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INVESTMENT VIEWS

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EQUITIES	:	Italy slumps and EMs struggle as tech drives the US higher
BONDS	:	“Save Haven” bonds rally as spreads widen on corporate issues
CURRENCIES	:	The US dollar, yen and Swiss franc are bid as the euro slides
COMMODITIES	:	Oil peaks, metals are mixed and gold stalls at $1,300

Unless Kim Jong-Un has a death wish, North Korea is a side show. Though he seems to have an arsenal of chemical and biological weapons and a nascent nuclear ability, if the Supreme Leader used them beyond his borders, the US would move swiftly to crush him and his regime. Before that came to pass, one imagines that China, the sole economic prop to Kim’s enduring tenure, would defuse matters or replace him on their own terms. North Korea is, for all intents and purposes, a Chinese protectorate.

Indeed, the biggest threat to the denuclearisation of the Korean peninsula is surely Trump’s trade braggadocio. Will President Xi allow Trump to achieve a Nobel prize-worthy Korean success if he is simultaneously initiating a trade war with China? We have our doubts.

Of course the Korean negotiations are more complex than this rather simplistic summary but the situation in Iran seems more urgent. The re-imposition of US sanctions, controversially enforced via the US dollar clearing system, impoverishes and further radicalises the Islamic State. At the same time, Trump’s explicit and implied support has emboldened the enemies of Iran, particularly Israel and Saudi Arabia. The tensions and animosity between the key regional players seem to be growing, making a wider conflict, beyond Syria, more likely.

Worrying about a Middle East melt down is nothing new. However, unlike North Korea, this anxiety can have an immediate global impact via higher oil prices and Iranian adventurism. Iran also has the means and the network to pursue its goal of becoming the dominant regional power, an ambition that could suck global players into the local theatre of conflict.

Closer to home, Italy replaced Brexit as the European “topic du jour”. The fragile alliance between the far-right League and the left-leaning 5 Star movement is the very definition of the odd couple. With an untested law professor, Giuseppe Conte, acting as the mouth piece for this political Frankenstein, one has to wonder if a coalition of such disparate views will endure. Indeed, with 5 Star now polling 30.1% of the vote (down from 32.7% at the March 4th election) and the League support surging to 28.5% from 17.4% (source: Corriere della Sera), both sides have an incentive to trigger new elections if they feel the outcome might improve their position. If that comes to pass, talk of a proxy referendum on Italian EU membership will resurface, reigniting market jitters.

Even if the coalition endures and they shy away from explicit “Italexit” policies, the combined policy agenda is a direct challenge to core EU principles and Italy’s financial stability and solvency. With €2.8trn of debt, Italy is the third largest European economy but has the largest debt pile. Locked into the straight jacket of the euro, it has been unable to devalue its currency to remain competitive; a favoured trick of the pre-EU days. Having eschewed the only other alternative, fundamental structural reform akin to 1980’s Thatcherism, Italy has seen its real living standards stagnate since the start of the millennium.

The newly elected incumbents rode to power on the resulting wave of discontent; youth unemployment stands at a staggering 32%. Though Macron’s triumph in the French elections was said to have slayed the thirst for European political populism, the Italian result would suggest otherwise. While the League will focus on tax cuts and lower immigration, 5 Star will push for a universal basic income for the poor. Both reject the 2011 Fornero law; pension reforms that lifted the retirement age to 67, shifted many to defined contribution schemes and cut indexing of benefits. The direct costs of scrapping the reform would be high, but it would be even more costly in terms of the country’s financial credibility.

In his first speech, Conte outlined his key objectives but remained vague on fiscal specifics, choosing instead to talk of reducing public debt “by making our wealth grow, not by austerity”. The bond market took a dim view.

If we avoid an election re-run, the Italian agenda seems to be fiscally over-optimistic and to confront EU orthodoxy. Furthermore, the arrival of the Conte government has surely scotched any hopes for the Macron EU integration agenda. Any significant progress was predicated on greater financial burden sharing between the “haves” and “have nots” of the union. As the prospect of Italy (and others) towing the fiscal line and implementing labour market reforms recedes, hopes for German largesse and financial solidarity surely follow.

So the EU looks set for its sternest test. Though this may arrive in a hurry, it could also be a slow burn as matters become clearer over the coming months. We will have to wait and see if there is another Draghi “do whatever it takes” moment to paper over the cracks in the union.

In the meantime, our early reading suggests that this is bad news for the UK and Brexit. Brussels may be distracted just as the Brexit timetable accelerates; a separation agreement is needed by October/November, to give the parliaments of individual member states time to consider the terms before the March 2019 exit date. The unfolding drama in southern Europe increases the possibility of a disorderly, “hard” Brexit. That said, we still feel some form of agreement is probable, even if it becomes increasingly vague, with the debate on detail being pushed into an extended transition period.

