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INVESTMENT VIEWS

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EQUITIES	:	A break down in US/China trade negotiations thumps stocks
BONDS	:	"Safe haven" buyers drive core Sovereign bond yields lower
CURRENCIES	:	The yen and Swiss franc rally as sterling slides on political turmoil
COMMODITIES	:	Falling real yields support bullion as profit-taking hits oil

Trump is upending global trade relationships and supply chains that have taken decades to establish. In the last few weeks he has threatened tariffs against Mexico, Japan, the EU and Australia whilst removing India's developing nation status; the designation allowed India to export 2,000 products to America duty-free. The US Treasury has been co-opted adding Singapore, Italy, Ireland, Malaysia and Vietnam to the list of nations it feels might be harming US interests by managing their currencies; they join China, Germany, Japan and South Korea.

Meanwhile the stand-off between China and the US has intensified. On May 10th, Trump raised tariffs on $200bn of Chinese imports from 10% to 25% and threatened to levy similar tariffs on a further $300bn of Chinese goods; taken together this would account for nearly all Chinese imports. Trump also dialled up his attack on Huawei. Having effectively banned US companies from working with the Chinese tech champion, he has threatened to withdraw security cooperation from nations that use Huawei technology (which is the vast bulk of US allies). Trump is trying to press gang others to take his shilling.

As China has a trade surplus of over $400bn with the US, tit-for-tat tariff retaliation is futile. Although it has raised duty on $60bn of incoming US goods, Xi has chosen subtler measures. As the dominant world producer of rare earth metals, China provides 80% of America's needs; these elements are vital constituents of batteries, smartphones and other pervasive technologies. As it did during a 2010 territorial spat with Japan, China may manage rare earth exports to apply political pressure. It is also establishing a list of "untrustworthy foreign entities" that will be subject to enhanced import checks, greater licence scrutiny and other effective barriers to business; a direct retaliation to the ban on Huawei. If China delivers on these threats, corporate US will suffer. Goldman Sachs estimates that Apple's profits would fall 30% if it lost access to Chinese domestic markets.

The deteriorating relations suggest that the chances of a meaningful trade agreement, during the 28th June G20 summit, are receding. Given Trump's ability to turn on a (policy) dime, a deal cannot be ruled out but any resolution seems more likely as we head into 2020. This is especially true given the bi-partisan domestic support for his robust trade stance.

As a client recently observed, the President's short term political gambit, to demonise Chinese trade transgressions in the run-up to the 2020 elections, has been high jacked by the long run ideological imperatives of US trade and security hawks. Even if we do get a (lightweight?) trade deal, this fundamental rivalry is set to endure. The US is keen to challenge China's emerging power and is forcing other nations to choose a side. A world bifurcated between an America sphere of influence and technology, and a Chinese equivalent, looks all but inevitable. Supply chains and cross-border investment will become increasingly local; this will be disruptive and inflationary.

Across the Atlantic, the picture is equally muddled. Whilst the recent EU parliamentary elections scotched the more extravagant hopes of the populist extremes, it did deliver a more fractured chamber. The long-dominant Socialist/Christian Democrat alliance must now rely on the Greens and the Liberals to legislate and to see off the enlarged cohort of Eurosceptic, populist MEPs. This less cohesive ruling alliance must deal with growing demands for less austerity and more spending, in direct contravention of core EU fiscal principles. This tension is clearly evident in Italy. With its right/left ruling coalition noisily discordant, La Repubblica is set to be reprimanded by the EU for not doing enough to reduce its epic debt pile; at 132% of GDP, it is more than twice the 'Growth & Stability' pact limit. It faces a potential fine of 0.2% of GDP (c. €3.5bn) and demands to increases taxes and cut spending; a reprise of the Greek debt-crisis policy prescription. The dominant Italian politicians have promised to face down such demands; an early test for the concord of the new EU leaders. Markets are waking up to this; the yield on Italian 5-year government bonds (BTPs) now exceeds the Greek equivalent with the yield premium on 10-year BTPs versus German bunds rising to 2.9%.

