BENTLEY REID

INVESTMENT VIEWS

MARCH 2019

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EQUITIES	:	US/China trade deal progress supports sentiment and markets
BONDS	:	Treasure drift lower as talk of reflation starts to surface
CURRENCIES	:	Sterling rises as the probability of a 'hard Brexit' recedes
COMMODITIES	:	Central Bank buying supports gold as crude oil marches higher

US political dramas like 'the West Wing' and 'House of Cards' are a theatrical dirge when compared to the current White House. Michael Cohen, Trumps erstwhile personal attorney and 'fixer', testified to the US Congress oversight and reform committee on February 27th. Already convicted of lying and tax fraud, Cohen dammed the President with colourful invective, questioning his suitability for high office. Although the evidence may cause legal troubles for some around the President (most notably Donald Jnr), Cohen did not seem to land a knock-out punch on his former client.

That may not be the case for Robert Mueller's 21-month investigation. As Special Counsel, he has been looking into any illegal links between Trump's 2016 presidential campaign and Russia. Mueller is expected to send his confidential report to the US Attorney General, William Barr, over the next couple of weeks. On delivery, we can expect very public histrionics between the Democrat-led congress and Barr, a Republican. The former will want to parse the report for any Trump misdeeds, whilst the latter only needs to disclose the reasons for any prosecution or declination thereof.

Whilst we wait to see what unfolds, the Brexit pot is (finally) coming to the boil. After various votes the ITN journalist, Tom Bradbury, summed up the next steps in a recent tweet:

"…the following is now likely (1) there will be a long delay to Article 50 (2) the commons will vote for a new referendum; Theresa May's deal vs Remain (3) we are likely to vote Remain. The only one thing that can stop this; MPs voting for her deal on March 12th."

Will MPs agree to May's deal at the March 12th "meaningful vote"? The probability has increased. Why? Well, if May loses the vote, she has now been forced to accept subsequent votes on whether the UK should leave without a deal and on whether the Brexit date (currently March 29th) should be delayed. Ardent Brexiteers understand that any delay significantly increases the possibility of a remain outcome, given that the majority of MPs do not want a 'hard' Brexit; polls also suggest a 12% lead for Remain in a 2nd referendum (source: YouGov, excluding "would not vote" and "undecided", 16.1.19). They have thus signalled that they might support May's deal if the UK Attorney General, Geoffrey Cox, signs off that codicils to the original exit agreement create a legally binding time limit and exit mechanism to the post-Brexit EU trade negotiations. Cox is struggling to achieve these codicils, but the softening Brexiteer tone suggests that some form of fudged compromise is possible.

If May wins the meaningful vote, the UK should leave on March 29th, triggering a 21-month period of EU trade negotiations. Having alienated key parts of her party taking matters this far, we suspect the Tories would replace May for this process. If she loses, we expect MPs to vote for a delay; if they do, this will probably be quite short lived. With European parliamentary elections in May, any revised agreement needs to be ratified by all 27 EU member states before the new parliament convenes on June 3rd. If an agreement is not finalised by then, we are in a constitutional no-man's land, as the UK would need to send unelected MEPs to Brussels. Furthermore, if a delay runs past June 30th, the UK would be engaging with a new set of parliamentarians. With the balance of power expected to swing towards more extreme, populist parties (left and right), negotiations would be challenged by a new cohort of MEPs who will place domestic imperatives about the collective EU good. Indeed, even if May's deal is passed and the UK leaves on March 29th, the subsequent trade negotiations will be hindered by this shift in the European political landscape.

With May's deal or a 2nd referendum more likely than a 'no deal' Brexit, we continue to feel that sterling is undervalued on a long term view; short term fluctuations are impossible to call. Domestically focused UK equities are also very cheap versus most long term valuation metrics. That said, a roaring bull market in both the currency and stock market seems unlikely. If the spectre of a 'hard' Brexit passes, investors will focus on a stalled UK economy; GDP only added 0.2% in the final quarter of 2018.

