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INVESTMENT VIEWS

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EQUITIES	:	Trade war worries and a firm dollar hit emerging markets
BONDS	:	Corporate bond yields rise as core sovereigns are little changed
CURRENCIES	:	The Yen and the Renminbi slide as the US dollar firms
COMMODITIES	:	WTI oil rises sharply on OPEC dynamics as gold falls back

The realpolitik of high office has not stopped Trump from honouring his campaign promises; tax cuts; leaving the TPP and Paris climate accord; renegotiating NAFTA; ending the Iran nuclear détente. One can argue that he has consistently delivered.

Despite this, it is hard to divine Trump's tariff intent. The initial levies are limited; economically these are a sideshow. It is the promise of more that serves to unsettle.

The proposed escalation (taxing another $200bn of Chinese imports after the initial $50bn) is a carefully calculated sum. As China imports about $120bn of goods from the US, it could not retaliate, tit-for-tat. It would force China to consider other avenues; excluding US companies from domestic contracts, boycotting US goods or devaluing the renminbi seem obvious candidates. However, this would go counter to Chinese efforts to increase inward investment, a vital flow as they deleverage their economy. Trump thus feels he has the whip hand. But does he?

On the one hand, the trade math suggests China will give ground, at least optically. But, if Trump takes this as a sign of weakness and demands too much, the risk is that China takes the long view and retaliates aggressively. Both sides would lose, with the global economy and markets caught in the crossfire. However, Xi would endure, ready to engage with the next POTUS. A full-blown trade war would surely scupper Trump's re-election in 2020.

For Trump to exert maximum pressure he needs to convince China that the US will deliver on his threats. If successful, markets would slump on the credible trade war narrative. Trump alluded to this when he stated, earlier this year, that there would be disruption as he addresses the perceived trade imbalances. This beggars the question, can the fragile narcissism of the US President stomach a significant drop in the S&P500? His behavior to date suggests not.

The final part of this jigsaw is the November mid-term elections. Trump is polling well. Does he see political advantage in tense trade relations on polling day? And, if he continues to command both

Houses after the autumn elections, will he feel emboldened to deliver on his rhetoric?

This delicate game of political poker suggests that the risk of policy error (of Trump over-playing his hand) is elevated. That said, Trump will probably have to push hard to trigger a full blown trade war; China will favour compromise, given their domestic slowdown.

Even if Sino-American relations do improve, this uncertainty is unfolding against a backdrop of elevated asset prices, over-indebtedness and rising interest rates.

As we have touched on many times, the world has spent the last decade gorging on debt. Since 2007, the value of global debt issued by non-financial corporates has tripled to $11.7trn; relative to world GDP, it has doubled. Two thirds of the increase emanates from developing nations, with China accounting for $2trn. At the same time, the quality of debt has collapsed; 22% has “junk” status with a further 40% rated BBB, at the margin of investment grade (source: McKinsey).

The bulls would argue that rates remain low, making debt sustainable, at least for the next couple of years. However the cost of money is rising. In the US, the Federal Funds rate is now 2% and is expected to rise to 2.5% by year-end and 3-3.5% by 2020. Furthermore, having priced for complacency, bond markets are starting to show signs of nerves. Over the last 24 months, the 10-year treasury yield has more than doubled to 2.9% with the average yield on US investment grade debt rising from 3% to 4.2%. As a record $7.5trn of corporate debt matures over the next 5 years, these richer rates will feed through to real world activity quite quickly.

The rising cost of capital will threaten companies’ ability to refinance debt and sustain the prodigious levels of share buybacks and dividend payouts (a major prop for current euphoria). Near record margins will also come under pressure just as revenues are undermined by waning growth. As China de-gears its shadow banking system, growth is slowing; the slide in the renminbi so attests. The mid-2017 period of globally synchronised growth is past with China and Europe showing clear signs of waning momentum. Rosy earnings forecasts look vulnerable.

Turning to markets, all of this is unfolding against a backdrop of historically over-valued US equities. Hussman Strategic Advisors produces a cyclically-adjusted price earnings ratio (CAPE). It is a margin-adjusted PE ratio, smoothed by taking an average of the last 12 years. Though a poor tool for market timing, the measure has historically proved a decent guide to returns over the subsequent decade. Currently standing at a CAPE of 45, the US market is valued akin to 1999 and 1929. This suggests US equity returns will be negative on a 10-year time horizon. We recall the 8% loss in the decade after the year 2000 peak; CAPE touched 42 at that time.

Finally, it is worth noting the increasingly narrow US market updraft. In the first half of 2018, 4 of the 505 index stocks (Amazon, Microsoft, Apple and Netflix) accounted for 84% of the 3% total return. This index winnowing historically occurs near market peaks.