As for Brexit, the Tory party are set to elect a new leader by mid-July, after PM May steps down on June 7th. Sitting MPs must select two candidates, from a field of 11, for the party members to choose from (unless they expedite matters and agree on one candidate). We continue to believe that this drawn out saga ends with some form of national vote, most likely a 2nd referendum. With a majority of MPs willing to vote against a no-deal Brexit and the House Speaker prepared to give them parliamentary time, a no-deal outcome is liable to be voted down, forcing the new Tory leader to seek a popular mandate. As a general election would probably unseat a large number of Tory MPs, we suspect that the Conservatives will coalesce around a re-run of the plebiscite. Cross-party support would follow. Even if Britain does leave the EU without a deal on the 31st October, we question the most doom-laden prognostications. We suspect that a chaotic early November would compel both the UK and EU to agree to a continuation of the status quo, with Britain paying into EU coffers until the terms of a future relationship could be hammered out.

The twists and turns of these political soap operas are inherently unknowable. We continue to look through the noise to focus on valuations and other tangible metrics. As such, we note that the global growth slowdown of 2015/16 is back and is accelerating; the 2017 economic sugar rush of a Trump tax cut and emergency QE (by the PBOC and the US Fed) has worn off. PMI surveys indicate that global manufacturing is now contracting, as new orders slump and swollen pre-tariff inventories get bled down. Other economic "canaries" also look sickly: semi-conductor sales, trade volumes and global auto sales have slumped.

The market is now attaching a 70% chance of a US rate cut by August, with more before the year end. If that happens, it may restore enough confidence and activity to prop up growth and equity markets for the rest of the year. The US dollar would likely soften, a boon to beaten-up emerging market assets and over-stretched global dollar borrowers. However, the risk is that the unfolding slowdown has now achieved self-sustaining momentum, as the delayed impact of trade friction and last year's US rate rises choke off anaemic growth; efforts to reflate, monetary and fiscal, may struggle to gain traction.

IN OTHER NEWS…

The current fashion for over-hyped tech IPOs and being vegetarian collided with the May 1st flotation of Beyond Meat. Inviting one to "break barriers and defy convention", the company produces plant-based protein that "looks, cooks and satisfies like beef". Their veggie patties fill the "Impossible Whopper" at Burger King. Having made losses of $30m on $88m of 2018 revenues, the company came to market with an eye (mouth?) watering value of $1.44bn. It closed the day up nearly 90% and ended the month over 400% higher. The company is now valued at $6bn. Whilst acknowledging that vegan and veggie popularity is on the up, we struggle to see this as rational behaviour. As competition arrives apace (including food behemoth, Nestle) the optimism seems 'Beyond Belief'……

EQUITIES

Global equity markets fell 6% in May after a barrage of negative political and economic news finally led investors to reappraise the earnings prospects of global equities. The S&P 500 fell 6.6% to post its second worst return for the month of May since 1962.

Despite evident signs of progress in the trade negotiations, on the 6th May Trump unexpectedly tweeted that the existing tariffs on $200bn worth of imports from China would increase from 10% to 25% a few days later. Within a week, the 'tech war' also ratcheted higher when the US placed Huawei on its export blacklist. In retaliation, China's Commerce Ministry announced it would draft a list of foreign companies that it deems to be 'unreliable'. The list is, as yet, undefined.

Having led stock markets higher all year, technology names around the world crashed in sympathy. The tech-heavy NASDAQ index fell 8% whilst the Philadelphia semiconductor index lost 17%, its worst monthly performance since the height of the financial crisis. Baidu, the Chinese equivalent to Google, fell 33%.