Like Europe, the slowdown in Britain has more to do with the rapid decline in global activity than Brexit. Global economic data has been almost universally weak since the turn of the year. Manufacturing output has slumped with trade following suit; exports from Germany, South Korea and Japan are shrinking at an average rate of 8% year-on-year (source: Trading Economics). Importantly, the US is no longer immune. As the temporary high of Trump's fiscal stimulus fades, the economy faces slower domestic growth borne of the delayed impact of prior and continuing monetary tightening; the US Federal Reserve continues to shrink its balance sheet and reduce dollar liquidity, despite pausing on further rate rises. Although the consensus forecast for 1st quarter American growth is 1.9%, the Atlanta and NY Federal Reserves are more pessimistic, predicting 0.3% and 0.9%, respectively. US corporate profits have moved to reflect this, with earnings on the S&P500 set to <u>fall</u> by 3.2% in the first 3 months of the year; 2.9% <u>growth</u> was forecast at the end of December. Despite this reappraisal, the market has bounced sharply from its December low, returning it to a chronically over-valued level. As Warren Buffet noted in his 2019 newsletter "prices are sky-high for businesses possessing decent long-term prospects."

For now, we retain our cautious bent with one major caveat; global reflation. Aping the more dovish tone of the US Federal Reserve, most of the major central banks are rowing back on tightening measures and openly musing on reflation policy options; with global growth slumping and inflation absent, this is no surprise. At this time, it is more talk than action and, while we may need a more serious slowdown to catalyse meaningful action, it now looks a question of 'when' not 'if' the authorities double down with the return of quantitative easing. Any such moves would amplify Government efforts to head off the growing populist backlash with increased social spending. As such, we continue to add incrementally to cheap assets that we feel will benefit from reflation and stand ready to accelerate such moves if Central Banks go "all in".

IN OTHER NEWS…

Following on from last month, we once again mine the Christmas list of jokes and bons mots shared by a friend.

Being powerful is like being a lady. If you have to tell people you are, you aren't – *Margaret Thatcher*

It is not true that people stop pursuing dreams because they grow old; they grow old because they stop pursuing dreams – *Gabriel García Márquez*

Davos is where billionaires tell millionaires what the middle class feels — *Jamie Dimon on the annual World Economic Forum*

Donald Tusk, President of the European Council, recently commented; "I've been wondering what that special place in hell looks like, for those who promote Brexit, without even a sketch of a plan how to carry it out safely."

Ex-Greek Finance Minister, Yanis Varoufakis, tweeted in reply; "Probably very similar to the place reserved for those who designed a monetary union without a proper banking union and, once the banking crisis hit, transferred cynically the bankers' gigantic losses onto the shoulders of the weakest taxpayers."

EQUITIES

US equity markets gained 3% last month as investor sentiment improved on news of a putative US/China trade deal. President Trump extended the deadline for talks past March 1st raising hopes for an agreement when Xi Jinping visits Trump's Mar-a-Lago resort later this month. If the two sides can agree some form of deal, it may help Trump deflect domestic political attacks. As noted above, his former personal lawyer Michael Cohen testified before a Congressional committee, describing Trump as a "racist", "conman" and a "cheat"; Mueller's report is imminent. Although any resolution would be welcome, we suspect that a deal will be "headline friendly" but leave some of the fundamental issues unresolved; the Sino/US hostilities are the start of a long-term tussle between the two super-powers.

In the UK, eight Labour and three Conservative MPs split from their parties to form 'The Independent Group'. Though not a formal party, the rebels appointed former Labour MP Chuka Umunna as their spokesman; the cabal has yet to articulate a cohesive policy agenda. The so-called 'Tiggers' are laying claim to the centre ground having become increasingly disaffected by the growing control of extreme elements in their respective parties (not to mention claims of anti-Semitism in the Labour party). Labour leader Jeremy Corbyn subsequently announced he would back a second Brexit referendum, in part to head off any further defections. Theresa May also caved in, agreeing to her MPs demands for votes on delaying Brexit and ruling out a hard Brexit, should she fail to carry the "meaningful vote". The FTSE All Share rose 2% during the month as prospects for a Brexit delay rose.