All of the above leads us to doubt the US Central Bank’s ability to deliver its stated stimulus withdrawal (so called ‘QT’). The question is what level of disruption would excuse a policy volte-face, given Fed Chairman Powell’s statement that asset markets may have to take some pain on the path to policy normalization. Perversely, all of the above reduces the importance of the Trump tariff debate. Slower growth, burdensome debts and rising rates question lofty markets, even if Trump and Xi manage to step back from the brink.

IN OTHER NEWS…

According to Wikipedia, Mark Eberhard and Marc Tarpenning founded Tesla in 2003; Elon Musk, founder of PayPal, led the Series A funding round in 2004, triggering his involvement and the eventual exit of both founders. Eberhard was CEO until 2007. Tesla was named after the electrical engineer and inventor Nikola Tesla (1856-1943).

Even though the market capitalisation of Tesla has fallen 20% from its 2017 peak, its current $53bn worth makes it $9bn more valuable than Ford. Whilst Ford sells over 2.6m vehicles a year in the US alone and made $7.6bn of net income in 2017, Tesla only recently delivered its 300,000th car. Last year it lost $1.9bn from ongoing operations. It takes Ford about 4 hours to produce Tesla's current weekly output.

To fund this cash flow black-hole, Tesla has raised nearly $9bn in equity and unsecured debt in 7 episodes since September 2012. Current cash burn suggests the company will, once more, need to ask investors for funds; estimates range from $2-10bn. With the 2020 Tesla bond now yielding 6% pa, up from 2.5% in late 2016, further funding will come at a cost. Tesla is surely a prime candidate for this bubble's "Investment Icarus". Caveat emptor.

EQUITIES

On the 12th June President Trump and North Korean Supreme Leader, Kim Jong-un, met in Singapore. Long on promise, but short on detail, the subsequent joint declaration offers the prospect of further progress towards a peaceful, nuclear-free Korean peninsula.

The Trump/Kim "bromance" was somewhat overshadowed by a fractious G7 meeting in Canada, where the US President managed to upset most, if not all, of his fellow leaders. The G7 has never been more divided in its 45-year history; a further sign that the post-WW2 established order is going through a period of fundamental change.

Last month saw a marked deterioration in US/China relations as Trump initiated his trade agenda. Trump started with tariffs of U$50bn on 1,300 Chinese goods. China responded by threatening U$50bn of levies on US products, including soybeans. This was aimed at Trump supporters ahead of the November mid-term elections; US farmers send half of their soybean exports to China. Trump then responded by proposing another U$200bn of tariffs, doubling it to $400bn as the exchanges heated up. If implemented, this would cover almost all Chinese exports to the US.

Though some tariffs seem inevitable, the scope and timetable is impossible to predict. Interestingly, we note that China has opted to cut certain tariffs with several Asian economies; Xi may well use American trade aggression to reinforce its regional sphere of influence. Beyond China, Trump also threatened tariffs on car imports, dragging the EU into the heart of the trade war. The US imported $335bn of cars, light trucks and parts in 2017. Cool heads could prevail, but a damaging trade war cannot be ruled out.

Markets were initially rather nonchalant about the trade threat, but this is starting to change. The MSCI World Equity index finished 0.2% lower in dollar terms last month, but its loss would have been greater were it not for continued resilience in US indices.

The emerging markets were amongst the worst performers. Some key exchanges in China and Latin America have entered bear market territory; a peak-to-trough loss of at least 20%. The trade situation has been a detractor, but a resurgent US dollar and a severe tightening in dollar liquidity have both played their part. Concerns about softer global growth and higher dollar debt costs have troubling echoes of previous EM funding crises.

The fact that investor EM outflows have spiked to an 18-month high reinforces our belief that the current correction could present a buying opportunity once liquidity pressures ease. Although economic growth is cooling, the EM outlook remains broadly constructive. This is true of Latin America where concerns about pending elections have amplified heavy losses. Brazil's Bovespa fell another 5% last month (a general election is due in October) whilst Mexican stocks and the peso steadied ahead of the 1st July vote. Although the staunch nationalist, Lopez Obrador, secured a resounding victory (and with it a promise to implement a socialist, anti-corruption agenda), many associated risks have already been discounted.

It was an inauspicious debut for China A-shares, with around 230 names joining the flagship MSCI EM index in June. The Shanghai Composite slumped by a further 8%, taking its quarterly loss to 14%. With almost U$1trn of Shanghai/Shenzen listings (equivalent to 12% of the total market capitalisation) pledged as collateral for loans, it seems plausible that some Chinese stock holders have become forced sellers to settle cash calls on distressed loans. The on-going de-leveraging of the shadow banking sector is increasing defaults and non-performing loans.

