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INVESTMENT VIEWS

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EQUITIES	:	Non-US indices stabilise after a tough summer; the US hits a new high
BONDS	:	Core Government bonds sell-off on QE withdrawal; EM debt recovers
CURRENCIES	:	The Canadian dollar and Mexican peso firm on US trade agreement
COMMODITIES	:	Oil prices jump on Iran export ban and lower inventories; Gold stalls

Politics will dominate November. On the 6th, US mid-term elections to both chambers of Congress will pass judgement on "Trumpism" with an EU/UK Brexit summit on the 17th/18th. Focusing on the latter, it is impossible to predict how Brexit will play out, especially as the dust settles on a discordant Tory party conference. Whilst acknowledging this uncertainty, bravely or foolishly, we set out below our 'best guess'.

At the risk of over-simplifying, there seem to be four core options; Norway, Chequers, Canada or a 2nd referendum. On the first, Norway's membership of the EEA and EFTA gives it access to the European free trade area, placing it inside the single market. However, it remains outside the common agricultural policy, the common fisheries policy and the auspices of the European Court of Justice (ECJ). Norway contributes to the EU budget but has negligible input into the rules of the single market and limited control over freedom of movement (ie. immigration). We discount this outcome as it trammels policy 'red lines' of every British faction.

Moving on to the Chequers plan, Mrs May's blueprint proposes a free trade area for goods; effectively a friction-free status quo for manufactured and agricultural products. In these sectors the UK would still accept EU regulations and the authority of the ECJ. However, Mrs May suggested a key carve-out, that the UK should retain the right to pursue trade deals beyond the EU. The proposal would allow frictionless trade to continue, protecting supply chains and negating concerns about a physical border between northern and southern Ireland.

As regards service sectors, which account for about 80% of the British economy, a framework of "regulatory flexibility" is favoured, effectively removing UK service sectors from the single market. Current levels of reciprocal market access would diminish. Finally, the Chequers approach would absent the UK from the EU's "four freedoms", including free movement of citizens. It is easy to see why the EU are cool on this plan, given the challenge to core EU "freedoms" and the half in/half out cant.

This leaves the third option, based on the 2017 Canada/EU free trade agreement that took five years to negotiate. Under this scenario, the UK would leave the single market completely but have a comprehensive free trade agreement for manufactured and agricultural products. Border friction would increase somewhat as both sides ensure adherence to regulatory standards and laws on 'rules of origin'; some form of physical or digital border between the two Irelands would be necessary. As with the Chequers option, there would be limited agreement on access for service sectors. However, the UK would not have to pay into the EU budget, would not subscribe to the "four freedoms" and would not answer to the ECJ.

When considering what might be agreed, we note that very little needs to be agreed. The UK and EU only need to agree a withdrawal deal before next March; effectively the financial aspects of the UK's departure (Britain's £39bn divorce bill) and a set of principles to inform further discussions. If you believe Michel Barnier, the EUs Chief Negotiator, the withdrawal agreement is 80% settled. The contentious detail of the UK's future trading relationship with the EU can be hammered out during a multi-year post-Brexit transition period. The key sticking point is political, not practical; how to avoid a physical border between Northern Ireland and Eire. If this is the final obstacle, perhaps naively we believe that a pragmatic policy fudge, anchored by talk of digital solutions, will be forthcoming.

Following this reasoning through, we expect May to return from the November summit with an agreement that draws on both the Chequers and Canada options; indeed, our Machiavellian side wonders if disagreements at the recent Salzburg summit were carefully orchestrated to burnish both sides domestic credentials. May then has to achieve Parliamentary sign-off. This will be a fractious 'moment critique' for the myriad players and their diverse agendas.

When considering how this plays out, we are informed by the fact that a majority of MPs are pro-remain or soft Brexiteers. As regards Rees-Mogg and the hard Brexit European Reform Group (ERG), though it claims the support of nearly 60 MPs, they would need cross-party support to force their agenda. Whilst we do not doubt the Brexit fervour of Jeremy Corbyn – EU rules outlaw his interventionist socialist agenda – we struggle to see an ERG/Labour alliance. Although Corbyn might consent to an opportunistic coalition in an effort to unseat May, such a tie-up would be an anathema to core Tory support and would risk Corbyn's preferred outcome, a general election.

Indeed, the only cross-party alliance we can envisage is a Remain grouping, catalysed by an intractable rejection of any November deal. In this scenario, we can envisage a group of cross-party MPs voting for a 2nd referendum rather than a general election; the latter could herald the arrival of Prime Minister Corbyn and a relatively hard Brexit, something centre-left Labour MPs fear almost as much as the Tories. This is the fourth option.

