition period. The UK cannot renege on this commitment without EU consent.

The separate DPC sets out the framework for the UK/EU future relationship. It is not a legally binding document and is intentionally benign to avoid discord. From a British standpoint it echoes Theresa May's Chequers plan that proved unpopular with MPs and the EU alike. From Europe's perspective, the DPC is explicit that any future agreements must respect the EU's 4 core principles; freedom of movement of capital, labour, goods and services. The draft does little to address the obvious areas of fundamental disagreement, speaking to a tortuous period of fractious negotiations.

In Mrs May's nirvana, parliament agrees to the DWA during a vote on 11th December; the individual EU member states do similar leading to an orderly Brexit on March 29th 2019. However, this looks unlikely with the British parliament set to vote down the DWA. Both Brexiteers and Remainers are

unhappy, fearing that the UK could end up in a never ending transition period, locked into EU rules without a say; borders would remain open and trade deals with non-EU countries would stall. With the EU dictating when the UK ends the transition, the British negotiating position would be emasculated.

So where does that leave us? Whilst acknowledging the ongoing uncertainty, we still believe a deal will get done. After rejecting the DWA on the 11th, we expect the Prime Minister to win modest concessions from the EU that will carry the bill through a second vote. A mooted "Norway-style" deal looks unlikely, as it entails free movement of EU citizens; our best guess is that changes will focus on the UK's ability to call time on the transition period without the EU's blessing (ie. a delayed "hard" Brexit option).

If we are wrong, we suspect a second referendum is more likely than a general election. As we noted in October "…the only cross-party alliance we can envisage is a Remain grouping, catalysed by an intractable rejection of any November deal. In this scenario, we can envisage a group of cross-party MPs voting for a 2nd referendum rather than a general election; the latter could herald the arrival of Prime Minister Corbyn and a relatively hard Brexit, something centre-left Labour MPs fear almost as much as the Tories." The probability of a second plebiscite is rising; Betfair odds on a "people's vote" before 2020 have tumbled to 2.44 (or 7/5).

What does this mean for investment? Even if there is a hard Brexit, we see the long term appeal of sterling below $1.30. Beyond that, the UK economic cycle looks set to roll over, regardless of the Brexit path, with the drama unfolding against an increasingly moribund global growth backdrop. Markets outside the US already reflect this. In US dollar terms, the FTSE100 is now 18% below its 2018 peak, similar to the Japanese Topix and the Hang Seng. The more trade sensitive German DAX has fared worse, giving up 23%, whilst the Shanghai Composite has lost over a third of its value. Bear markets are in full swing beyond American shores.

In the US, the S&P500 is struggling to claw back its 11% October fall. A hint of slower rate rises from the Federal Reserve Chairman has helped, as has the Trump/Xi delay to trade hostilities. On the latter, to quote Anatole Kaletsky, the Donald "shouts loudly and carries a white flag". Having benchmarked his success against the surging stock market, the October tumble seems to have elicited a more pragmatic President. The weak showing at the mid-term elections and the simmering Mueller investigation will also have played their part; Trump needs a win.

No matter. Despite the administration's best efforts, US equities and projections for 10% earnings growth next year look exposed. American companies are starting to feel the delayed impact of rising rates; since 2017, US 3m LIBOR has nearly trebled to 2.7%, whilst the average yield on a BBB-rated corporate bond has risen 1.2%, to 4.7%. These moves might seem modest until you remember the sheer scale of the accumulated debts. Private individuals are similarly challenged, with the interest charged on the average 30-year mortgage touching 4.8% in November, a rise of more than 1% this year. As activity has slowed, the S&P House-builders index has shed 33% from its January peak.

The firm dollar will also have an increasingly visible impact. With the trade weighted dollar up 10% from its January low, we expect the greenback to be blamed for a slew of 1st quarter earnings disappointments. Finally, as the tailwind of Trump's 2017 fiscal stimulus wears off, we expect the resulting surge in net treasury issuance, to pay for the swollen government deficit, will crowd out private sector activity.