As we have touched on before in these pages, the backlash against technology companies continues to gather momentum. In the UK, an eighteen-month inquiry into Facebook released its findings. It did not hold back: "It is evident that Facebook intentionally and knowingly violated both data privacy and anti-competition laws…the big tech companies must not be allowed to expand exponentially, without constraint or proper regulatory oversight…only governments and the law are powerful enough to contain them". Germany's competition authority seems to agree. Their recent antitrust action bars the social-media giant from automatically harvesting user data by tracking 'likes' and 'shares' on millions of sites. Although German users only account for 32 million of the more than 2 billion FB users, this decision sets an important digital precedent. Wired magazine summed it up neatly: "German Regulators Just Outlawed Facebook's Whole Ad Business". Regulators in Australia and India are also considering action, whilst US anti-trust and privacy advocates are getting a receptive hearing from a more left-leaning Capitol Hill. The tech companies' regulatory free-pass is under threat, questioning the lofty valuations attached to their current unfettered business models. Despite the threat of increased regulation, technology shares were the best performing sector last month. The MSCI World Technology index gained 6% clawing back much of their late 2018 losses.

The best performing market last month was the onshore Chinese equity market (A shares). The local market was one of the worst last year as efforts to address accumulated debts crimped growth; A shares lost 30% from their January 2018 peak. However, the Shanghai Composite gained 14% in February and is now up 18% in 2019 as deleveraging moderated and monetary support returned. January saw record monthly domestic bank loans of $527bn, equivalent to the annual GDP of Poland. The market also benefitted from news that exposure to A shares will rise in broader emerging market indices. This month, MSCI confirmed that it would increase the weight of A shares in the MSCI EM index to 3.3%, up from the current weight of 0.7%. During the month, we added to related exposures in growth portfolios and initiated a position across balanced mandates.

Broader emerging markets (EM) gained 1% as a firmer US dollar led to some profit taking after recent outperformance.

BONDS

Chair Jay Powell suggested the Federal Reserve would probably complete the reduction in its balance sheet (so called 'QT') much earlier than expected, probably before the end of 2019. His wording was somewhat vague but the Fed meeting in March should provide greater detail. Having peaked at $4.5trn, it is likely that the Fed's balance sheet will settle at over $3.5trn, more than 4 times the pre-crisis level. In the meantime, he preached a message of patience on both rates and inflation. Bond prices softened on the news, with the yield on a ten-year US treasury widening to 2.7% from 2.6%.

UK gilts were relatively subdued last month, with ten-year yields moving to 1.3% from 1.2%. Bank of England (BoE) Governor Carney rowed back on his previous guidance that he might have to hike rates in a hard Brexit scenario, to offset the forecast inflationary slump in the pound. In evidence to the Commons Treasury Select committee, he said the bank would now be more likely to cut rates to support the economy if Britain left without a deal. In its inflation report the BoE forecast 2019 growth at 1.2%, the slowest since the financial crisis.

Despite the slowdown, UK unemployment remained low at just 4%, the best in 44 years. Honda took the shine off rosy employment data when it announced plans to close its factory in Swindon; a loss of 3,500 direct jobs. Although Honda mentioned Brexit as part of its reasoning, two other factors were at play; the recent EU-Japan trade agreement (making imports from Japan cheaper) and the broader global auto slow-down. The tight labour market fed through to UK wage growth; average weekly earnings rose 3.4%, the highest level in ten years and a 1.2% real rate (i.e. after inflation). This data suggests current gilt yields remain unattractive.