Taken together, talk of the European Central Bank tapering its QE support this year looks increasingly fanciful; a softer tone to economic data reinforces this view. Indeed, it also calls in to question the pace and quantum of US quantitative tightening as we head into the latter part of 2018.

IN OTHER NEWS…

The American novelist, Philip Roth, died on May 22nd aged 85. Writing his first novel, "Goodbye, Columbus" in 1959, he won the Pulitzer prize in 1998 for his work, "American Pastoral". His books often generated strong reactions, especially as he explored his Jewish roots and contemporary American society. His views on women, often seen as dismissive or mocking, also generated heated debate. In his later years, old age attracted his articulate ire. A few quotes….

"Old age isn't a battle: old age is a massacre." – Everyman

"The only obsession everyone wants: 'love.' People think that in falling in love they make themselves whole? The Platonic union of souls? I think otherwise. I think you're whole before you begin. And the love fractures you. You're whole and then you're cracked open" – The Dying Animal

"I said the screen will kill the reader, and it has; the movie screen in the beginning, the television screen, and now the coup de grace, the computer screen."

And providing unexpected investment insight – "Fear tends to manifest itself much more quickly than greed, so volatile markets tend to be on the downside. In up markets, volatility tends to gradually decline."

EQUITIES

Political risk returned with a vengence in May, with Italy in the eye of the storm. Since the election in March, Italian politicians have spent months negotiating a coalition pact. Finally, on 23rd May, the two anti-establishment parties (the Five Star Movement and the far-right League) announced a populist agenda with former law professor Giuseppi Conte as the compromise Prime Minister. Already nervous, markets were then spooked on 27th May when the independent President, Sergio Mattarella, refused to appoint Eurosceptic Paolo Savona as finance minister. The coalition declared this an outrage. The prospect of an election re-run morphing into a referendum on Italian EU membership riled markets.

On the last day of the month, President Mattarella approved a revised list of ministerial appointments that helped to stabilise the situation. In an ironic move, the coalition appointed Savona as Europe minister. The new government will pursue a clear anti-immigration agenda and very loose fiscal policy, estimated to cost up to €126bn in the first year (source: Carlo Cottarelli). The ratings agencies placed Italy and its banks on review for downgrade, given how unaffordable this looks. As noted above, Italy is the third largest economy in the Eurozone with the largest stock of debt by value (€2.8trn); equivalent to 130% of GDP. The Italian equity market fell by 9% this month, whilst the yield on a 2-year Italian bonds blew out from negative 0.3% to 2.8%. The latter was amplified by a troubling lack of market liquidity.

On the Iberian Peninsula, Mariano Rajoy had the ignominy of being Spain's first democratically elected prime minister to be ousted by parliament. Socialist opposition leader Pedro Sanchez replaced him when Mr Rajoy lost a vote of no-confidence after senior party officials were found guilty of corruption. Mr Sanchez, nicknamed "El Guapo" (Mr Handsome), now leads a minority government with only 84 of a possible 350 seats. He has promised to call early elections, but is yet to give a timeframe. The next ones are scheduled in 2020. The Spanish stock market shed 5%. Most European stock markets were dragged lower with financial stocks particularly hard hit; the Stoxx

Europe 600 Banks ETF lost 8%. The UK was a notable exception with the FTSE All Share up 2%, helped in part by further weakness in the pound.

American stock markets were amongst the better performing ones this month. The S&P 500 gained 2% whilst the tech-heavy Nasdaq continued to defy gravity and was up 5%. The rally looks increasingly narrow and fragile; 23% of the month's gains were accounted for by Apple, with Microsoft and Amazon close behind. First quarter earnings soared 23%, boosted by the Trump tax cuts. Stripping this out, pre-tax profits showed a more pedestrian 4% annual gain. Corporate investment and productivity will have to accelerate from here to justify the US market's nose-bleed valuation. However, the rising cost of debt, higher oil/commodity prices and real wage growth all pose a challenge to record corporate profit margins. Indeed, US company costs are rising at their fastest rate for 7 years (source: Markit Economics).

Towards the end of the month, Trump's administration pressed on with import tariffs on steel (25%) and aluminium (10%) from the EU, Canada and Mexico. Those on the receiving end threatened retaliation against a host of US exports, though detail was lacking as we went to print. Despite this busy schedule, Trump managed to find time to host a high profile meeting with a famous Kim; reality star Kim Kardashian. The New York Post quipped that 'Kim Thong Un pitches Prez on prison reform'; to us, the spectre of these two personalities debating prison reforms reinforces the impression of the White House as one large reality TV show.

Political risk was also a headwind for emerging markets this month. The broad MSCI EM index fell by 2% with Latin America down 9% and Greece off 12%. Emerging markets are discussed in more detail in the currency section below.