Whilst all of the above argues for our continued caution, several areas are already starting to peak our interest; particularly outside the US. Emerging market debt and China 'A' shares both fall into this category, as do unloved gold miners. Having hunkered down, it is encouraging to see signs of opportunity; we expect these to grow as we head into 2019.

IN OTHER NEWS…

In 1972, BBC Radio 4 launched "I'm sorry I haven't a clue", a humorous parody of radio and TV panel shows. One of the games is the "Uxbridge English Dictionary" where panellists suggest amusing redefinitions of words. A selection was kindly forwarded by a reader, a few of which we share below.

Allocate – greeting, for example, Ms Winslet
Capitulate – the mistake BP made in the Gulf of Mexico
Propaganda – a post for one legged geese
Miasma – the reason I need an inhaler
Exorbitant – the retired first insect astronaut
Gladiator – an unrepentant cannibal
Gregorian – someone unsure of his name
Gurgle – to steal a ventriloquist's dummy

EQUITIES

The MSCI World Equity index gained 1% last month. Asia and Emerging markets led, whilst Europe lagged. US indices benefited from a slightly more dovish tone from the Federal Reserve. Energy stocks struggled due to falling oil prices and technology shares suffered as euphoric investor sentiment finally cracked.

In the short term, Fed Chair Jerome Powell helped to calm stock market nerves with a more dovish tone (see Bond section below). The S&P 500 index gained 2% whilst the technology heavy NASDAQ was flat. Many FAANG stocks are now in bear market territory (defined as a peak-to-trough fall of 20%+). Tech heavyweights Apple and Alphabet (previously Google) have both lost more than 20%, whilst the likes of Facebook and Netflix have slumped by 40%. Nvidia, a supplier of chips and graphics cards to smartphone and crypto currency sectors, has more than halved from its September peak; its market capitalisation fell from $175 billion to $88 billion in seven weeks. In the 2002 and 2008 stock market booms the same stock lost 90% and 85% of its value. Perhaps there is more pain to come.

As forecast, the Democrats seized control of the House of Representatives in US mid-term elections, winning 235 seats compared to 200 for the Republicans: a swing of 41 seats. The Republicans retained control of the Senate 53 to 47, a gain of two seats. Voter turnout was extremely high, approaching 50% compared to an average of 40% for prior mid-terms. Noisy political gridlock now looks likely, hemming in Trump's policy program; not necessarily a negative for equity markets.

The UK was one of the worst performing markets during November. The FTSE All Share was down 2%. European leaders signed off on Theresa May's proposed Brexit deal, triggering the resignation of Brexit Secretary Dominic Raab. Disgruntled Tory Brexiteers failed to gather enough letters to prompt a vote of no confidence in Mrs May, validating our belief that they lack the numbers to force their agenda. The proposed withdrawal agreement now moves to a parliamentary vote on 11th

December, with Theresa May and Jeremy Corbyn set for a (pointless?) TV debate just before. Should the vote fail, the labour party has pledged to call a vote of no confidence in the government; we doubt they would win, as this would require the support of the DUP. Even if May did lose a no confidence ballot, a subsequent vote to trigger a general election would need a two thirds majority.

European stock markets fared little better than the UK. The broad MSCI Europe ex UK index lost 1%, with French and German markets both down 2%. The French public is protesting against a proposed increase in fuel taxes, scheduled for 1st January. The "gilet jaune" protestors took to the streets in high visibility jackets to try to force a re-think of the related environmental policy, widening the criticism to Macron's "Presidency for the rich". In Germany, Angela Merkel announced her decision to stand down as CDU party chair after 18 years (though not as Chancellor). The Franco-German political axis now looks significantly weaker, just as the Italian debt problems challenge EU fiscal orthodoxy.

The Trump-Xi showdown at the G20 meeting in Buenos Aires produced a short-term truce in the trade war. Tariff levels have been frozen for 90 days while negotiations continue. The US agreed not to raise import duties to 25% on $200bn of Chinese goods on January 1st. China agreed to buy a "very substantial amount" of US agricultural and other products, ban exports of the opioid drug fentanyl and offered to re-consider their veto of the Qualcomm-NXP merger. Asian and Emerging markets rallied strongly. The MSCI Asia ex Japan index was up 4%, led higher by the 6% recovery of the Hang Seng. The Indian market also performed well, up 5%, as this net energy importer benefitted from collapsing oil prices.

