BENTLEY REID

INVESTMENT VIEWS

MAY 2019

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EQUITIES	:	The first quarter recovery continues as tech stocks lead the way
BONDS	:	"Dovish" central banks encourage corporate bond buyers
CURRENCIES	:	Petro-currencies rally, the Aussie $ slides and the Krona slumps
COMMODITIES	:	Iranian sanctions support crude oil as gold gives up 2019 gains

The VIX index measures the magnitude of expected price fluctuations in options contracts on the S&P500. In more simple parlance, it indicates the expected volatility of US stocks and shares. Futures contracts on the VIX allow investors to speculate on the index level. These contracts are usually in contango, meaning that the price of a long-dated VIX future is usually higher than a near-term one.

For investors this represents an opportunity. If you short or sell a (more expensive) long-dated VIX future and buy the (cheaper) short-dated contract, you can profit from the price difference absent a significant rally in the underlying index. To quote the FT, "SocGen estimates that the shape of the VIX curve means that investors are currently pocketing a monthly 8% yield by shorting the index".

If we look at the last few years, the VIX or volatility of US stocks has tumbled. Why? The key drivers are inter-linked. Firstly, the low interest rate environment has encouraged investors to allocate to equities. This has created a 'buy the dip' mentality that has reduced the amplitude of market troughs. Secondly, quoted companies have been prodigious buyers of their own stock, creating a steady drum beat of price-insensitive demand whilst reducing the number of shares in issue. Last year saw US companies buy back a record $1.1 trillion of stock or 3% of the market; 2019 is on track to exceed this.

This, in turn, has flattered the returns of momentum-based investment strategies that eschew fundamental analysis in favour of trend following; funds that pursue this approach have bet on the persistence of the current bull run. This rules-based investing further deadens price volatility, encouraging another major player; risk-parity funds. This strategy allocates, in part, based on the relative volatility of different asset classes. If stock markets are rising but with low or falling price volatility, the strategy interprets this as higher prices with less risk. It thus allocates more to equities, ceteris paribus. So lower volatility encourages key marginal investors to buy equities, often amplifying their bets with cheap debt. Their actions reduce volatility further which, in turn, triggers additional buying. 'Soros-esque' reflexivity at work.

This circularity made 2017 the least volatile year for US stocks since the VIX index launched in 1986. By the start of 2018, this had fostered a record level of shorts on the VIX future; investors wagered aggressively on continued market calm. As usual, retail investors joined the party late, buying complex, opaque exchange traded notes (ETNs) that enabled them to profit from a subdued VIX.

This manufactured tranquillity broke early last year. Having touched a record high in January, US stocks slumped 10% as the US central bank signalled an accelerated withdrawal of QE support. The VIX rose from 9 to 37 in less than a month, a four-fold increase. This rapid rise in market volatility forced investors to cover their short VIX positions, increasing market volatility and the pace of the equity market decline. It also shuttered several risk-parity funds whilst a short VIX ETN, that had returned 1,000% from 2011 to 2017, went bust in a day (February 5th). The same happened before Christmas, as the hawkish tone from the US Fed surprised markets. The VIX trebled to 36, as the S&P500 rapidly dropped 20%.

Why are we dwelling on such technical matters? By the end of April, the level of (net) shorts on the VIX had hit a new record, even as the VIX index sat near a 12-month low. Investors have made huge bets that the current calm will continue; the “short vol” gun has been reloaded. This suggests that, after its recent bounce, the US market is vulnerable to a sharp correction on any bad news (market, economic, political). It also speaks to a wider reality and, perversely, an opportunity.

For nearly a decade, low interest rates have encouraged investors to favour growth stocks, often tech names that have rapid revenue growth but low or non-existent profits. When money is cheap, you forego little or no yield when investing in the promise of future profits and dividends. The investment behaviour above has magnified this trend, with momentum and risk-parity strategies favouring market leading, growth sectors.

Together this has driven growth stocks to nose bleed valuations; the recent spate of tech company IPO’s ably illustrates the point. In 2018, UBER and Lyft had average revenue growth of 72% but lost more than $2.7bn. Despite this, their combined market worth looks set to be around $100bn. This growth bias has led to the chronic underperformance of value stocks (defined as companies where their market value is less than their intrinsic worth). Over the last 5 years the S&P growth index has outperformed its value counterpart by 43%.

