BENTLEY REID

INVESTMENT VIEWS

AUGUST 2018

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EQUITIES	:	US technology names pause – emerging markets bounce
BONDS	:	US yield curve inversion approaches – UK rates rise to 0.75%
CURRENCIES	:	The renminbi slides as the Brazilian real and Mexican peso rally
COMMODITIES	:	Gold and oil fall back as the European heatwave spurs agri prices

The US economy expanded at an annual rate of 4.1% in the second quarter, the fastest rate since 2014. Though a triumphant Trump tweeted "We're going to go a lot higher than these numbers – and these are great numbers", some of the underlying drivers suggest a softer tone as we head into the back end of 2018.

A jump in net exports added about 1.1% to the GDP figure; the most since June 2013. This was due, in large part, to a surge in soya bean shipments ahead of retaliatory tariffs. An impressive increase in consumer spending also looks unsustainable though, on a positive note, business investment rose more than expected.

The world economy is slowing after the mid-2017 period of synchronised growth. The peak impact of unprecedented monetary stimulus in late 2015/early 2016 has passed, as all the major central banks either moderate their monetary support (the US, UK and EU) or talk about doing so (Japan). As receding QE cools the global expansion, will central banks be forced to abandon their hawkish timbre and re-embrace expansionary policies? As we have discussed many times in these pages, the sheer scale of global indebtedness suggests that global economic stall speed could be quite low, as rising rates rapidly undermine activity.

Indeed, China has already been forced to act. As it continues to clamp down on financial risks and unregulated lending, its economy has lost momentum. Money supply figures suggest a sharper deceleration than the headline GDP figures suggest. This has prompted various targeted steps. State banks have been encouraged to extend more credit to private sector firms and to support struggling bond issuers. The authorities are trying to maintain orderly debt markets as improved credit discipline triggers more defaults.

The People's Bank of China has also allowed the yuan to slide, losing 5% and 3% respectively against the US dollar and a trade weighted basket this year. Some see this as part retaliation to Trump's trade tactics; indeed, Goldman Sachs suggests that the softer currency could add 0.5% to GDP this year, blunting the impact of tariffs on up to $250bn of goods. Whilst this is no doubt helpful, the fundamental drivers are slower Chinese growth and falling real RMB rates. To date, capital flight from the mainland has been controlled; any sign of accelerating flows would be a cause for concern.

So the Chinese have been the first to blink, as their indebted economy struggles to cope with tighter monetary and fiscal policies. In the same vein, given their economies' trade dependence and stubborn lack of inflation, we struggle to see the ECB and Bank of Japan delivering significant policy changes any time soon. Though they may moderate their QE programs, a full scale unwind, with higher rates and the gradual reduction of bloated central bank balance sheets, looks unlikely. As for the UK, it has taken baby steps to unravel QE. However, Brexit uncertainties will surely limit progress. Indeed, if a "no deal" transpires (not our core scenario), Governor Carney could be in the invidious position of having to raise rates to defend a besieged sterling.

This leaves the US as the poster child for monetary policy normalisation (or QT). At their June meeting, the Fed increased the target for the Fed funds rate to 1.75%-2% pa; the 7th increase since 2015. They also continue to reduce their balance sheet, selling down debt that was purchased under QE. We note that actual net sales have been somewhat shy of the $40bn monthly target; a point to monitor.

With US inflation approaching 3%, sub-4% unemployment and growth slowing but not stalling, further rate hikes seem assured; indeed, the Fed recently doubled its forecast to 2 more rate hikes this year. With the economy at or near full employment, inflation pressures should finally surface in the second half (even if the economy slows). Will the Fed, in an effort to control prices, risk raising rates to a level that chokes off growth and triggers a recession? Or will the Fed take a more dovish stance, focusing on employment, and thereby risk higher inflation as a price for robust employment and decent nominal GDP?

Only time will tell. We lean towards the second scenario, as the current political zeitgeist favours "Main Street" over "Wall Street". Rising inflation is also the most politically acceptable way to retire debt and speaks to a softer dollar; Trump friendly. If we are wrong and a hawkish Fed raises rates to head off incipient inflation, markets would take a very dim view. Regardless, the stock and bond markets are not priced for these uncertainties. Indeed, markets seem remarkably sanguine about a whole host of issues including trade wars; Italian politics and EU unity; Brexit bosh and the fragilities born of restructuring "China PLC".

