BENTLEY REID

# INVESTMENT VIEWS

## SEPTEMBER 2018

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**EQUITIES** : Profits push the US to new highs as emerging markets tumble
**BONDS** : Emerging market debt sells off sharply as US$ liquidity dries up
**CURRENCIES** : The Turkish lira and Argentine peso lead EM currencies lower
**COMMODITIES** : Supply concerns boost oil as gold and industrial metals retreat

The 2017 economic sugar rush, engendered by 2016's panicked QE stimuli, is wearing off. Global growth is slowing, leaving yen and euro base rates firmly anchored at the zero bound; sterling rates are stalled at 0.75%. For all the talk of QE withdrawal, the European, Japanese and British central banks are proceeding at a glacial pace. In China, the People's Bank has reversed course and is once again injecting funds into its economy, struggling to support growth as it attends to its vast debts. As we have long suspected, it is increasingly evident that global growth and accumulated debts are unsustainable, absent crisis-era monetary support.

For now, the stand out exception is America. Pouring fuel on a well-lit economic fire, Trump's tax cuts and spending have sustained US momentum. Last December he announced US$300bn of extra expenditure in 2018 (an election year) with net new spending projected to nearly double the budget deficit to US$1trn, or more than 5% of GDP, by 2020 (source: Congressional Budget Office). Such shortfalls are unprecedented outside times of recession or war.

Little wonder then that real GDP growth accelerated to 4.2% in the second quarter, with US corporate earnings per share rising by 25%, year-on-year; the best since 2010. The latter were aided by one-off factors. Profits have been boosted by a significant cut in corporation tax and temporary incentives to repatriate overseas cash reserves. Though many hoped that these steps would stimulate productive investment, company boards have different ideas; earnings per share have been amplified by record share buybacks that are set to rise 46% this year, to US$1trn (source: Goldman Sachs).

This robust growth and above target inflation of 2.9% pa have enabled the US Federal Reserve to gradually accelerate monetary policy normalisation. The Fed funds target rate has risen to 1.75%–2%, with the reduction of its balance sheet progressing as planned. Having more than quadrupled over the last decade to nearly US$4.5trn, the Fed is now cutting its bond holdings by US$50bn per month.

Dollar-denominated debt, outside the US, has more than doubled to US$11trn since 2008 (source: BIS). With about a third owed by the non-financial sectors in emerging markets (EM), rising US rates and receding dollar liquidity have brutally exposed the over-indebted. Markets have been swift to judge those nations that they feel have unsustainable dollar debts and that are over-reliant on external funding.

Turkey and Argentina stand out, with their currencies more than 40% lower than their February peaks (versus the US dollar). However, the malaise has spread with the broader JPMorgan EM currency index now off 15%. Related EM sovereign and corporate debt has been similarly stressed, with the JPMorgan EM local Government bond index 19% lower; we are now exploring EM debt funds that carry an 8% yield to maturity from much cheaper local currencies.

Equity markets have not been immune, as investors have reassessed the spiralling cost of companies funding dollar obligations. Whilst Europe and the UK bourses are 12% and 8% off their January highs, the MSCI EM equity index has declined 17%, with the Shanghai Composite and Brazilian Bovespa both seeing 30% falls (2018 peak to end August, US dollar terms).

Throughout this episode, US markets have enjoyed a period of “splendid isolation”. The S&P500 is up 8% this year, the 10 year Treasury yield is becalmed below 3% and credit spreads (the premium corporates pay to borrow money) remain tight. The question is, with receding dollar liquidity and US rates set to rise further, will the distress in non-US regions snowball with weak economic players dragging their stronger peers down? And, if this comes to pass, can the US continue to sail on regardless? US monetary policy is key.

Ironically, Trump’s attacks on the US Central Bank, questioning the need for higher rates, could impede any Fed policy reassessment; Governor Powell may delay to demonstrate independence. Furthermore, Trump’s late-cycle stimulus is inherently inflationary, arguing for further rate hikes even if US growth starts to slow (as it is predicted to do).