Admittedly, many cheap stocks are a value trap; they deserve to be unloved. Some companies face an existential threat due to the unfolding tech revolution; retail is an obvious candidate. Cheap, plentiful money is also keeping many insolvent companies afloat. The Bank of International Settlement (BIS) estimates that 12% of quoted companies in advanced economies share ‘zombie’ status, where their debt interest costs exceed their profits before interest and tax. Conversely, some growth names deserve a rich valuation premium as they have established a dominant market position, with high barriers to entry. That said, the risk in such names is shifting from markets to the political. Cavalier stewardship of monopoly power is attracting the ire of anti-trust politicians. We still believe that platform companies like Google and Amazon risk being broken up, like Standard Oil in 1911.

Despite our headline caution, we see an opportunity in value stocks. Their rejection has reached an extreme whilst the lofty valuation of many growth stocks are vulnerable to slower global activity and waning profit growth. Over the last 18 months, we have been gradually shifting the emphasis of our equity book from growth names to value. Whilst we acknowledge that it may take time for value plays to shine, patience should be rewarded. Furthermore, during the torrid Christmas sell-off, value stocks significantly outperformed growth, suggesting they may also offer some defence if this aged bull ever tires.

IN OTHER NEWS…

At the turn of the year, we shared extracts from the "Uxbridge English dictionary". As a reminder, the UED provides alternative definitions to well known words and was made famous by contestants on Radio 4's "I'm sorry I haven't a clue". A generous reader sent in a complete UED, from which we share a few of the entries under "E".

Equidistant	an ant who's been slagged off by a horse
Erectile	where they keep the Viagra in the supermarket
Euthanasia	young people in China
Exact	the performance denoting poverty during a divorce hearing
Extractor fan	one who used to like farm machinery

EQUITIES

Global equity markets gained 3% in April as technology stocks once again led indices higher. The US market fared well with the S&P 500 adding 4%; the tech-heavy Nasdaq index rose 5%. President Trump also had a good month, when the much-anticipated Mueller report concluded that his campaign team did not collude with Russia in its 2016 election interference. However, the report stopped short of offering a full exoneration, leaving the President open to further Democratic sniping.

Trade talks between the US and China seemed to be progressing well until 'the Donald' threatened to derail the process in early May. He cited Chinese back-sliding on promises as he threatened to increase the current 10 per cent tariffs, on $200bn of Chinese goods, to 25 per cent. Global stocks reacted negatively, with the Chinese A share market losing 6% when it opened after the Golden Week holiday. With Trump seeking re-election in 2020, some form of deal still looks likely but the timing of it remains unclear. We are also conscious that Trump is lining up the EU as his next tariff target, suggesting that the fractious global trade narrative will drag into the 2020 election period and remain a source of noise and volatility.

The MSCI UK index rose 2% last month whilst Brexit machinations rumbled on. The EU agreed to extend the Brexit deadline to 31st October from 12th April, allowing time for PM Theresa May to enter discussions with the Labour Party in an attempt try to break the parliamentary deadlock. Unsurprisingly, the talks have delivered little progress given the intra-party schisms on both sides of the House. The electorate were swift to register their displeasure, with the Tory party losing over 1,300 councillors in mid-month local elections. The Labour party also lost 84 seats as they failed to profit from the Tory disarray. The main winners were the Liberal Democrats, the Green Party and 'Others' (including independent candidates). Given the EU extension to the Brexit deadline, the main parties are now braced for a further drubbing in European elections on 23rd May; Nigel Farage's new Brexit party is polling well given the clarity of his message. His populist peers across the continent are also ahead in the polls, suggesting the EU will shortly have to deal with its own Trump/Brexit moment.

European markets added 4% in April. Germany led with an 8% rebound, despite continued weakness in German economic data; the German government halved its forecast for 2019 growth to just 0.5%. However, early signs that Chinese economic data may be stabilising gave succour to the export dependent Republic. Chinese growth in the first quarter was estimated to be 6.4%, according to the National Bureau of Statistics; ahead of market expectations. German auto and industrial companies responded positively. Given the weak economic narrative and the challenges we allude to above, we continue to shun arguably cheap European equities (and the currency), until some of the mist clears.