Furthermore, with six large tech stocks accounting for all of the gain in the S&P500 this year, the market updraft continues to narrow. At one point in July, before Facebook took a tumble, the FAANG stocks were collectively worth more than the entire FTSE100. However, clouds are gathering. During July, Facebook fell 20% after its second quarter earnings evidenced the impact of the Cambridge Analytica scandal and remedial steps to address its cavalier attitude to user data. Google was hit by a €5bn fine for monopolistic, anti-competitive practices; its second multi-billion-dollar penalty from the European Commission. Finally, Amazon revealed a 1,200% increase in quarterly profits, to $2.5bn. It also revealed a miserly 3% income tax provision, triggering further calls from US politicians for this tax-lite, dominant player to be broken up. The online retailer now accounts for 50% of all American online shopping. These market leaders are priced for perfection, despite rising threats to their business models.

We continue to view asset markets as offering an asymmetric risk; we see modest potential equity market upside but an elevated risk of a market correction, centred around the most highly rated US stocks. Where we are taking limited risk in portfolios, we favour cheap, 'value' stocks and regions/sectors with sustainable debt and growth profiles. AAA-rated USD bonds, yielding 2.8% pa, also have safe haven appeal.

IN OTHER NEWS…

Alexander Hamilton was one of the 18th century US founding fathers. Amongst other things, he laid the foundations of the current US financial system, created the American coast guard and established the NY Post. His life story is also the focus of a wildly successful rap musical, based on the 2004 biography by Ron Chernow. The show holds the Broadway box office record for most money grossed in a week; it took $3.3m for 8 performances. A very quote-worthy individual, the following from August 18th 1792 seems prescient…

"The truth unquestionably is, that the only path to a subversion of the republican system of the Country is, by flattering the prejudices of the people, and exciting their jealousies and apprehensions, to throw affairs into confusion, and bring on civil commotion…when a man unprincipled in private life desperate in his fortune, bold in his temper, possessed of considerable talents…despotic in his ordinary demeanour…known to have scoffed in private at the principles of liberty…when such a man is seen to mount the hobby horse of popularity…to join in the cry of danger to liberty…to take every opportunity of embarrassing the general government and bringing it under suspicion…to flatter and fall in with all the nonsense of the zealots of the day…it may justly be suspected that his object is to throw things into confusion that he may 'ride the storm and direct the whirlwind'."

EQUITIES

The US market posted another month of gains despite technology shares lagging the broader index. The S&P 500 gained 4% in July whilst the FANG+ index, which comprises 10 of the most widely owned tech names, fell by 4%. Facebook, Netflix, Twitter and Tencent were all marked-down by at least 20% from their recent peaks. Twitter has lost one third of its value in less than a month. Tencent has lost over $150bn of market value, with Facebook narrowly behind ($120bn). They disappointed the market, guiding projected sales and user engagement lower. Noise around increased regulation also continues to build. Apple was a notable exception, as non-iphone revenues picked up speed. In early August it became the first US listed company to be worth one trillion dollars. Whilst the S&P 500 fared well this month it has yet to recover its January high; it feels like the market is forming an extended top, as internal measures of momentum break down. Downside risks remain as investors start to focus on slower earnings growth in 2019.

Trump ramped up the trade rhetoric with a keen eye on November mid-term elections; polling suggests that his protectionist orotundity is popular with his core electorate. His modus operandi is to make aggressive, unrealistic demands before settling for a less extreme outcome; create, then solve, the problem. The US Trade Representative published a list of $200bn of imports from China that would be subject to a 10% tariff; 'the Donald' has since threatened to hike the rate to 25%. The proposed levies are in addition to the existing $50bn. China cannot respond on a like-for-like dollar basis as China only imports $130bn of goods from the US. China is more likely to respond with indirect measures. Indeed, the objection of Chinese regulators recently scuppered the merger between US chipmaker Qualcomm and Dutch group NXP. An early sign of things to come?

Meanwhile, the IMF warned that Trump's tariffs could reduce global growth by 0.5% pa by 2020. Against this backdrop, it was no surprise to see equity markets of export nations fall back; China and Korea were amongst the weakest, both losing 1% this month. More broadly, MSCI Emerging Markets gained 1%, led higher by a 6% recovery in Latin America. A softer US dollar encouraged bargain hunters after the recent, sharp pullback.

In a trademark volte-face, Donald Trump called a trade truce with Europe, following a summit with EC President Jean-Claude Juncker; thankfully there was no sign of Junkers "back pain" that made him stumble like a drunkard at the recent NATO gathering. US tariffs on steel and aluminium imports remain in place, as do the EU's retaliatory tariffs. However, the threat of American tariffs on car imports was postponed, with the EU making ill-defined commitments to increase soya bean and LNG imports from the US. Juncker is rumoured to have used colour-coded cue cards with simple explanations to improve his communication with Trump. The trade relations thaw led European markets to rebound. The MSCI Europe ex UK index gained 4% in July.