BONDS

Since the middle of 2016 we have seen a gradual increase in bond yields around the globe. Rising US short rates and quantitative tightening has led bonds to sell off and yields to rise from historically low levels. However, this month saw a counter-trend move, as quality bonds offered safe harbour from the political storms.

US economic data remains firm. The US economy added 223,000 jobs in May and the unemployment rate dropped to 3.8%, an 18-year low. Average earnings rose 2.7%, from 2.6% in the prior month. The data all but sealed a 0.25% rate rise (from 1.75%) at the June Federal Reserve meeting. Although rates at the short end of the curve have moved higher, the yield curve continues to flatten. In 2014 the 10-year treasury yielded 2.5% more than its 2 year equivalent; by the end of May that spread had shrivelled to 0.4%. If short rates move much higher, the yield curve will invert (long rates lower than short). This signal is a historically reliable predictor of impending recession, as markets price in lower growth, inflation and rates.

The Bank of England left rates unchanged this month as generally weak economic data gave pause for thought. Governor Carney told a Treasury select committee that households should expect "interest rates are more likely to go up than not, but at a gentle rate". Annual UK inflation fell to 2.4% this month (2.5% previous), despite the pronounced weakness of sterling. Air fare deflation supressed the headline figure whilst the introduction of a sugar tax on soft drinks was less inflationary than expected; many retailers chose to absorb the cost. The UK consumer remains fragile, even though wages are now rising faster than inflation.

None-the-less, gilts rallied with the yield on UK 10-year bonds falling 0.2% to 1.2%. With growth stalling, we suspect that the BoE will struggle to raise rates, especially given the Brexit uncertainties; higher, rather than lower, inflation looks likely leaving the yield on long dated gilts unattractive. Conversely, our preference for inflation-linked bonds endures. UK index linked gilts fared well in May, as their (average) long duration amplified the rally. The FT Index Linked All Stocks index gained 2.4% in May.

The European bond market was clearly bifurcated between core and periphery this month. Core German 10-year bond yields fell from 0.5% to 0.3% as the yield on Italian equivalents blew out 1% to 2.8%; they touched 3.2% mid-month. Spanish bonds also suffered, though to a lesser extent, finishing the month yielding 1.5%. At such a large spread over German bunds, some are arguing that Italian yields offer value. We prefer to stay on the side-lines as the incoming Conte government policies wreak of fiscal incontinence. Turning to inflation, European core CPI ticked higher, from 0.7% to 1.1%, whilst higher energy prices pushed broader CPI to 1.9%; a jump from the prior 1.2% print. With EU growth and unity seemingly reliant on ECB QE, any signs of sticky/rising inflation will give voice to hawks who argue for less ECB support. This monetary policy tug-of-war will only amplify market neuroses.

Whilst on the topic of European bond markets, S&P downgraded Deutsche Bank from A- to BBB+ after US regulators designated one of its US subsidiaries as 'troubled'. We are not forecasting the imminent demise of this German mainstay. However, it is a systematically important bank due to its sizeable role in global derivative markets; any further signs of distress will simply add to the febrile atmosphere currently encircling EU financial stocks.

In general, corporate spreads continued to widened this month. The Bloomberg Barclays Pan European High Yield spread widened from 3.1% to 3.8% whilst the UK and US investment grade spreads ended at 1.2% and 1.5% respectively, both up 0.3% from their January lows. Anecdotally, several high yield issues are starting to show distress. Labaras, a telecoms company, is currently quoted at 70 cents on the Euro, whilst a Tesla 2025 bond is marked around 87 cents in the dollar (source: TwentyFour AM). If bond yields and spreads continue to move higher, corporate delinquencies and defaults will start to snowball.

The Reserve Bank of Australia left rates unchanged at 1.5%. Australian retail sales rose more expected in April, but wage growth and inflation remain largely unproblematic for rate-setters. Governor Lowe reiterated the bank's outlook for economic growth at just over three per cent in 2018 and 2019. The 10-year government bond ended May yielding 2.7%, little changed on the year.

CURRENCIES

Traditional safe haven currencies were in demand this month as EU news flow rippled through markets. The trade-weighted US dollar rose by 2.3% whilst the Japanese yen and Swiss franc were also strong (both up by 0.5%). Sterling, the euro and emerging market currencies were all down sharply against the dollar. In particular, EM countries with large current account deficits were amongst those hit the hardest.

The Turkish lira sold off steeply. It lost 11% against the dollar and is now 28% lower than this time last year. President Erdogan has voiced his opposition to high interest rates, calling them "the mother and father of all evil". His bombastic tone in the run up to elections on June 24th has certainly not helped central bank efforts to stabilise asset markets. As inflation rose to 12% the Turkish central bank raised rates by 3%, to 16.5%, in an attempt to put a floor under the currency. Short term external debt, mostly held in foreign currency, is estimated at $181bn (source: FT). At 20% of GDP, this is an increasingly costly burden.

