BENTLEY REID

INVESTMENT VIEWS

APRIL 2019

www.BentleyReid.com

EQUITIES	:	China and India advance, but elsewhere the rally loses steam
BONDS	:	Bond prices surge as Central Banks confirm their dovish turn
CURRENCIES	:	The euro's losses mount despite EM currency unrest
COMMODITIES	:	Oil's best quarter since 2009, but demand concerns remain

At the time of writing, there is no obvious majority for any Brexit option amongst MPs, making it impossible to predict the Westminster endgame. For what it's worth, although a tweaked version of Theresa May's deal remains the favourite, we feel that the odds of a 'hard' Brexit or a 2nd referendum are rising. Regardless, our valuation work suggests that the pound is cheap, especially for those with long-term sterling liabilities. For the brave, domestic UK equities also look inexpensive versus nearly every historic measure.

Whilst the UK side of Brexit remains a byzantine mystery, the European reality is somewhat clearer. Growth on the continent has stalled, led by a slump in manufacturing activity; the auto sector is struggling as trade volumes slide. The European Central Bank (ECB) now forecasts 2019 GDP growth of 1.1% with inflation of 1.2%; with forward looking data like consumer sentiment and new order levels softening, recession is a distinct possibility. This, in turn, has forced the ECB to maintain its emergency monetary policy. The euro base rate is anchored at 0% whilst ECB is charging commercial banks 0.4% pa on their deposits and is offering them discounted funds (so called TLTRO) in an effort to encourage lending.

We question the efficacy of more QE. Decent companies already have access to cheap money; BMW 10-year bonds only yield 1.3% pa. Growth and inflation have refused to accelerate, despite a decade of extraordinary global stimulus. As Ashmore (an emerging markets manager) notes "developed economies have expended more than $15 trillion in asset purchases, pushed interest rates to historically low levels and burned through literally trillions of dollars of fiscal stimulus". The only inflation has been in asset prices. Any future stimulus will unfold against a backdrop of near full employment, suggesting an even lower growth payback for every unit of costly stimulus.

Focusing back on the EU, this failure of post-crisis policy to translate into widely shared prosperity, looks set to deliver a Brexit/Trump moment at the ballot box. European parliamentary elections on May 23rd could spawn an "alliance of populist parties on the right campaigning against the Maastricht treaty and, of course, freedom of movement” (quote: CLSA). Populist, domestic imperatives will replace any sense of self-sacrifice for the EU collective. This, in turn, suggests that the fundamental, structural deficiencies of the EU project will, once again, come to the fore. To quote Wolfgang Schäuble from “Lunch with the FT”:

“The original mistake was in trying to create a common currency without a common economic, employment and social policy for all Eurozone member states. The fathers of the euro decided that if they waited for political union to happen first they’d wait forever….we should have taken the bigger steps towards integration earlier on, and now, because we can’t convince the member states to take them, they are unachievable”.

“Unachievable”; that is a strong word. If he is right, the euro is fundamentally flawed. And one cannot dismiss the 76-year old Schäuble as a crackpot Eurosceptic; he was German finance minister from 2009 to 2017 and negotiated the treaty that unified east and west Germany on October 3rd, 1990.

We are not arguing for a sudden European schism. However, the continent’s slowdown will occur just as the new populist MEPs find their purpose and their voice. As their constituents suffer, they will be emboldened to challenge the European orthodoxy, exposing the existential fragilities to which Mr Schauble refers. A re-run of the 2011 European debt crisis, or a derivative thereof, seems possible if not probable. To make matters worse, if he can come to some form of US/China trade détente, President Trump looks set to levy tariffs on European auto exports as a sop to his core support; the 2020 US Presidential election countdown has already started.

Putting all this together, whilst we see some appeal in sterling assets, we are nervous of the euro and European equities despite similar cheap valuation metrics. The summer may well offer a more compelling entry point. Conversely, the trade-weighted dollar could well firm, given that the euro makes-up 58% of this currency basket. Finally, we would discourage Brexiteer schadenfreude at the euroland travails. Unless Britain chooses to revoke article 50 and remain, it will negotiate the terms of a post-Brexit relationship with the new-look Europe. It will be far harder to find compromise and common ground with leaders in Brussels as they try to placate increasingly hostile member states who put domestic obligations above those of the EU. In fact a tortuous Brexit may serve their purpose, to quieten the Eurosceptic clamour from within.