Markets are pricing in three more rates rises before the end of 2019, including 0.25% increments in September and December; this is at odds with the five increases currently envisioned by the Fed. We side with the markets as the US expansion faces the delayed impact of higher rates and the trade/tariff uncertainties. Less dollar liquidity will also challenge over-priced US equity and debt markets just as the boost from tax cuts and offshore cash repatriation ebbs and investors focus on slower profit growth next year.

We thus believe that Governor Powell will be forced to moderate policy tightening earlier than the Fed predicts; a peak Fed funds rate of about 2.5% seems increasingly likely. Furthermore, Powell recently acknowledged that US monetary policy must be set with at least one eye on external ramifications, given the dollar’s role as the global reserve currency. EM turmoil will influence the Fed rate setters.

With global growth slowing but solid, a Fed policy retreat over the next couple of months (or a belief thereof), could soften the dollar and head off growing fears of EM contagion. Concurrent retreats from policy tightening by other Central Banks would aid this narrative. In this regard, the “EU-toxic” populist fiscal agenda of the Italian Government and on-going Brexit rumblings suggest euro and sterling rates will remain low, whilst the PBoC looks set on an expansionary course.

However, if markets continue to anticipate fewer and dearer dollars, whether due to accelerating inflation and/or robust US growth, the probability rises that the current EM shakeout will metastasise. Many EMs, particularly in Asia, are less vulnerable than the crisis period of 1997/98; external funding is less important and most currencies are not dollar-pegged. Even so, enduring distress in the weak can undermine the strong, with investor flows fanning the economic and market wildfires. Developed markets would not escape a widening narrative, including gravity defying US asset prices.

## IN OTHER NEWS…

A regular reader, having listened to (endured?) our bearish musings, sent through the following quotes. He kindly noted how "sage" we currently sound…

"If you say the world has been getting better you may get away with being called naïve and insensitive. If you say the world is going to go on getting better, you are considered embarrassingly mad. If, on the other hand, you say catastrophe is imminent, you may expect a McArthur genius award or even the Nobel Peace Prize" – Matt Ridley

"Only pessimism sounds profound. Optimism sounds superficial" – Teresa Amabile

"For reasons I have never understood, people like to hear that the world is going to hell …yet pessimism has consistently been a poor guide to the modern economic world" – Deirdre N. McCloskey

"Optimism appears oblivious to risks, so by default pessimism looks more intelligent" – Mogan Housel

## EQUITIES

The US stock market reached two important milestones last month. On 22nd August the S&P 500 clocked up a record 3,453 consecutive days (almost 9 ½ years) without a peak-to-trough loss of 20% (the standard definition of a bear market) and later broke out to a fresh all-time high. The tech-based Nasdaq and small-cap Russell 2000 indices also hit new peaks.

The magnitude of US equity outperformance is unusual. Year-to-date the MSCI US index is 8% higher, but the MSCI World ex-US benchmark is down 4% in dollar terms. Investor concentration in dollar assets is now at historic extremes.

Outside the US, selling pressure has been most acute in the emerging markets and related commodity plays. Slowing Chinese growth and a stronger dollar have reignited deflation fears. The ongoing Sino/Yankee trade war is also having an outsized impact on the more export-reliant EMs.

Turkey and Argentina seem to be battling each other in a race to the bottom with high inflation and egregious debt burdens spooking investors. The MSCI Turkey index slumped 29% in dollar terms last month with the Turkish lira and government bond prices falling heavily too. The country's U$218bn of external financing needs have become more expensive as the US dollar has rallied, whilst the public spat between Presidents Trump and Erdogan – over the Turkish arrest of a US pastor during the 2016 attempted coup – also weighed on sentiment and intensified trade friction.

The Argentine economy remains crippled by debts despite the 2015 election of a more business-friendly administration. With 80% of the government's liabilities denominated in US dollars, last month's 35% collapse in the peso feeds directly into higher borrowing costs. In an effort to defend the peso, the Central Bank rushed through an emergency 15% hike, taking the target lending rate to a staggering 60%. President Macri has also asked the IMF to expedite the release of the U$50bn bailout package it announced in June. The largest ever IMF credit line, it may not be enough to arrest the decline.