BONDS

US bond yields dropped back on a more dovish Fed, a softer economic timbre and falling inflationary pressures from a collapsing oil price. In a speech on 28th November Fed Chair Powell said policy rates were "just below" the neutral level. Markets read this as a more dovish outlook when compared to his previous description of "a long way from" the neutral. Further evidence of a struggling consumer sector combined with falling financial markets may have persuaded the central bank to consider a slower pace for future tightening. The bond market moved swiftly to price in fewer rate hikes next year. Projections by the FOMC (the Fed's rate setting committee) suggest one or two rate hikes next year, compared to previous estimates of between two and four. The yield on a ten-year US government treasury fell 0.1% to 3%. US CPI inflation remained unchanged at 2.5%, whilst core CPI fell to 2.1% from 2.2%. US new home sales dropped 9% on the prior month, as higher interest rates weigh on housing affordability; the property market has historically provided a reliable lead for future GDP growth. Although government bond yields fell this month, the yield premium (the spread) on corporate lending widened across investment grade and high yield bonds. Given our well-flagged concerns about this sector, spreads are key metric to monitor.

The Bank of England published their assessment of the impact of a "worst-case" Brexit. Their 'disorderly' 3-year exit scenario suggested a decline in GDP of 8%; house prices falling 30%; sterling touching parity with the dollar; CPI inflation accelerating to 6.5% and interest rates rising to 4%. Governor Carney insisted this was a low probability outcome and not a central prediction, despite widespread media hysteria. Interestingly, given their supposed political neutrality, the Bank chose not to issue a "best case" scenario. UK ten-year gilts rallied slightly, ending the month yielding 1.4%; a negative real yield of 0.5% given core CPI (unchanged) at 1.9%.

The impasse between the EU and Italy over the latter's 2019 budget delivered its first casualty this month. Banca Carige was forced into an emergency fund raising after losses on its bond holdings jeopardised its capital adequacy. Carige's local peers were forced to club together to rescue the bank. Italy's banks have a worrying link to their governments debt. Since 2008, they have more than doubled their holdings of Italian government debt (BTPs) from €165bn to €387bn. This was driven by 'Long Term Financing Operations' introduced in 2011. Under the initiative, banks could borrow from the ECB at fixed rates, as low as -0.4%, and invest in higher yielding BTPs; the profitable yield spread was meant to offset sizeable losses realised on vast non-performing loan portfolios. Local banks now own 20% of all Italian government debt. The current populist government's borrowing plans have unsettled bond markets, driving the yield on BTPs higher. A ten-year BTP now yields 2.8% more than its German equivalent, having nearly doubled to 3.2% this year. If the fiscal standoff between Italy and Brussels escalates, yields could climb further/bond prices fall, triggering more bank failures. These in turn could drive yields higher, setting off a negative spiral. With economic news in Italy suggesting a 2019 recession, this narrative will be one to watch in 2019.

CURRENCIES

Major currency markets were relatively calm this month. The trade-weighted dollar was up 0.1% against a basket of its peers as the second estimate of US Q3 GDP growth was unchanged at 3.5%. Business capital expenditure was higher than expected, which helped to offset downward revisions to consumer spending and exports; rising rates undermined the former as tariffs and slower global GDP hurt the latter. The euro, yen and sterling all moved by less than 0.5% against the dollar.

The Australian dollar rebounded 3.3% this month. The Reserve Bank of Australia kept rates unchanged at 1.5%; quiescent inflation, softening house prices and slower growth suggest it may stand pat for a while. It maintained its (optimistic?) forecast for economic growth at 3.5% over two years, before slowing in 2020. Australian unemployment fell to 5% in October, the lowest since April 2012. Currency speculators had placed large bets that the currency would continue to fall, setting up the conditions for November's short squeeze. Looking forward, the Aussie looks range bound as we head into the new year.