IN OTHER NEWS…

Childish whimsy aside, a unicorn is a private company valued at over $1bn. Over the last decade, cheap QE capital has enabled more start-ups to stay private; the discipline and transparency of a stock market listing has been deferred. Unicorns are now a common sighting; China alone has 168, collectively valued at over $600bn (source: Stray Reflections).

As the market cycle matures, a blessing of unicorns is racing to the market. The IPO for Lyft, a ride-sharing service, will value the company at $24bn. Whilst revenues have risen six fold to £2.2bn over the last 3 years, losses have swelled to $911bn. This almost seems good value when compared to Uber. Their pending IPO is set to value the company north of $100bn despite it losing $3.3bn on $11.8bn of 2018 revenues; this “global motion” firm has burnt through $20bn of investor capital since its creation 10 years ago.

This whacky world of fantasy valuation is not restricted to private markets. The US stock market values Tesla at $48bn; last year, the company lost $1bn and generated $2.3bn of negative cash flow as their erratic CEO smoked weed during a podcast interview and was charged with securities fraud.

We have no firm view on the long-term merits of these companies; inevitably some will end up in the knacker's yard. Even if myth becomes reality, we are reminded that Amazon fell 94% in the 21 months to October 2001. Echoes of the 1999 'dotcom' delirium abound.

EQUITIES

Concerns over the slowing global economy intensified last month, preventing equity prices from extending their impressive bounce and sparking a dramatic fall in bond yields. The S&P 500 added almost 2%, taking its quarterly gain to 13%, despite an increase in short interest (bets that the market will fall). The much awaited Mueller report was a damp squib with the 22-month investigation finding no collusion between President Trump and Russia in influencing the 2016 election. Last month's 2-3% declines in US mid and small cap indices are perhaps a harbinger of a tougher environment for large-cap stocks; their underperformance was a notable feature of last year's market turmoil.

Financial names struggled as the Fed's U-turn gathered momentum with policymakers formalising a premature end for QT (the process of selling the bonds bought during the quantitative easing program). By the end of Q3 '19, the Central Bank's balance sheet will have fallen to around $3.7trn; 20% below its $4.5trn peak, but way above the $2.5trn level many expected it would trough at in 2021. The removal of this structural seller caused rates to tumble and the yield curve to invert (meaning shorter-dated yields exceeded those of longer maturities); a major headwind to lenders' profit margins.

The rebound in tech stocks continued despite the EU fining Google $1.7bn for anti-competitive practices. This takes total European penalties levied on the US search engine to €7bn. The early exchanges in the 2020 US Presidential campaign suggest the anti-trust threat will build; Elizabeth Warren, a Democratic candidate, has pledged to break up the big tech firms if she wins. For now, the market is more focused on the continued surge in share buybacks, which have fuelled the recent tech strength, but the forthcoming blackout period (that prevents insiders from trading stock around the quarterly earnings results) will be a headwind for further price gains.

Brexit day came and went on 29th March with everything but the UK leaving the EU on time. After another month of high drama in Westminster, Theresa May was defeated for the third time trying to secure MP's approval for her withdrawal deal. What happens next remains anyone's guess with multiple outcomes still possible. A long delay to Article 50 or a second plebiscite (with a version of the Prime Minister's deal being one of the options) seem the more probable scenarios, but a "hard exit" on 12th April could occur in the unlikely event of the EU refusing to extend negotiations.

The pound struggled in response, falling by 2% against the dollar. This boosted the export-heavy FTSE 100, which rose by 3%, but the more domestically focused mid and small caps struggled to make headway. A Tory leadership campaign is set to take place later this year as May has pledged to resign if Parliament passes her deal. At least a dozen candidates will jostle for the top spot in a contest that will likely amplify tensions within the Conservative party.