In Japan, Emperor Akihito abdicated, paving the way for his son Naruhito to ascend to the Chrysanthemum Throne. Japanese markets were closed for an extended ten-day holiday to celebrate. The Topix gained 2% which was broadly in line with other Asian markets during the month. Emerging markets fared a little better, up 3%, as oil heavy countries such as Russia benefited from a higher oil price.

BONDS

US GDP growth was 3.2% in the first quarter, better than many expected and well ahead of early year predictions. Unemployment declined to 3.6%, a 49-year low, but inflation remained benign. Core inflation (PCE) posted 1.6 per cent with headline CPI at 1.9%. Fed Chair Powell maintained that monetary policy was appropriate for current conditions and that he did not see a strong case for moving rates in either direction. His pragmatic approach reflects the markets own uncertainty about the direction and strength of the US expansion. The yield on a ten-year treasury nudged 0.1% higher to finish the month at 2.5%.

In the UK, gilts also softened with the yield on a ten-year issue rising to 1.2% (from 1.0%) during April. This is still a negative real yield of 0.7%, as March inflation came in at 1.9%, unchanged from February. Chancellor Philip Hammond kicked off the search for a replacement for Bank of England Governor Mark Carney; he is set to step down in January 2020. In the meantime, UK interest rates remain at 0.75%, pending further clarity on Brexit. Carney cautioned that the market expectation of only one rate rise over the next three years is complacent. His warning is based on the assumption of that activity will recover after an orderly Brexit. There was good news on Government borrowing which hit the lowest level in seventeen years (source: Office for National Statistics). Total borrowing for the 2018-19 financial year was £24.7bn (equivalent to just over 2% of GDP), dramatically lower than the prior year's £41.8bn deficit. Income and capital gains receipts were ahead of forecast and social security costs moderated, as unemployment fell and wage growth accelerated.

European economic data remained moribund, as mentioned in the previous section. This left the yield on ten-year German bunds around 0%. Real yields (nominal yields minus inflation) remained firmly in negative territory, as Eurozone inflation rose to 1.7% in April, from 1.4% the prior month; higher energy prices were the main culprit. It was no surprise to see the Italian government cut its 2019 GDP growth forecast to 0.2% from the 1.0% it predicted in December. As growth slows, the deficit is expected to rise to 2.4% (and beyond), reigniting fears about the sustainability of Italy's prodigious debt pile. Market nerves are starting to resurface, with the yield premium on Italian government debt over German bunds rising to 2.5%. Any post-EU election talk of a populist fiscal expansion could well put pressure on the Italian bond market and, by extension, its domestic banking system.

Corporate bond markets rallied this month. The yield premium (or spread) on US BBB-rated bonds over treasuries shrunk 0.1% to 1.6% whilst US high yield spreads fell to 3.6% from 3.9%. With the Fed standing pat and inflation absent, yields caught a bid. With spreads so tight, the reward for taking credit risk remains low by historic standards; corporate bond markets are primed to suffer acutely at the first sign of rising delinquencies. There was plenty of action in credit markets this month. GE's mortgage unit filed for Chapter 11 bankruptcy protection in the US, after it agreed to pay $1.5bn to settle litigation with the US Justice Department. Tech darling Netflix raised $2bn in debt an average yield of c. 4.5%. The highly popular TV platform burns through cash at an alarming rate, forecast to be $3.5bn in 2019. Future debt issuance looks inevitable as it seeks to fight off competition from the likes of Amazon Prime and soon-to-be-launched services from behemoths Apple and Disney. Like Tesla, its vast accumulated debts make it very vulnerable to any deterioration in credit markets and/or any signs of slower top line growth borne of credible competition.

CURRENCIES

The trade-weighted US dollar was broadly flat last month, and is now up just over 1% since the start of the year. It was unchanged against both the euro and sterling.

The Swedish krona sold off 2% this month as it slumped to its weakest level since 2002. The Swedish central bank was the pioneer of negative interest rates and it surprised markets this month when it said it would maintain the current base rate of -0.25% for longer than anticipated. It also announced a fresh wave of bond purchases, starting in July.