The FTSE 100 was a beneficiary of its negligible (1%) weighting to tech companies and a 3% fall in the value of sterling; both factors saw the UK market fair relatively well, declining only 3.5%. The emerging market equity index fell 7% as its 31% allocation to Hong Kong and Chinese-listed stocks bore the brunt of the trade war tactics. The Hang Seng index fell 9%. Brazil proved to be a relative safe haven once again, rising 1% for the month to leave its 1-year return at a world-leading 20% in US dollar terms. Though President Jair Bolsonaro's disapproval rating increased to 36% from 31% in April, Brazil recently saw demonstrations in favour of the President's reform program, which seeks to right size Brazil's unaffordable state pension system.

The Australian equity market outperformed all of its developed world peers in May. It rose 1% after the ruling Conservative party was re-elected in a result described by Prime Minister Morrison as a 'miracle'. Opinion polls had favoured the opposition Labour party for much of the past two years. The Labour manifesto pledged to reduce tax breaks on housing. It proposed to eliminate certain

CGT reliefs and to reduce tax credits for negative gearing on investment properties (where debt interest costs exceed rental income). With a home ownership rate touching 65% and the ratio of household debt to disposable income at an all-time high (c. 200%) such manifesto pledges proved a step too far for most Australians. The result triggered an 8% relief rally in Australia's dominant banking sector. This respite may prove temporary. With the local economy slowing, bank earnings remain vulnerable to lower rates (and net interest margins) as well as the ongoing slowdown in local property prices and activity. If mortgage defaults start to rise, their (tiny) average loan-loss provision of 0.13% will leave profits exposed.

BONDS

As investors reappraised the outlook for US monetary policy amidst the escalating US/China trade tensions and softening economic data, May saw sovereign bond yields tumble (and prices rise) at their fastest pace since the financial crisis.

The Trump Administration's confrontation with China is already having a negative effect on both survey-based and hard economic data. US durables goods orders fell 2% in April, while new home sales fell by 7%. Latest data for US retail sales and industrial production were also weak. Forecasts for US Q2 GDP growth are slipping after a 3.1% expansion in Q1 that was flattered by pre-tariff inventory building.

US 10-year treasury yields touched 2.1%, down from 2.5% at the start of the year. Despite the sharp treasury rally of the past seven months, speculators continue to bet on a sell-off; they remain net short 10-year treasury futures. The size of this short position has declined from a peak in September 2018 when virtually every 'guru' was predicting a gloomy outlook for bonds. With US inflation expectations broadly constant since then, real (after inflation) US 10-year yields have continued their descent from a high of c.1.2% in November 2018 to their current level of 0.4%. As we note below, this falling real yield has been a boon for bullion.

In the UK, gilt yields fell for all maturities. The 10-year gilt yield fell by 0.3%, to 0.9%, within touching distance of the 0.5% all-time low in July 2016. As is the case in US, UK real rates have declined sharply as inflation expectations have remained firm. Indeed, the Office of National Statistics admitted that its latest inflation reading (which informs index-linked gilt pay-outs) contained an error, resulting in an inflation understatement. RPI inflation actually rose 3.1% pa in April (not the published 3.0%), up strongly from 2.4% pa in March. An incorrect fuel price was to blame. The decline in real yields now sees the UK 10-year 'Linker' trade at a record low real yield of -2.5% (ie. the bond offers a yield of 'RPI - 2.5%' pa).

The 10-year German Bund yield moved into negative territory for only the second time in history, and then kept falling. It ended the month at -0.2%, its lowest level since reunification in 1990 (source: Bloomberg). There are now more than $11trn of negative yielding bonds, nearly double the level of October last year. As noted in the lead article, Italian BTPs were the notable laggard as political instability increased the yield premium demanded by investors.

In China, Ashmore (an EM fund manager) noted the launch of the first bond index ETF. This will enable retail investors to access fixed income products, allowing them to balance the inherent volatility of their local equity holdings. The funds are expected to prove popular, helping to deepen local debt markets and improve liquidity. Elsewhere in the emerging market bond universe, both of our chosen EM debt funds added value during the month, despite the risk-off sentiment. The Schroder fund was flat whilst the 1167 fund rose 1%.