As mentioned in the lead article, European economic news is worsening with a slump in German manufacturing activity suggesting all is not well in the Mittelstand and beyond. Yet European shares have been resilient, supported by the ECB's dovish stance and the concomitant euro weakness, which boosts the prospects of the region's many export firms. The German DAX finished flat, but most other bourses added 2-3%. ECB President Draghi has confirmed that QE will remain in situ indefinitely. He also announced a renewal of specific liquidity support for the under-pressure banking system, via the TLTRO mechanism.

The emerging market rally took a breather too, but India and China were the (positive) exceptions. Although volatile during the month, the Shanghai Composite rose by 5%, taking its quarterly gain to 24%, its best since 2014. With the economy on a downward trajectory, the stock market's recovery from last year's slump is a liquidity story; January's record-breaking 4.6trn yuan increase in credit availability was a sure sign that the Chinese authorities are reverting to monetary easing (which has historically boosted equity prices). But aggregate financing levels tumbled to "only" 703bn yuan in February, suggesting policymakers are adopting a more nuanced approach this time around. This is true of fiscal policy too. At last month's National People's Congress in Beijing, Premier Li moderated 2019 GDP growth targets from a fixed 6.5% to a 6-6.5% range, but announced fresh stimulus via a 3% cut in the VAT rate. It is clear that tax cuts, rather than indiscriminate infrastructure spending, are becoming the preferred fiscal tool as the authorities seek to address the slowdown.

Brazil's Bovespa index hit the 100,000 level for the first time, but the party was short-lived as political risks again took centre stage. It finished the month slightly in the red, but still managed to produce a respectable 9% quarterly gain. Ex-President Temer was arrested for his alleged role in the on-going "Lava Jato" (car wash) corruption scandal that has felled many of the country's political and corporate elite. This dented hopes that a new, more business-friendly political era is underway in Brazil.

India was last month's surprise winner. The Sensex and the rupee rallied strongly with 8% and 2%, respective gains, although the mid and small cap stocks posted more modest returns. Most pundits had expected the looming election to dampen investor enthusiasm, but Prime Minister Modi's popularity has rebounded since the February conflict with Pakistan (which reinforced his "strongman" credentials) and a victory for his BJP party now looks likely. A staggered voting process begins on 11th April and will run until 19th May. An estimated 900 million people are eligible to vote in what will be the world's largest democratic exercise. If the majority endorse the incumbent Modi, it will buy the economy more time to further much needed structural reforms.

BONDS

Bond yields witnessed a sharp descent last month as investors continued to digest the Central Banks' capitulation on their tightening plans. Such has been the demand for safe-havens that longer-dated German and Japanese government yields are back below zero; a total $10trn worth of global bonds now have negative yields.

Late last year, Federal Reserve policymakers were still projecting two 0.25% hikes in 2019, but they have since culled their GDP growth and interest rate expectations. The average rate-setter is now forecasting no additional rate hikes and, as mentioned above, an official end to the balance sheet reduction is scheduled for September. We have long believed that the Central Banks would struggle to raise rates (hence our large allocations to gold bullion), but the pace and magnitude of the U-turn has been a surprise.

Faced with poor macro data, money markets are reflecting an even weaker outlook, now pricing in a greater than 80% probability of a US rate cut this year, up from a little more than 0% just a month ago. The US Treasury market followed suit with the 10-year yield tumbling by 0.3% to just 2.4%. This inverted the yield curve with the 3-month yield exceeding the 10-year equivalent for the first time since 2007; a trait that has preceded every US recession since World War II.

In general, the economic evidence is consistent with a pronounced slowing of US growth rather than an outright recession, suggesting bond yields may have fallen too far. Q4 GDP was revised down from 2.6% annualised to 2.2%, but came in at 3% for the calendar year; the strongest since 2005 (much to President Trump's delight). Recent consumer trends, including retail sales and monthly hirings, have been weak and validate the bond market's caution. We also struggle to see how the equity market rebound could endure should US recession risks build over the coming months. That said, February wage growth registered a new cycle high of 3.4% year-on-year, suggesting the soft patch in US household spending may be temporary.