Assuming May gets through the next few weeks, we see her committing to a relatively soft Brexit, with UK/EU trade relations being agreed during a multi-year transition process. We also see May stepping down shortly after the March exit date. At that stage Tory MPs will finally get a say on the gasconade of Boris Johnson. High office seems to have exposed the short comings of this erudite wordsmith and we sense that the Conservative party would be best served selecting a young, centre-right candidate who can set out a contemporary Tory vision without the policy baggage of the last 10 years.

As we noted at the outset, uncertainty remains high. Though we have gamed various outcomes, we do not have a high level of confidence in our "best guess"; portfolios are not aggressively positioned for a particular outcome. We retain our cautious stance. As for markets, they share our indecision. With the USD/GBP exchange rate trading around the $1.30 mark, we are right in the middle of the "Brexit spread". If signs of a soft outcome or a 2nd referendum grow, a return to the pre-Brexit $1.45 level seems plausible. On a real effective exchange rate basis, sterling is currently on the cheap side of fair value. Conversely, if a hard exit gains credence, with the possibility of a general election, sterling will surly test the recent lows of $1.20. Given the kind of fear any such move would engender, we would be looking for bargains amongst the emotion rubble.

IN OTHER NEWS…

Unexpectedly, we learned this month that Hitler is running for re-election on October 7th, despite the best efforts of Lennin. This is not a gruesome form of political resurrection but the unfolding narrative in Yungar, a small town in the Peruvian Andes. Hitler Alba is seeking a new term as mayor, despite the objections of Lennin Vladimir Rodríguez Valverde. Unsettling namesakes are not new in Peru; last year Osama Vinladen was named in Peru's national youth football team.

On a wholly unrelated note, it is interesting to read that Directors of US companies sold $10bn of stock in their companies in August, approaching a monthly record. By the 21st September, these insiders had sold a further $5.7bn, the most for any September over the past decade. As we wrote last month, the same Directors have been buying the very same shares for their shareholders, on track for $1trn of buybacks this year, a 46% annual increase (source: Goldman Sachs). Conflicted corporate hypocrisy?

EQUITIES

Trade wars rumble along as we approach the US mid-term elections in early November. As widely expected, Trump imposed further tariffs on an additional $200bn of Chinese goods. The tariffs took effect on 24th September at a rate of 10%. The President threatened to increase the rate to 25% in 2019 if the Chinese did not cease unfair trade practices. The latest move follows previous tariffs on $50bn of Chinese imports, mainly steel and aluminium products. China responded in a measured way, announcing tariffs on $60bn of US products including meat, wheat and textiles. Interestingly, Trump chose to omit a range of consumer electronics from the latest measures. Whilst the anti-China rhetoric may poll well, he is less keen to alienate voters by raising the cost of their beloved smartphones.

As October arrived, Trump announced a new trade deal with Canada and Mexico. Affecting $1.2trn of trade, the new deal will be known as the USMCA (US, Mexico, Canada) trade deal, replacing NAFTA (the North American Free Trade Agreement); Trump previously described NAFTA as the single worst deal in US history. The Donald's negotiating tactics of rhetorical bombast, an extreme initial bargaining position and eventual compromise is straight out of his 'Art of the Deal' playbook.

US mid-term elections see all 435 seats in the House of Representatives, and one third of 100 seats in the Senate, up for grabs. The Democrats face a difficult task in the Senate where twenty three of their incumbents are up for re-election (alongside eight Republicans and two independents). The House of Representatives looks more interesting. The bookies have the Democrats as favourite to win a majority, which would lead to political deadlock in Washington. If the Democrats do take the House, impeachment chatter will grow. However, unless they also win the Senate, the risk of this seems negligible given the 2/3rd Senate majority required for such proceedings. The index of US small business optimism set a record high in August, surpassing the prior peak in 1983. Robust economic data argues for a decent Republican showing but Trump's slump in the polls muddies the water. The S&P 500 index rose 0.4% this month.

The Italian budget was front and centre in European markets. Policy makers from the La Lega and Five Star parties pressured the moderate Finance Minister to agree a budget deficit of 2.4% for the next three years, higher than markets had been expecting. It is likely that the EU commission will push back against the plans, based as they are on rosy economic projections. Italian markets fell by 4% on the day of the announcement, with Italian banks dropping like a stone. Whilst within the EU deficit cap of 3% of GDP, with debt-to-GDP at 130% and rising, markets expected greater fiscal parsimony. It is potentially catastrophic for Italian banks if ratings agencies now downgrade Italian sovereign debt (BTPs) two notches to junk status. It would exclude BTPs from the ECB asset purchase program and disqualify them as collateral at the central bank. As core holders of BTPs, Italian bank capital would be crucified by the fall in BTP prices/rise in yields. The MSCI Europe ex UK index lost 0.1% this month.