In the US, the S&P 500 inched 0.5% higher last month. The rally looks increasingly stretched. Despite sound US economic and corporate news flow, the index has tried and failed to recover its January high and remains 5% below that peak. Without the stellar year-to-date performance of Netflix (up 104%) and Amazon (up 45%) the S&P 500 would be materially lower.

Indeed, only 3 sectors outperformed the MSCI World Equity benchmark's 1% loss in the first half of the year: tech, consumer discretionary (which is dominated by Amazon) and energy. We note that senior executives at Facebook, Amazon and Alphabet (Google) have become net sellers of their own stock, amounting to almost U$5bn collectively year-to-date (source: Bloomberg). Seldom a good sign.

Elsewhere, financial stocks were amongst the worst performers last month. Even though most Central Banks are talking about raising rates, yield curves are flattening as short-dated yields rise by more than their longer-dated counterparts. This reduces bank lending margins and future profit potential; it also often presages weaker activity. The European and Japanese banks have been the main laggards, but US listings have drifted lower too.

Finally, in Europe and Japan, their export heavy bourses ended June less than 1% lower. The yen fell back 5% during the second quarter, with the euro giving up 4%; this supported the earnings forecasts of key exporters, even as trend growth slowed. A similar dynamic has supported the FTSE 100, which is benefiting from sterling's woes. The UK index fell just 0.5% last month and is 1% lower for the year-to-date.

BONDS

Recent US data suggests the economy is faring reasonably well. The labour market remains in rude health and wage growth should continue to trend higher; the US now has more job openings (6.7mn) than job seekers (6.1mn). This probably explains why consumer spending has held up even as disposable income has been hit by the spike in gasoline prices and mortgage/rent costs. US manufacturing indices remain relatively robust, unlike similar gauges in Europe and Asia.

This encouraged the Federal Reserve to raise its target interest rate range by 0.25% (to 1.75-2%) at the June meeting, whilst signalling a more hawkish outlook. The committee's "dot plot" summary suggests there will be another 2 rate rises in 2018, taking the total for the calendar year to 4; one more than the market was pricing in shortly before last month's meeting.

With core inflation accelerating, the Feds quantitative tightening seems set for now. Core CPI has ticked up to 2.2% y/y, driven mainly by shelter (housing and rental) costs, which represent over 40% of the index. Interestingly, US bonds shrugged off the Fed's more hawkish tone with the US 10-year treasury yield unchanged at 2.9%. This came despite rumours that Russia had dumped half its U$48bn of treasury holdings during April (source: Zero Hedge).

UK CPI was surprisingly steady at 2.4% y/y in May despite a record monthly increase in fuel costs of almost 4%. Weakness in the price of other goods offset the impact on headline inflation with core CPI coming in at just 2.1% y/y. The UK gilt market has remained well bid in recent weeks with the yield closing the quarter a little lower at 1.3%.

The pound's renewed weakness against the dollar poses an upside risk to inflation (as it did in the aftermath of the 2016 Brexit vote) and this seems to be stirring the hawks on the Monetary Policy Committee (MPC). Whilst there was no rate change at last month's meeting, the Bank of England's Chief Economist, Andy Haldane, split with the majority for the first time and voted for a hike. This raises the odds of the MPC increasing rates by 0.25% when they meet in August. That said, UK base rates look set to remain low until the Brexit clouds clear.

In Europe, Italian bonds rallied strongly after the new Finance Minister committed the country to the EU and the euro. However, we suspect that Italy's expansionary fiscal agenda will remain a significant threat to EU markets and stability, jarring as it does with core EU principals and German fiscal discipline.

The ECB reaffirmed its intention to end its QE program; the current €30bn of monthly bond purchases will taper to zero by year-end. However, unlike the Fed, there are no plans to reduce the value of bonds held and President Draghi guided that rates will not rise before September 2019; later than many expected and a month before his term is due to end. Both the euro and core sovereign bond yields fell in response.

CURRENCIES

The Fed appears to be the only major Central Bank that is committed to normalising monetary policy and this continues to have huge implications for EM currencies. Many have depreciated to levels not seen since Trump's 2016 election victory and some, including the Indian Rupee, have hit an all-time low. Last month, this prompted Urjit Patel, Governor of the Reserve Bank of India (RBI), to write an open letter in the FT, urging Fed policy makers to halt rate rises and quantitative tightening or risk fuelling a major EM crisis. With US inflation ticking higher we doubt Chairman Powell and his colleagues will heed the advice unless conditions get a lot worse.