CURRENCIES

As noted in the lead article, the European parliamentary election saw centre-left and centre-right groups cede ground, although the overall shift to populism was less marked than many feared. Even though the centre-ground alliance now has more members, it continues to control more than two thirds of the seats. The euro found support as a result, ending the month broadly unchanged at $1.12. Given the euro's 58% weighting in the trade-weighted dollar index (DXY), the greenback was broadly flat in May.

In contrast, the EU elections saw support for the two biggest UK parties crumble; this helped push sterling down 3% to $1.26. The Conservatives haemorrhaged to Nigel Farage's Brexit Party (who gained 29 of the UK's 73 EU parliament seats), prompting Theresa May to announce that she would resign as Prime Minister on the 7th June. The Labour Party, with its confused Brexit message, did almost as badly, losing seats to both pro and anti-EU parties. The Lib Dems and Greens, who ran on a clear Remain message, won a combined 23 seats, 19 more than the 2014 election. A subsequent poll of general election voting intentions revealed the extent of the division in UK politics. The Liberal Democrats moved into first place (24%), trailed by the Brexit Party (22%). Labour and the Conservatives tied in third place on 19% (source the Times/YouGov). The poll reinforced our belief that the Tories will opt, if pushed, for a referendum over a general election.

Towards the end of the month, 'the Donald' unexpectedly announced a new set of tariffs on Mexican goods; the peso dropped sharply on the final day of May, suffering its biggest decline in seven months. President Trump's move was in response to a large rise in illegal migration across the shared border. "All goods" from Mexico will be subject to a 5% levy from 10th June. President Trump declared the tax "will gradually increase (on a monthly basis, to 25% by 1st October) until the illegal immigration problem is remedied". In a typically Trumpian irony, the biggest losers on the day of the announcement were the 'Big 3' Detroit-based car manufacturers and, by extension, US workers and consumers. Mexican-made vehicles account for about 15% of US light-vehicle sales, according to LMC Automotive. Although Trump has made an 'auto renaissance' a key pledge of his Presidency, his policies have had the opposite effect. Tariffs on steel and aluminium imports saw Ford, GM and Fiat Chrysler report a combined $2.5bn hit to 2018 earnings, according to the Washington Post. Squeezed by rising costs and falling US car sales, Ford announced in May that it would cut its global workforce by 10%.

The 'risk-off' mood saw China's renminbi give up all of its year-to-date gains, falling 2.5%. The psychologically important level of RMB7 is now in sight and may well be breached if the next round of US tariffs is implemented. The RMB slide benefitted two traditional safe-haven currencies despite their negative base rates; the Japanese yen led with a 3% gain against the dollar, while the Swiss franc rose 2%.

In India, Prime Minister Modi increased his majority in the general election; a staggering 900m people were eligible to vote. The BJP-led National Democratic Alliance took 353 of the 545 seats in the Lower House, an improvement on 2014. The scale of Modi's win surprised pundits as his economic reforms have produced short term pain; India's unemployment rate recently rose to 6%, its highest level in over 40 years. Modi's landslide victory helped the Indian stock market to a 2% return and left the rupee unchanged against the dollar.

GOLD/COMMODITIES

The oil price corrected in May. Brent prices fell 11% to a 3-month low of $64 a barrel whilst the US WTI benchmark fell even more, losing 16%. Stockpiles of US crude remain near their highest levels for two years following a smaller than expected drop in US crude and gasoline inventories. The sharp pullback still leaves the world's key commodity price 20% higher for the year-to-date, supported by lower global production and robust demand. Figures published by the Energy Intelligence Group show global oil production was 96.8m barrels per day (bpd) in April. This was an increase of 0.6m bpd compared to a year earlier (in line with demand growth) but down more than 2m bpd since the end of 2018. Despite the recent fall, the supply/demand balance argues against a collapse in oil prices; indeed, with US shale oil production dependent on a steady stream of cheap debt to finance operations, the recent rise in high yield energy spreads could well presage lower US output.