It was a similar story for UK bonds with the index-linked market rallying sharply on falling nominal yields and "sticky" inflation that remains around the Bank of England's 2% target. The result was a material decline in inflation-adjusted (real) yields that boosted the appeal of linkers. This was particularly true of the ultra-long duration exposure that we own across all mandates; the UKTI 2068 issue witnessed a trough-to-peak surge of 25% during the month so we booked some profits around the high.

Quarterly UK GDP growth stabilised around +0.2% in the 3 months to the end of January. The manufacturing sector remains weak as Brexit and the global trade slump take their toll, but household spending is proving resilient (for now), buoyed by a record 76.1% employment rate for the 16-64 age group. The 10-year gilt yield fell 0.3% over the month, finishing at exactly 1% p.a.

The moves were as extreme in Europe with the 10-year German Bund yield turning negative for the first time since 2016. This means that at month-end, investors were willing to pay 0.07% p.a. to lend funds to the German government. With strong deflationary forces weighing on the European economy, it could be many years before a meaningful monetary tightening emerges; unfortunate parallels with Japan's "lost decades" are becoming commonplace. President Draghi's 8-year tenure ends later this year so he is all but guaranteed to be the first ECB president to have never overseen a single rate hike.

CURRENCIES

A "risk off" mood hit certain emerging markets last month, weighing on their bonds and currencies alike, although as noted above the Indian rupee fared well. Foreign investors have been piling into large-cap equities to capitalise on Modi's improved popularity, which has boosted demand for the currency.

It was a different story for the Brazilian real, which tumbled 4% on the political corruption scandal, whilst the Turkish lira returned as the "bad boy" of EM currencies. At one stage it had fallen 8% with investors spooked by a $10bn monthly decline in FX reserves that raised fresh concerns about the country's fragile (and highly indebted) economy. In response, the authorities imposed draconian restrictions on the lending of lira in the offshore market that saw the overnight swap rate more than triple to 1,200% p.a. This cut off speculators' ability to borrow and sell short the currency.

In Asia, the HK dollar traded back at its lower band of HK$7.85 against its US namesake, forcing the HKMA to deploy around $2bn of reserves to defend the peg. It is reported that this year's big rally in mainland Chinese stocks has led to a surge in HK-based speculators selling the HKD to fund equity purchases north of the border; the material increase in the Stock Connect program's northbound fund flows supports this thesis. The yuan was little changed against the dollar despite the postponement of the Trump/Xi gathering that was set to conclude the trade talks. Larry Kudlow, a White House advisor, threatened that negotiations could last for months, but news that the US trade deficit hit a 10-year high of $621bn in 2018 suggests the President will seek to expedite an agreement (that he can sell as a "win" at home).

Amongst the major currencies, the euro remains the laggard despite all of the Central Banks adopting a more dovish stance. The market is gauging (correctly in our view) that the European economy is in need of the most support. The single currency fell another 1% to $1.12 whereas sterling retreated 2% because of the Brexit shenanigans alluded to above. We note with interest that it continues to catch a strong bid every time it falls back towards U$1.30.

GOLD/COMMODITIES

The fact that industrial metals prices are struggling to make headway suggests the recent stimulus is yet to filter through into the global economy. Strong gains in the likes of copper and aluminium have been notable features of past reflationary episodes, but they have produced only modest year-to-date returns. Chinese data will be key in judging where we are in the cycle and recent trends are mixed; at 5% y/y, factory output growth has eased to the slowest since records began in 1995 and the new export orders component of the the PMI survey has collapsed to a 10-year low. However, the latest China Beige Book (which collates data on over 3,000 Chinese firms) concludes there were "unmistakeable" signs of a recovery in activity in Q1.

The gold price fell almost 2% in dollar terms, to $1,292/oz, as a firmer greenback weighed on all precious metals. The recent falls in cash and bond yields bolster the relative attractiveness of bullion (as a safe-haven asset) over the medium-to-longer term, but its near-term path is less clear as a firmer US dollar would likely pose a test. Interestingly, the related equities have gained ground despite bullion's recent softness; the NYSE Gold Bugs index added 1% in March, meaning it was a positive start for the position that we established in multi-asset portfolios a month ago.