The UK market was one of the weaker developed bourses, as Brexit negotiations continue to cast a shadow. The FTSE All Share gained 1%. Foreign Secretary Boris Johnson and Brexit Secretary David Davis both resigned shortly after the cabinet signed up to the 'Chequers agreement', Theresa May's soft Brexit compromise plan. The strategy included: free trade of goods; no free trade in services; withdrawal from the customs union and single market; and continued co-ordination of regulatory and administrative matters (source: Ashmore). There is now intense lobbying and behind the scenes negotiation as the October EU summit, at which an agreed UK exit plan needs to be agreed, approaches. The risk of a hard Brexit has risen but our base case remains a vague, fudged agreement that leaves the contentious, detailed work for after the UK's March 2019 departure.

BONDS

The Federal Reserve left US interest rates unchanged at 2% (upper bound). The central bank reaffirmed its previous guidance to expect 0.25% rate hikes in both September and December. As we have discussed in prior newsletters, the yield on 10-year treasuries remains anchored around 3%. With 2-year bond yields approaching 2.7%, the yield curve is set to invert, when short term bond yields exceed those on long term bonds. This is normally a sign of impending recession, as banks have less incentive to extend credit to the economy. That said, the extra yield on lesser quality debt remains very low (the "spread"), suggesting markets do not expect a slowdown anytime soon.

Trump criticised the more hawkish stance from the Federal Reserve in an interview on CNBC; "I don't like all of this work that we're putting into the economy and then I see rates going up". The President cannot challenge the independence of the Federal Reserve without legislation, but his preference (and advocacy) for cheap money is clear.

The US Treasury was forced to increase its third quarter borrowing forecast by $56bn to $329bn last month. With higher spending and tax cuts starting to show through in the debt figures, the price of "Trumpenomics" (a.k.a. growth at all costs) is becoming increasingly clear. To us, all this amounts to upside risks to inflation, hence our preference for TIPs or inflation linked bonds. They lost 1% this month, but their role as an inflation hedge remains valid.

As expected, the Bank of England raised rates by 0.25% to 0.75% at the start of August. The MPC voted unanimously in favour, saying that recent data suggested the first quarter slowdown was temporary. UK unemployment is at a 43-year low of 4.2%. In terms of future rate hikes, the minutes of the recent meeting said that "any future increases in bank rates are likely to be at a gradual pace and to a limited extent". At the risk of repeating ourselves, further hikes seem unlikely as Brexit negotiations intensify especially as a disorderly Brexit would probably trigger a soft pound, rekindling fears of imported inflation. Indeed, as UK CPI inflation touched 2.4% in June, the Bank attributed this to prior sterling weakness and higher energy prices. Core inflation, that excluded food and energy prices, actually dipped to 1.9% as traditional retailers offered discounts to fend-off online competition. One bright spot was UK supermarkets that reported 4% sales growth in July; alcohol sales soared as Gareth Southgate and the England soccer team reached the World Cup semis. The ten-year UK gilt yield remains unchanged at 1.3% whilst inflation linked gilts produced a total return of 0.5%.

Rates were unchanged in Europe. Eurozone GDP growth was 0.3% in Q2, down from 0.4% in Q1. Eurozone CPI rose 2.1%, up from 2% in June, driven by higher energy prices (as per the UK). Core inflation rose to 1.1% from 0.9%. The ten-year German bond ticked up to 0.4%, as Draghi openly discussed the eventual withdrawal of European QE. Progress on the latter is set to be glacial, absent a pick-up in both activity and general prices.

In Australia, the RBA also stood pat at its July meeting, leaving rates at 1.5%. The board noted concerns over international trade policy, but maintained forecasts of economic growth above 3% pa for both 2018 and 2019. The evolving pattern of Chinese growth will have an outsized impact on future policy.

CURRENCIES

The trade weighted dollar index was broadly flat this month. US second quarter GDP came in at 4.1%. As noted above, the figure was boosted by a 9.3% rise in exports as overseas buyers front-loaded purchases ahead of agricultural trade restrictions. This alone added over 1% to the headline GDP figure.

Whilst the dollar gained against both the yen and sterling, it fell against the euro and Australian dollar. Despite this divergence, the relative direction of monetary policy continues to support the greenback in the near term. Emerging Market currencies were a real mixture. The Brazilian real and Mexican peso rallied sharply from oversold levels, benefitting from the "risk on" mood, whilst the Turkish lira and Chinese RMB both sold off.

In Turkey, the lira slumped by over 6% as the central bank kept rates on hold at 17.75%, defying market expectations of a 1% rate hike. Turkey is heavily reliant on external debt financing so access to international bond markets is crucial to avoid an economic melt-down; Turkey's current account deficit widened by $400m between April and May. President Erdogan's recent changes to his cabinet, which included the appointment on his son-in-law as the new Minister of Treasury and Finance, were very poorly received by investors. The central bank's independence looks under threat. A key part in the geo-political jigsaw, Turkey is increasingly fragile and vexatious under the authoritarian rule of Erdogan.