Whilst some industrial metals fell back in May, the price of iron ore bucked the trend. Since a tailings dam disaster in January at one of the world's largest mines in Brazil, global iron ore supply has been challenged. As safety inspections continue to shutter swathes of Brazilian production, the global shortfall was compounded by the forced closure of Australian production due to the threat of an unseasonal tropical cyclone. The iron ore spot price gained 12% in May and is now 60% higher than a year ago. The chronic underinvestment in production facilities and their vulnerability to the effects of a warming climate illustrate the inflationary potential of supply-side fragilities.

Echoes of this could be found in US food prices that responded in spectacular fashion to the extreme wet weather affecting swathes of the US Midwest. Corn prices jumped 21% over the month, to a three-year high, as farmers delayed planting crops. Only 58% of corn fields had been sown by 26th May, compared to an average of 90% over the past 5 years (source: the US Department of Agriculture/USDA). Soybean prices rose 4% despite China, the world's largest buyer, placing US crop purchases on hold. Delays in US soybean planting leave just 29% of acreage planted compared to a 5-year average of 66%. Finally, the US wheat futures contract rallied 20% as USDA data showed planting to have materially lagged the pace of prior years.

The price of gold bullion rose 2% in US dollar terms last month, to $1,305 per troy ounce. The decline in US real interest rates is a key driver of the dollar price of gold bullion. The relatively dull performance of gold in the preceding months was in large part due to US investors selling gold ETFs and bearish speculators in the gold futures market. Total known gold ETF holdings have declined by 2.8m ounces since their January high (equivalent to $3.6bn at current prices). As for speculators, they now have a bigger net short position than they did at gold's $1,050 bottom in December 2015. With Central Bank (ex-US) continuing to accumulate bullion and US real rates set to fall further, we retain a core exposure to gold and the related mining stocks.

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-MAY-19	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.2629	-3.1%	-4.8%	-5.0%
CHF	0.9992	+1.8%	-0.3%	-1.5%
AUD	0.6938	-1.6%	-2.2%	-8.3%
JPY	108.29	+2.9%	+2.9%	+0.5%
EUR	1.1169	-0.4%	-1.8%	-4.5%
BOND YIELDS (10 yr)				
UK	0.89	-0.30	-0.42	-0.34
US	2.13	-0.38	-0.59	-0.73
Germany	-0.20	-0.22	-0.39	-0.54
Australia	1.46	-0.33	-0.65	-1.21
Japan	-0.10	-0.05	-0.07	-0.13
EQUITIES				
US. S&P 500 (USD)	2,752.06	-6.6%	-1.2%	+1.7%
UK. FTSE 100 (GBP)	7,161.71	-3.5%	+1.2%	-6.7%
MSCI Europe ex UK (EUR)	1,278.17	-6.0%	-0.9%	-2.3%
Japan. Topix (JPY)	1,512.28	-6.5%	-5.9%	-13.5%
China. Shanghai Comp (RMB)	2,898.70	-5.8%	-1.4%	-6.4%
HK. Hang Seng (HKD)	26,901.09	-9.4%	-6.0%	-11.7%
Australia. All Ords (AUD)	6,491.81	+1.1%	+3.8%	+6.0%
MSCI Pacific ex Japan (USD)	1,330.52	-3.7%	-1.7%	-4.3%
MSCI World (USD)	2,046.25	-6.1%	-1.9%	-2.2%
MSCI World (GBP)	1,620.40	-3.0%	+3.1%	+2.9%
COMMODITIES				
Oil (WTI)	53.50	-16.4%	-8.5%	-14.9%
Gold	1,305.45	+1.7%	-0.6%	+0.5%

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