Brent crude oil rose 4% last month and 27% over the quarter as supply-side factors dominated. The ascent was enough for President Trump to again call upon OPEC to boost production, but the alliance between the cartel and Russia seems committed to the 1.2 million barrels per day cut that they agreed to at the start of the year. However, a sustained improvement in economic activity (and energy demand) is likely needed if oil is to continue rallying.

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 Gold Miners China A Shares	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.

	31-MAR-19	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.3035	-1.7%	+2.2%	-7.0%
CHF	1.0047	+0.3%	-1.4%	-4.2%
AUD	0.7096	+0.0%	+0.7%	-7.6%
JPY	110.86	+0.5%	-1.1%	-4.1%
EUR	1.1218	-1.3%	-2.2%	-9.0%
BOND YIELDS (10 yr)				
UK	1.00	-0.30	-0.28	-0.35
US	2.41	-0.31	-0.28	-0.33
Germany	-0.07	-0.25	-0.31	-0.57
Australia	1.78	-0.33	-0.54	-0.83
Japan	-0.09	-0.06	-0.09	-0.14
EQUITIES				
US. S&P 500 (USD)	2,834.40	+1.8%	+13.1%	+7.3%
UK. FTSE 100 (GBP)	7,279.19	+2.9%	+8.2%	+3.2%
MSCI Europe ex UK (EUR)	1,303.97	+1.1%	+11.9%	+0.6%
Japan. Topix (JPY)	1,591.64	-1.0%	+6.5%	-7.3%
China. Shanghai Comp (RMB)	3,090.76	+5.1%	+23.9%	-2.5%
HK. Hang Seng (HKD)	29,051.36	+1.5%	+12.4%	-3.5%
Australia. All Ords (AUD)	6,261.73	+0.1%	+9.7%	+6.7%
MSCI Pacific ex Japan (USD)	1,358.86	+0.4%	+10.9%	+0.2%
MSCI World (USD)	2,107.74	+1.0%	+11.9%	+2.0%
MSCI World (GBP)	1,622.21	+3.2%	+9.8%	+10.1%
COMMODITIES				
Oil (WTI)	60.14	+4.4%	+29.3%	+0.8%
Gold	1,292.30	-1.6%	+0.8%	-2.5%

DO YOU RECEIVE INVESTMENT VIEWS?

If you would like to receive a regular digital copy at the start of each month please email us at UK@bentleyreid.co.uk. Alternatively, Investment Views is available via the Bentley Reid App, which can be downloaded onto all Apple devices.

Instructions for downloading the Bentley Reid App on Apple devices:

1. Scan or click the QR code below, or search for 'Bentley Reid' in the Apple App Store. Note the search must take place in the 'iPhone Apps' section, which sits at the top of the screen, regardless of the device being used. If you search in the 'iPad Apps' section no results will appear.

2. Install the app and click 'Open'.

3. Once the app is installed, to ensure you receive a pop up notification that new publications have been posted, go to the general 'Settings' section on your device and then choose 'Notifications'. Scroll down on the right hand side and select Bentley Reid. In the 'Notification Center' section choose 'On,' the type of 'Alert Style' you would like and then return to the main screen.

Your BR App will now be ready to receive the latest Investment Views and Fund Factsheets.

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
Authorized and regulated by the Financial Conduct Authority, registered office 29 Queen Anne's Gate, London SW1H 9BU. Registered Number 07602886

Published and distributed outside the UK by **Bentley Reid & Co Limited**
24 Floor Diamond Exchange Building, 8–10 Duddell Street, Central, Hong Kong,
Tel +852 2810 1233, Fax +852 2810 0849, Email HK@bentleyreid.com
Licensed by the Securities and Futures Commission in Hong Kong

The content of this document is for information purposes only. The authors believe that, at the time of publication, the views expressed and opinions given are correct but cannot guarantee this and readers intending to take action based upon the content of this document should first consult with the professional who advises them on their financial affairs. Neither the publisher nor any of its subsidiaries or connected parties accepts responsibility of any direct or indirect or consequential loss suffered by a reader or any related person as a result of any action taken, or not taken in reliance upon the content of this document.