The Chinese RMB lost 3% against the dollar this month and 7% over the last quarter. The escalating tariff rhetoric has impacted the currencies of all export nations but the RMBs slide is more to do with the slower domestic expansion. As touched on above, a weaker RMB does help limit the impact of US tariffs on imports from China as it reduces the US dollar cost of Chinese goods. As the trade narrative intensifies ahead of the November elections, this exchange rate looks set to become increasingly politicised.

GOLD/COMMODITIES

Having been strong for much of the year, the price of oil fell back this month. US based WTI fell by 5% whilst European Brent dropped by 6%. Saudi Arabia ramped up production by more than 0.4m barrels in June after it struck a deal with other OPEC members to add another 1m barrels per day to total output. This more than offset the loss of production elsewhere in the cartel, most notably in Libya. Crude looks range bound for now.

Gold continued its recent slide. The price fell by 2% this month, finishing July at $1,224. Bullion has fallen by 6% this year as investors have shied away from the yellow metal in the face of rising US rates. As discussed previously, we think the current rate hikes will cease earlier than many believe as the rising cost of accumulated debts crowd out growth. This will be positive for gold, especially if the Fed favours employment over price control as it shapes its' policy response. As contrarians we also note that, according to the World Gold Council, bullion demand in the first half of 2018 was the lowest since 2009. Demand from industry and for jewellery was steady but tracker fund demand (ETFs) sunk to 61m tonnes versus 161m tonnes in the same period last year.

Heatwave conditions across much of Europe have pushed up agricultural prices. The current European record temperature of 48C, set in Athens in July 1977, is likely to be challenged on the Iberian Peninsula in the coming days. Corn prices rose 6% this month, whilst wheat was up 11%. The German Farmers' Association said its yield would likely plunge to a 15-year low. Across Europe, wheat production is expected to fall short of 130m tons for the first time in six years (source: Strategie Grains). Meanwhile, wildfires have raged across the continent. Portugal and Greece were badly affected with the latter suffering over 90 fatalities (to date).

In the UK comparisons are being made with the summer of 1976, when extreme heat and dry conditions led to PM Callaghan to introduce a Drought Act and a Minister for Drought, Denis Howell. How do the two years compare? With half the summer to go, 2018 has seen nine days when the mercury topped 30C; 1976 saw 18 days in total. Though this may seem a mild distraction, having met recently with Lloyds of London insurance experts, the incidence of extreme weather events seems to be steadily increasingly. Whilst we remain mute on the causes, the investment implications are becoming increasingly relevant, with water access and security a political, as well as economic, imperative.

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.

	31-JUL-18	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.3124	-0.6%	-4.6%	-0.7%
CHF	1.0097	+0.0%	+0.0%	-2.4%
AUD	0.7424	+0.3%	-1.4%	-7.2%
JPY	111.86	-1.1%	-2.3%	-1.4%
EUR	1.1691	+0.1%	-3.2%	-1.3%
BOND YIELDS (10 yr)				
UK	1.33	+0.05	-0.09	+0.10
US	2.96	+0.10	+0.01	+0.67
Germany	0.44	+0.14	-0.12	-0.10
Australia	2.65	+0.02	-0.12	-0.03
Japan	0.06	+0.03	+0.01	-0.02
EQUITIES				
US. S&P 500 (USD)	2,816.29	+3.6%	+6.4%	+14.0%
UK. FTSE 100 (GBP)	7,748.76	+1.5%	+3.2%	+5.1%
MSCI Europe ex UK (EUR)	1,353.95	+3.9%	+0.8%	+3.9%
Japan. Topix (JPY)	1,753.29	+1.3%	-1.3%	+8.3%
China. Shanghai Comp (RMB)	2,876.40	+1.0%	-6.7%	-12.1%
HK. Hang Seng (HKD)	28,583.01	-1.3%	-7.2%	+4.6%
Australia. All Ords (AUD)	6,366.16	+1.2%	+4.9%	+10.3%
MSCI Pacific ex Japan (USD)	1,390.03	+1.9%	-0.4%	+2.2%
MSCI World (USD)	2,153.10	+3.1%	+3.2%	+9.8%
MSCI World (GBP)	1,640.20	+3.6%	+8.2%	+10.3%
COMMODITIES				
Oil (WTI)	68.76	-5.1%	+1.6%	+36.1%
Gold	1,224.09	-2.3%	-6.9%	-3.6%

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CONTACTS AND REGULATION

Published and distributed in UK by **Bentley Reid & Co (UK) Limited**
29 Queen Anne's Gate, London SW1H 9BU, England,
Tel +44 (0) 20 7222 8081, Fax +44 (0) 20 7227 8440, Email UK@bentleyreid.co.uk
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