Latin American currencies were also marked down this month. The Argentine peso lost 20% after reformist President Macri announced that he was in negotiations with the IMF about a support package. The Argentine central bank raised short term rates to 40% to support the currency. The 100-year government bond, issued in June 2017, finished the month trading at 83 cents in the dollar, 20% lower than at the start of the year. Elsewhere in South America, the Brazilian real and the Mexican peso both lost 6%. Whilst talk of trade wars with the US has hit the Mexican currency, both countries are experiencing increasingly acrimonious elections punctuated by popular dissent. Mexico goes to the polls in July, with Brazil in October; populist candidates are polling well. Valuation and the early stage of the economic recovery argues for ongoing exposure to both but the election noise could yet temper our enthusiasm.

As noted above, the US dollar gained over 2% this month, mainly driven by euro weakness as markets wrestled with Italian uncertainty. The euro lost 3% against the dollar and has fallen nearly 8% from its February high of 1.25; it finished May at 1.17. If dollar strength persists, emerging markets could struggle, as their dollar debts become costlier and investor monies flow back to the greenback; others could join Argentina and Turkey in intensive care. Sterling also struggled against the resurgent dollar, ending 3% down for the month.

GOLD/COMMODITIES

Oil prices have been firm this year. US WTI has risen by 12% and UK Brent prices are 16% higher. This has spurred US shale output, with production touching 10.8m barrels per day (source: DEA). Infrastructure has failed to keep pace. This has led to pipelines running close to capacity and bottlenecks at refineries. WTI crude inventories are thus building, leaving Brent crude trading at a $12 premium to WTI (at $78/barrel). Higher oil prices are already feeding into global inflation data, further complicating the delicate balance between loose monetary policy, rising inflation and moderating global growth. It is little wonder than Trump is now lobbying OPEC and Russia to increase production and cap further gains.

Metals were a mixed bag this month as tariff talk muddied an already opaque supply and demand picture. Iron ore prices fell by 3% whilst aluminium rose 2% and copper gained 1%. China remains a key marginal player but their demand for, and supply of, industrial metals is hard to assess at this time. India's largest copper plant, operated by London listed Vedanta Resources, was shut down following a tragedy in which 13 protestors were killed by police. UK shadow chancellor John McDonnell called for the company to be delisted from the stock exchange.

The price of gold ended May down 1% to trade at $1,298/oz. Bullion is flat in dollar terms this year despite the headwind of rising US rates. We find this reassuring given our desire to hold gold as a hedge against currency debasement. In non-USD portfolios gold has generated a modest positive return this year due to the strength of the dollar.

Finally, agri commodities are notably higher this year. So far in 2017 soybean prices are up 7%, corn up 12% and wheat up 23%. Wheat prices rose 3% this month as persistently dry weather in key countries from Australia to the US has undermined crop estimates. Brazil's winter corn crop forecast was cut by 2m tons to 55m tons, according to Argoconsult, a farming consultancy.

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, 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.

	31-MAY-18	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.3298	-3.4%	-3.4%	+3.2%
CHF	1.0144	+0.5%	-4.2%	-1.8%
AUD	0.7568	+0.5%	-2.5%	+1.9%
JPY	108.82	+0.5%	-2.0%	+1.8%
EUR	1.1693	-3.2%	-4.1%	+4.0%
BOND YIELDS (10 yr)				
UK	1.23	-0.19	-0.27	+0.18
US	2.86	-0.09	+0.00	+0.66
Germany	0.34	-0.22	-0.32	+0.04
Australia	2.67	-0.10	-0.14	+0.28
Japan	0.03	-0.02	-0.02	-0.01
EQUITIES				
US. S&P 500 (USD)	2,705.27	+2.2%	-0.3%	+12.2%
UK. FTSE 100 (GBP)	7,678.20	+2.2%	+6.2%	+2.1%
MSCI Europe ex UK (EUR)	1,308.88	-2.5%	-1.2%	-1.5%
Japan. Topix (JPY)	1,747.45	-1.7%	-1.2%	+11.4%
China. Shanghai Comp (RMB)	3,095.47	+0.4%	-5.0%	-0.7%
HK. Hang Seng (HKD)	30,468.56	-1.1%	-1.2%	+18.7%
Australia. All Ords (AUD)	6,123.49	+0.9%	+0.1%	+6.3%
MSCI Pacific ex Japan (USD)	1,389.73	-0.4%	-2.2%	+8.5%
MSCI World (USD)	2,092.92	+0.3%	-1.2%	+9.5%
MSCI World (GBP)	1,574.46	+3.9%	+2.5%	+6.2%
COMMODITIES				
Oil (WTI)	67.04	-2.1%	+10.5%	+36.6%
Gold	1,298.52	-1.3%	-1.5%	+2.3%

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