European economic data continued to deteriorate. Eurozone GDP grew by just 0.2% in the fourth quarter. Germany saw zero growth, whilst Italy entered recession. Leading economic indicators reflected the malaise with the manufacturing PMI dipping below 50 for the first time since June 2013 (a sub-50 reading indicates a contraction in the sector). With long-term German bond yields anchored at 0.2%, Greece took advantage of tight spreads to announce the first ten-year bond issue since its bailout. Ratings agency Moody's upgraded the country's debt two notches to B1 as yields on ten-year Greek debt sank to a twelve-year low of 3.6%. This seems a very modest yield for such a poor credit; B1 is 'junk' and signifies the issuer is relatively risky with a higher than average chance of default.

EM bonds drifted lower last month following a solid rally in January. The local currency sovereign bond index was down 1% in USD terms and 2% in GBP terms. Most EM bond markets offer high nominal rates and positive real rates (i.e. after inflation), in stark contrast to most developed markets. A good example of this is Russia, where the economy expanded 2.3% in 2018, 0.4% ahead of expectations. With core inflation of 4.1%, short term rates of 7.75% equate to a real yield of 3.65%. Moody's upgraded the country to investment grade with a stable outlook; the rise in oil prices has helped. The Russian ten-year bond yield rallied from 8% to 7.8% during February.

Indian bond markets fared less well. The Reserve Bank of India cut rates by 0.25% to 6.25% despite fiscal hand-outs to the electorate from the incumbent government ahead of second quarter elections. Whilst the long-term story of structural reform remains compelling, any signs of Prime Minister Modi being vulnerable will probably dent Indian stock and currency markets. We would be interested to add exposure on any material pullback.

CURRENCIES

The trade-weighted US dollar (DXY) gained 1% in February, reversing its 2019 losses. The US dollar made gains against the yen, euro and Swiss franc but fell against sterling. The pound has been one of the better performing developed market currencies this year. It has rallied 4% to $1.33 on rising hopes that the UK will avoid a disorderly hard Brexit. The near term direction of sterling remains tied to EU negotiations. On a longer-term perspective, sterling looks cheap absent a precipitous economic slowdown.

The Australian dollar remained weak in February. It fell by 2.5% against the US dollar. The Reserve Bank of Australia kept rates unchanged at 1.5% as broadly expected. However, RBA Governor Lowe unsettled markets when he suggested that the next move in the cash rate could easily be down rather than up (as previously telegraphed). He cited downside economic risks and a weaker property market. Australian national house prices fell 1.3% in December, the largest monthly fall since 1983 (source: CoreLogic). House prices have fallen by over 6% since the market peaked in October 2017.

EM currencies were weak in general, handing back some of their strong January performance. Latin America currencies led, with the Brazilian real off 3% whilst the Mexican Peso dropped 1%. In Brazil, the government presented details of eagerly awaited pension legislation; reform is critical for the long-term financial sustainability of the country. The retirement age will be raised to 65 years for men and 62 years for women; currently employees can retire at any age as long as they have contributed to the system for 30/35 years (women/men). The government is targeting savings of

BRL1.1 trillion. The reform will be debated over coming months with a final vote expected later this year; the policy is sound but the passage through a fractious parliament is not assured. Elsewhere in Latin America, Ecuador announced a $10bn IMF support programme after agreeing structural reforms. Further north, Venezuela approached crisis point after a stand-off between President Maduro and a US-led international coalition; the latter support his removal and the legitimate claims of the opposition leader, Juan Guaido. Venezuela desperately needs change as inflation is set to hit 10 million per cent in 2019 (source: IMF); the fabric of a functioning society is rapidly disintegrating.