Some of the biggest moves in currency markets last month were related to the rapid fall in the price of oil. The Indian Rupee gained 6% whilst the Russian Ruble lost 2% as the oil price collapsed. India is a major importer of oil, whilst Russia is one of the main exporters; it produces about 13% of world output, akin to the US or Saudi Arabia

GOLD/COMMODITIES

As noted above, the price of oil plummeted 22% this month, completing wiping out the gains of the past year. US WTI fell from $65 to $51, whilst European Brent fell from $75 to $59. US sanctions against Iran have been behind much of the prior rise in the oil price. As rising gasoline prices tend not to be a vote winner, with the US mid-term elections in mind, the US administration announced waivers to eight of the largest importers of Iranian oil, including China, India and Turkey. This change of heart led to a rapid unwind of a popular carry trade in the hedge fund community; long oil and short natural gas. As this unwound, oil slumped and natural gas roofed, rising 40% in November. US oil production posted another bumper number, pumping 11.7m barrels per day (bpd), according to EIA estimates. US exports of refined products also hit a record 6.3m bpd; a remarkable turn-around from the country being a net importer until 2011.

At the end of the month, Qatar announced plans to pull out of the OPEC cartel as relationships soured with its Arab neighbours. Four states – Saudi Arabia, UAE, Bahrain and Egypt – have imposed trade and travel embargo since June last year. A major natural gas producer, Qatar is a modest oil player, pumping just over 600,000 barrels per day or 2% of OPECs total. This cartel withdrawal is rare, bringing Qatar's 57-year membership to an end.

Gold benefited from the less hawkish rhetoric from the Fed. The price of bullion rose to $1,222 from $1,215 during November. Although most investors have shied away from the precious metal this year, it was interesting to see the World Gold Council (WGC) report that central bank buying grew 22% in Q3 from the previous year. These numbers do not include purchases by the Bank of China; it hasn't reported monthly data since 2015. We retain a core holding in gold across mandates as we feel it offers protection from both falling equity markets and further monetary debasement by the eventual return of QE. We are also watching gold equities closely; on nearly every valuation metric they are cheap and offer a geared play on bullion, as and when the gold price moves meaningfully higher.

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.

	30-NOV-18	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.2749	-0.1%	-1.6%	-5.7%
CHF	1.0015	+1.0%	-3.0%	-1.5%
AUD	0.7306	+3.3%	+1.6%	-3.4%
JPY	113.57	-0.5%	-2.1%	-0.8%
EUR	1.1317	+0.0%	-2.5%	-4.9%
BOND YIELDS (10 yr)				
UK	1.36	-0.07	-0.06	+0.03
US	2.99	-0.16	+0.13	+0.58
Germany	0.31	-0.07	-0.01	-0.05
Australia	2.59	-0.03	+0.07	+0.09
Japan	0.09	-0.04	-0.01	+0.05
EQUITIES				
US. S&P 500 (USD)	2,760.17	+1.8%	-4.9%	+4.3%
UK. FTSE 100 (GBP)	6,980.24	-2.1%	-6.1%	-4.7%
MSCI Europe ex UK (EUR)	1,240.59	-0.8%	-6.4%	-8.3%
Japan. Topix (JPY)	1,667.45	+1.3%	-3.9%	-7.0%
China. Shanghai Comp (RMB)	2,588.19	-0.6%	-5.0%	-22.0%
HK. Hang Seng (HKD)	26,506.75	+6.1%	-5.0%	-9.2%
Australia. All Ords (AUD)	5,749.31	-2.8%	-10.6%	-5.1%
MSCI Pacific ex Japan (USD)	1,251.44	+2.4%	-7.7%	-8.8%
MSCI World (USD)	2,041.36	+1.0%	-6.2%	-1.7%
MSCI World (GBP)	1,600.56	+1.0%	-4.7%	+4.1%
COMMODITIES				
Oil (WTI)	50.93	-22.2%	-26.0%	-6.9%
Gold	1,222.50	+0.6%	+1.8%	-4.1%

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