Few emerging markets have been immune. This year's dramatic tightening in Chinese credit conditions remains a drag on the economy and domestic markets; the mainland Shanghai Composite index fell 5% last month and is down 30% from its January high. Some of the flagship tech names such as Alibaba, Tencent and Baidu have been hit hard, losing 6% on average last month. Tencent is now 33% below its 2018 peak. The government's efforts to de-leverage the shadow banking sector have drained liquidity with "off balance" sheet lending contracting for 5 months running. This has dented growth with retail sales weakening further and infrastructure spending contracting 5% year-on-year.

Hong Kong indices also trended lower with the Hang Seng losing a little over 2%; it is now down 7% for the year to date. The property developers were notable laggards, given the sector's sensitivity to rising rates. Last month saw HK mortgage rates increase for the first time in over a decade as banks finally passed on higher HIBOR funding costs. As we noted a few months back, the HIBOR discount to US LIBOR has gradually eroded as the HK Monetary Authority has been forced to intervene, buying HK dollars to defend the HK/US dollar peg.

Indian equities were one of the few success stories with the Sensex adding 3%. Like the US, the rally has been dependent on a handful of large-cap, multinational names, particularly the software firms that stand to benefit from the rupee hitting a record low of INR71. Though less exposed than most to the global trade tensions, India is a large importer of dollar denominated oil and has a fiscal deficit totalling 3.5% of GDP. Gavekal, a research firm, notes that foreigners have sold U$500mn worth of local equities this year; a maturing, deeper pool of domestic institutional investors is an increasingly important support.

Many developed market names have been caught up in the EM sell-off. European financials were marked down heavily because of their links to the Turkish economy; the Spanish banks are most at risk with U$83bn of loans to Turkish entities. This weighed heavily on European bourses with the German DAX falling 3% and the Spanish IBEX down 5% last month. Italy's MIB index fared worse with a 9% slump as investors priced in growing political risks; the clash between the austerity-averse, populist government and Brussels looks set to intensify over the coming weeks as Italy prepares to submit its 2019 budget. Interior Minister, Matteo Salvini, is whipping up public support for a more expansionary fiscal approach, even blaming last month's tragic Genoa bridge collapse on EU-imposed austerity.

Bar crude oil, commodity prices fell sharply last month in response to the stronger dollar and the slower Chinese growth. This dragged the resource-heavy FTSE 100 4% lower, but the more domestically focused mid and small cap indices finished in the red too. There is little fundamental reason to cheer for UK PLC as economic activity is cooling despite the pound's 10% fall since April.

The currency drifted 1% lower and spent much of the month in the U$1.20s as both 'remain' and 'leave' advocates attacked the Prime Minister's "Chequers" Brexit strategy.

The S&P 500's record-breaking 3% advance was fuelled by a bumper Q2 earnings season with aggregate profits growing by 25% y/y. This pace is typically only seen as the economy recovers from recession but, as noted in the lead article, firms can thank Trump tax cuts and a share buyback boom. Profits growth looks set to ease from here and, as we noted last month, any stocks missing profits forecasts are being severely punished. This is particularly true of the tech sector, which has been mixed of late. Apple's shares soared on the back of surprisingly strong results, helping it become the first ever US listing to reach a market cap of U$1 trillion (Amazon has since followed suit). However, Facebook, Netflix and Twitter all slumped when earnings missed lofty expectations. This underperformance of prior market darlings, and narrowing breadth within the tech space, suggests the "melt up" of US stocks is increasingly fragile.

## BONDS

US credit markets remain benign with spreads on high yield debt (the premium over similar maturity government bonds) still anchored around 3% p.a. This suggests domestic US liquidity conditions are still loose despite the Fed's multiple rates hikes and ongoing balance sheet reduction. This could also help explain why the S&P 500 continues to power higher whilst most other risk assets head south.