GOLD/COMMODITIES

Gold bullion fell 1% last month to $1,313. It is up 7% over the last three months. Central Bank net gold purchases in 2018 were the highest since the dissolution of the Bretton Woods exchange rate system in the 1970s. Central Banks added 651 metric tons to their reserves last year; a 74% annualised increase. Of this, Russia added 274 tons, marking the fourth consecutive year of purchases over 200 tons as it seeks to "de-dollarise" its reserves. Turkey and Kazakhstan were also notable buyers, adding over 50 tons each. Over the last six years, Central Banks have sold a net $130bn of US Treasuries and purchased $140bn in gold (source: 13d Research). Bullion remains a core holding across mandates.

Gold mining shares also fell 1% last month as measured by the NYSE Arca Gold mining index. M&A activity continued to pick up as the industry looks to consolidate following a difficult few years. Barrick Gold launched a hostile $18bn bid for rival Newmont Mining in a deal that would create the world's largest gold miner with annual production of more than 10mn ounces. Newmont rejected the offer and instead proposed a joint venture for their neighbouring Nevada operations. Newmont also insisted that their proposed $10bn acquisition of Goldcorp presented better value for shareholders. We believe that gold mining shares offer a combination of cheap valuations, solid balance sheets and geared exposure to a bullion price that looks set to break higher. Whilst growth mandates have existing exposure, we took advantage of some short-term weakness in the sector to add gold mining shares across clients' portfolios.

Iron Ore prices rose 3% last month, and are up 26% over the past three months. Iron ore prices rose after a dam in Brazil burst in January, flooding a major mine and leading to the estimated death of more than 300 people. Vale chief executive Fabio Schvartsman resigned after popular anger and pressure from prosecutors. It was the second dam collapse involving Vale in less than four years. The company is the world's biggest producer of iron ore.

Oil prices rebounded 6% during February. US Energy Information Administration data showed a surprisingly large drawdown in domestic inventories; they fell by 8.6m barrels. US petroleum exports made the US a net exporter for just the second time ever (after a brief period in November last year). The improvement in US oil production was underlined by national production figures that hit a record 12.1m barrels per day. Although impressive, we question how shale oil production will fare when/if this (broadly) cash flow negative, debt financed sector has to deal with higher interest rates and a less forgiving bond markets. Energy-related debt makes up a large part of the high yield bond market; caveat emptor.

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
○		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.

	28-FEB-19	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.3263	+1.2%	+4.0%	-3.6%
CHF	1.0020	-0.4%	+0.0%	-5.4%
AUD	0.7094	-2.5%	-2.9%	-8.6%
JPY	111.39	-2.3%	+1.9%	-4.2%
EUR	1.1371	-0.7%	+0.5%	-6.7%
BOND YIELDS (10 yr)				
UK	1.30	+0.08	-0.06	-0.20
US	2.72	+0.09	-0.27	-0.15
Germany	0.18	+0.03	-0.13	-0.47
Australia	2.10	-0.14	-0.49	-0.71
Japan	-0.03	-0.03	-0.12	-0.08
EQUITIES				
US. S&P 500 (USD)	2,784.49	+3.0%	+0.9%	+2.6%
UK. FTSE 100 (GBP)	7,074.73	+1.5%	+1.4%	-2.2%
MSCI Europe ex UK (EUR)	1,289.20	+4.1%	+3.9%	-2.7%
Japan. Topix (JPY)	1,607.66	+2.6%	-3.6%	-9.1%
China. Shanghai Comp (RMB)	2,940.95	+13.8%	+13.6%	-9.8%
HK. Hang Seng (HKD)	28,633.18	+2.5%	+8.0%	-7.2%
Australia. All Ords (AUD)	6,252.66	+5.3%	+8.8%	+2.2%
MSCI Pacific ex Japan (USD)	1,353.51	+3.3%	+8.2%	-4.7%
MSCI World (USD)	2,085.85	+2.8%	+2.2%	-1.5%
MSCI World (GBP)	1,572.32	+1.7%	-1.8%	+2.3%
COMMODITIES				
Oil (WTI)	57.22	+5.9%	+11.4%	+1.0%
Gold	1,313.31	-0.6%	+7.4%	-0.4%

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