The Australian dollar continued to slide, falling 1%, as the Reserve Bank of Australia kept rates unchanged at 1.5%. RBA Governor Philip Lowe has become more dovish in the face of a slowing domestic housing market and subdued inflation. Annual CPI was 1.3% at the end of March, down from 1.8% at the turn of the year. Although Aussie rate cuts now look inevitable, the RBA is unlikely to move before elections finish in May. Although the Australian dollar is starting to look cheap on various measures, we feel it is too early to call a bottom.

The Russian rouble was once again one of the better performing emerging market currencies. It rallied 2% last month and is now 7% higher this year. A rising oil price has clearly been beneficial for the Russian balance sheet. Conversely, a rising oil price would normally be bad news for major importers such as India. However, the Indian Rupee has been fairly robust, despite cuts in the central bank's interest rate. This month saw another 0.25% reduction, taking the headline rate down to 6%. The Indian government successfully lobbied for lower rates in advance of the general election, which runs for 6 weeks from April 11th. With results due on May 23rd, signs of a Modi win were generally well received by the currency market (as well as the local stock market). Despite various short-comings, Modi is expected to remain a reforming PM.

GOLD/COMMODITIES

Gold bullion fell 1% last month to $1,283. The price is now unchanged on the year. Several central banks remained enthusiastic buyers of bullion, according to the latest report from the World Gold Council. Following a record year of net purchases in 2018, central bank gold reserves grew by 145 tonnes in the first quarter. Russia was once again the largest buyer, adding 55 tonnes. China and Turkey were also notable buyers, as these nations continue to diversify their reserves away from the US dollar. Trump's 'weaponisation' of the greenback should underpin this dynamic a while longer.

The oil price rose 6% in April. US WTI oil now costs $64 per barrel, with European Brent at $73. The Trump administration announced an end to Iranian sanctions waivers, demanding countries halt all imports of Iranian crude. Secretary of State Mike Pompeo proudly declared "we are going to zero".

The US had given India, China, Japan, South Korea and Turkey a brief period to make alternative arrangements. President Trump assured markets that he had agreed with Saudi Arabia to increase production to mitigate disruption. According to OPEC Saudi Arabia (allegedly) has 1.9m bpd of spare capacity, well in excess of Iranian oil exports' which amounted to 1.4m bpd at the end of March (source: Bloomberg). Regardless, oil markets remain well bid as Libyan and Venezuelan supplies remain compromised.

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.

	30-APR-19	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.3032	-0.0%	-0.6%	-5.3%
CHF	0.9811	-2.3%	-2.4%	-2.8%
AUD	0.7048	-0.7%	-3.1%	-6.4%
JPY	111.42	-0.5%	-2.3%	-1.9%
EUR	1.1215	-0.0%	-2.0%	-7.1%
BOND YIELDS (10 yr)				
UK	1.18	+0.19	-0.03	-0.23
US	2.50	+0.10	-0.13	-0.45
Germany	0.01	+0.08	-0.14	-0.55
Australia	1.79	+0.01	-0.46	-0.98
Japan	-0.05	+0.04	-0.05	-0.10
EQUITIES				
US. S&P 500 (USD)	2,945.83	+3.9%	+8.9%	+11.2%
UK. FTSE 100 (GBP)	7,418.22	+1.9%	+6.4%	-1.2%
MSCI Europe ex UK (EUR)	1,359.24	+4.2%	+9.8%	+1.2%
Japan. Topix (JPY)	1,617.93	+1.7%	+3.2%	-9.0%
China. Shanghai Comp (RMB)	3,078.34	-0.4%	+19.1%	-0.1%
HK. Hang Seng (HKD)	29,699.11	+2.2%	+6.3%	-3.6%
Australia. All Ords (AUD)	6,418.38	+2.5%	+8.1%	+5.7%
MSCI Pacific ex Japan (USD)	1,380.95	+1.6%	+5.4%	-1.1%
MSCI World (USD)	2,178.67	+3.4%	+7.4%	+4.4%
MSCI World (GBP)	1,670.51	+3.0%	+8.1%	+10.2%
COMMODITIES				
Oil (WTI)	63.91	+6.0%	+17.1%	+2.4%
Gold	1,283.55	-0.7%	-2.8%	-2.4%

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