Last month the US Central Bank held the target federal funds range at 1.75-2%, but looks set to hike twice more this year. Beyond this, the trajectory for interest rates is less clear. US inflation remains sticky with CPI hitting a 7-year high of 2.9%. With energy and shelter costs as the main drivers, inflation could yet rollover if economic activity slows. Most consumer and business indicators have softened over the past month, suggesting Q3 GDP will come in lower than Q2's upwardly revised 4.2% annualised. The prospect of a less hawkish Fed helped the 10-year US Treasury yield dip 0.1% to 2.9% last month.

Having aborted its planned rate rise in May, the Bank of England finally hiked by 0.25% (from 0.5% to 0.75%) in August, only the second increase in borrowing costs in a decade. It was so well flagged that gilts were little changed; the 10-year yield finished 0.1% higher at 1.4%. Higher transport and computer game costs caused UK CPI to accelerate for the first time in 8 months, from 2.4% y/y to 2.5% y/y, but the market is not pricing in another rate hike until the latter part of 2019. Growth is clearly slowing and rate-sensitive activity has reacted badly to the hike; a Nationwide survey showed UK house prices fell 0.5% in August, the most since 2012.

Despite another sell-off in Italian bonds there was unexpected good news in Europe as Greece exited its 8-year bailout program. However, with its debt/GDP ratio still hovering around 180%, the country remains far from solvent. Worryingly, some of the more debt-laden EM economies are starting to resemble Greece, such has been the explosion in debt issuance. According to BIS data, at the end of Q1 2018, total EM corporate dollar debts amounted to almost U$4trn, double the 2010 level. It is no coincidence that most of the pain is being felt by EM economies with the highest dollar debts; Turkey and Argentina are setting the pace, but South Africa and Brazil have also seen their bond yields spike and currencies slump in recent weeks too. This leaves many hard (US dollar) and local currency EM debt indices trading near all-time lows.

## CURRENCIES

It was a month of two halves for the all-important US dollar, rallying strongly in the first couple of weeks before retracing most of its gains. The trade weighted dollar (or DXY) finished 0.6% higher. Even though sterling and the euro both shed 1%, weakness in developing nation currencies caught one's attention. Recent US data has been generally softer and most commentators' interpreted Governor Powell's debut speech at the annual Jackson Hole Central Banker summit as slightly more dovish than expected. Markets are rightly fixated on the Federal Reserve as any hint of a U-turn on rate rises and quantitative tightening should check the dollar's advance, to the benefit of EM's.

An easing of trade tensions also prevented the dollar from extending its gains in the second half. After July's compromise with the EU, President Trump announced a revised NAFTA deal with Mexico that, bar a few tweaks, looked remarkably like the old one. The Mexican peso fell 2% over the month, having already rallied 12% from a June low. In Brazil, renewed political unrest caused the real to slump by 7%. Ex-President Lula currently leads the polls for October's election despite serving a 12-year prison sentence for corruption and money laundering. A recent court ruling reminded voters that he cannot stand for office.

The Chinese renminbi was broadly flat last month, capping its loss since April at 9%. It failed to trade through the symbolic RMB7 level that some observers believe would trigger further downside. A weak renminbi tends to add to global deflationary pressures so “risk on” investors may draw some comfort from recent government efforts to defend the currency. Last month a 20% tax was introduced on derivative contracts that short (bet against) the renminibi and the authorities reintroduced a “counter cyclical factor” that affords them more flexibility when setting the daily exchange rate against the dollar. A further depreciation cannot be ruled out though, as real rates continue to slide. US/China trade tensions also serve to unsettle with fresh US tariffs on U$200bn of Chinese imports set to be imposed this month.

Finally, the Aussie dollar fell 3% amidst the slump in raw material prices and Prime Minister Turnbull's ousting in favour of former Treasurer, Scott Morrison. A split within his Cabinet sparked Turnbull's downfall, although Morrison saw off the more populist challenger. The change leaves Australia with its 7th PM in just 10 years.