The EM Central Banks are doing what they can to protect their currencies; the RBI has raised rates (by 0.25% to 6.25%) for the first time in 4 years, whilst the Brazilian authorities are using their FX reserves to fund purchases of the real. No matter, the Brazilian currency fell 4% last month, taking the quarterly loss to 15%.

Conversely, China's PBoC seems content to preside over a depreciating yuan; it has fallen 7% from its March peak. A weaker currency is a counterpunch to US trade restrictions and helps alleviate some of the domestic economic strains, borne of the clampdown on "shadow bank" lending. The PBoC has marginally loosened policy since April by trimming the bank reserve ratio a couple of times. This enables banks to lend more, reducing the risk of a sharp decline in credit growth and a concurrent economic hard landing.

Closer to home, sterling remains unloved. If fell a further 1% last month to U$1.32; the loss would likely have been greater but for talk of an August rate rise. Recent macro news has been a little stronger than expected, suggesting UK Q2 GDP growth will be an improvement the prior quarter's meagre 0.2%. However, the economy needs to be much stronger if currency investors are to ignore Brexit gridlock.

On that matter, Prime Minister May is expending huge efforts to retain a semblance of Conservative party unity and last month faced down rebellions from both pro and anti-EU Tory MPs. With a UK Brexit framework conspicuously absent, there remains little progress in Brexit negotiations with the Irish border issue a particular sticking point.

GOLD/COMMODITIES

The oil market was dominated by OPEC's June meeting in Vienna. After much speculation the cartel agreed to raise production by up to 1 million barrels per day (mbpd). Only Saudi Arabia has the capacity to do so and the Kingdom is under pressure from Trump to ease supply constraints. Higher oil and gasoline prices are hurting US voters ahead of the November elections.

The oil supply outlook remains cloudy and much still depends on failing production in Venezuela and Iran. New US sanctions will see Iranian oil output fall by at least 0.5 mbpd, potentially more. This helped drive the WTI oil price up 11% last month to U$74/barrel as did US refinery and storage bottlenecks that limited the impact of rising shale oil output. Brent crude finished just 2% higher at U$79/barrel.

June was a perfect storm for gold with the easing US/North Korea tensions, the stronger dollar and a more hawkish Fed all acting as headwinds. Bullion fell by 4% to U$1,253/oz. We expect a more dovish tone to emerge from Central Banks as we head towards Christmas which should prove supportive to bullion prices.

Hard commodities are at the forefront of the trade war with tariffs on steel and aluminium already in place. Metal prices remained under pressure last month, partly due to a global growth concerns, but also because Chinese supplies are rising after the winter production curbs. The aluminium price fell 7% in June and iron ore drifted 2% lower, taking its year-to-date loss to 15%.

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-JUN-18	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.3207	-0.7%	-5.8%	+1.4%
CHF	1.0096	-0.5%	-3.7%	-3.2%
AUD	0.7405	-2.2%	-3.6%	-3.7%
JPY	110.76	-1.7%	-4.0%	+1.5%
EUR	1.1684	-0.1%	-5.2%	+2.3%
BOND YIELDS (10 yr)				
UK	1.28	+0.05	-0.07	+0.02
US	2.86	+0.00	+0.12	+0.56
Germany	0.30	-0.04	-0.19	-0.17
Australia	2.63	-0.04	+0.03	+0.03
Japan	0.03	+0.00	-0.02	-0.05
EQUITIES				
US. S&P 500 (USD)	2,718.37	+0.5%	+2.9%	+12.2%
UK. FTSE 100 (GBP)	7,636.93	-0.5%	+8.2%	+4.4%
MSCI Europe ex UK (EUR)	1,302.84	-0.5%	+0.5%	+0.4%
Japan. Topix (JPY)	1,730.89	-0.9%	+0.9%	+7.4%
China. Shanghai Comp (RMB)	2,847.42	-8.0%	-10.1%	-10.8%
HK. Hang Seng (HKD)	28,955.11	-5.0%	-3.8%	+12.4%
Australia. All Ords (AUD)	6,289.68	+2.7%	+7.2%	+9.1%
MSCI Pacific ex Japan (USD)	1,364.40	-1.8%	+0.6%	+4.6%
MSCI World (USD)	2,089.30	-0.2%	+1.1%	+9.0%
MSCI World (GBP)	1,583.52	+0.6%	+7.5%	+7.5%
COMMODITIES				
Oil (WTI)	74.15	+10.8%	+15.8%	+53.5%
Gold	1,253.16	-3.5%	-5.4%	+0.9%

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