## GOLD/COMMODITIES

A chaotic month in resource markets left most industrial and precious metals nursing heavy losses. Copper, often seen as a reliable gauge of global growth, fell 5% in the face of the stronger dollar and weaker Chinese activity. It is now down 17% year-to-date.

Oil was a notable exception with Brent crude rising 4% to U$77/barrel. A relatively tight supply-side is keeping the price well bid with Saudi Arabia announcing it cut production by 200,000 barrels per day in July; it had promised to lead OPEC's efforts to raise output. This coincided with the announcement that the IPO of state-owned Saudi Aramco, which could have valued the company at a record U$2trn, has been indefinitely postponed. US production seems to be slowing too and, with Iranian exports slumping in the face of the US sanctions, oil supplies look set to remain stretched.

Bullion's woes continued last month, falling 2% to U$1,201/oz; the dollar rally has softened the blow for any non-USD investors. Although gold originally fell on rising US real rates, this has morphed into a more technical sell-off. Speculative bets against gold, measured by COMEX futures, have now hit extremes last seen in 2001. Any sign of a more dovish Fed could well spark a short squeeze and a sharp rise in the price of gold. Gold equities, by extension, are looking increasingly attractive.

## 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<br>Latin America | Inflation Linked<br>Emerging Market | Uncorrelated Strategies, Gold |
| O | | UK, Japanese<br>Australian<br>High Yield<br>Healthcare<br>Resources | US, Australian | |
| – | EQUITIES<br>BONDS | US, European<br>Technology | UK, European<br>Japanese<br>Corporate<br>High Yield | |

# MARKET PERFORMANCE

All performance numbers show % changes except for bond yields which show yield changes.

| | 31-AUG-18 | 1 MTH | 3 MTH | 12 MTH |
|---|---|---|---|---|
| **CURRENCIES (VS USD)** | | | | |
| GBP | 1.2960 | -1.2% | -2.5% | +0.2% |
| CHF | 1.0321 | +2.2% | +1.7% | -1.0% |
| AUD | 0.7189 | -3.2% | -5.0% | -9.5% |
| JPY | 111.03 | +0.7% | -2.0% | -1.0% |
| EUR | 1.1602 | -0.8% | -0.8% | -2.6% |
| **BOND YIELDS (10 yr)** | | | | |
| UK | 1.43 | +0.10 | +0.20 | +0.39 |
| US | 2.86 | -0.10 | +0.00 | +0.74 |
| Germany | 0.33 | -0.12 | -0.01 | -0.04 |
| Australia | 2.52 | -0.13 | -0.15 | -0.20 |
| Japan | 0.10 | +0.04 | +0.07 | +0.10 |
| **EQUITIES** | | | | |
| US. S&P 500 (USD) | 2,901.52 | +3.0% | +7.3% | +17.4% |
| UK. FTSE 100 (GBP) | 7,432.42 | -4.1% | -3.2% | +0.0% |
| MSCI Europe ex UK (EUR) | 1,326.08 | -2.1% | +1.3% | +2.3% |
| Japan. Topix (JPY) | 1,735.35 | -1.0% | -0.7% | +7.3% |
| China. Shanghai Comp (RMB) | 2,725.25 | -5.3% | -12.0% | -18.9% |
| HK. Hang Seng (HKD) | 27,888.55 | -2.4% | -8.5% | -0.3% |
| Australia. All Ords (AUD) | 6,427.83 | +1.0% | +5.0% | +11.3% |
| MSCI Pacific ex Japan (USD) | 1,355.57 | -2.5% | -2.5% | +0.1% |
| MSCI World (USD) | 2,175.50 | +1.0% | +3.9% | +11.0% |
| MSCI World (GBP) | 1,678.76 | +2.4% | +6.6% | +10.5% |
| **COMMODITIES** | | | | |
| Oil (WTI) | 69.80 | +3.2% | +5.6% | +39.6% |
| Gold | 1,201.40 | -1.9% | -7.5% | -9.1% |

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