UK PM Theresa May was humbled, if not humiliated, at the EU summit in Salzburg. The EU rejected her 'Chequers Plan' without any serious counter-offer. EC President Donald Tusk posted a photo on social media of Mrs May next to some cakes, commenting "a piece of cake, perhaps? Sorry, no cherries"; hardly statesman-like. Mrs May retaliated with a speech threatening to leave the EU without a transition arrangement. Party conference season soon ceased the headlines. Jeremy Corbyn called for an election in the case of a 'no deal' scenario, whilst the shadow Chancellor, John McDonnell, announced plans to nationalise railways and utilities; an increasingly popular policy. He also floated plans for workers on corporate boards, with large companies settling 10% of their equity into employee trusts. Study of the detail revealed a multi-billion tax on the related dividends. The FTSE All Share gained 0.5% in September.

Following a difficult few months, emerging markets benefited from a pause in US dollar appreciation. However, signs of self-help also played their part. The Turkish Central Bank announced an emergency rate hike to underpin the Lira and contain inflation; annual Turkish CPI has risen from 10% to 25% this year. Argentina secured a revised $57bn bail-out from the IMF. The worst-case scenario for Mexico was avoided with the new USMCA trade deal. Meanwhile in Brazil, Presidential candidate Bolsanora was stabbed on the campaign trail (not fatally), gaining the unpopular candidate some much need sympathy. He is set to face the far-left candidate, Fernando Haddad, in the second round of the October elections. Whilst the broad MSCI EM index lost 1.4% this month, China and Brazil both bounced over 3% whilst the Russian market was up 9%, helped by higher oil prices. The Indian market fell by 6% after banks accelerated bad loan loss provisions; higher crude prices also had an impact as the nation is a major oil importer.

BONDS

Government bond prices fell (and yields rose) across developed markets this month. The US Federal Reserve proceeded as planned with a 0.25% rate hike, taking rates to a range of 2-2.25%. The Fed projected one further hike in December and three more during 2019. This was consistent with its projections at the June meeting. However, it also upgraded its 2019 growth projections (from 2.8% to 3.1%) and removed reference to maintaining an "accommodative" policy stance. Fed Chair Powell was keen to downplay this development in the subsequent Q&A. Powell seems to be following a "wait and see" approach to inflation. Core PCE inflation was unchanged at 2%, which means the US now has positive real interest rates for the first time in a decade. We see increasing value in high quality, short duration US bonds. Two-year notes yield nearly 3% versus a 10-year Treasury yield of 3.1%.

The Norges Bank became the fourth developed market central bank to raise interest rates this year, following the US, Canada and the UK. Whilst the hike from 0.5% to 0.75% was modest, it reinforces the message that global liquidity conditions are tightening. Meanwhile, the ECB started a gradual unwind of its €2.5 trillion QE program. The ECB halved its monthly bond purchases (from €30bn to €15bn) and will phase them out entirely by the turn of the year. German ten-year paper finished the month yielding 0.5%, 2.7% less than the Italian BTP equivalent for the reasons outlined above.

The Bank of Japan (BoJ) made some subtle changes to its monetary policy. It announced a reduction in bond purchases at the long end of the yield curve, with greater flexibility permitted range around the BoJ's 0% yield target. If the long end of the yield curve were allowed to move higher in a controlled fashion, it would alleviate pressure on the banks, enabling them to lend more. Prime Minister Abe won re-election as president of Japan's LDP party with around 70% of the vote. He looks set to become Japan's longest serving prime minister, should he serve his full three-year term.

In the UK, weekly nominal wages gained 2.6% pa, leaving real wage growth in negative territory after UK inflation rose 2.7%. The latter surprised to the upside driven by 'recreation and culture' spending; consumers splashed out on theatre shows, computer games, transport and clothing. UK retail sales also accelerated, with food stores benefiting from the glorious summer weather. Core inflation rose 2.1%, above the Bank of England's 2% neutral rate. Further rate rises remain contingent on the Brexit negotiations. The 10-year gilt yield ended at 1.6%, up 0.15% on the month.

In Australia home prices in Sydney and Melbourne have now declined by 6% and 4% respectively from their 2017 peak (source: CoreLogic). The Royal Commission on Misconduct in the Financial Services industry published an interim report prior to its final publication in February. The report suggests that basic greed is behind a raft of poor behaviour ('how else is charging continuing advice to the dead to be explained?'). Stronger enforcement of current regulations is expected. The final report will coincide with a general election, which the Labour party is forecast to win. Labour is expected to end attractive tax breaks on investment property loans and to remove the tax credit on bank dividends (source: CLSA). The RBA kept rates on hold at 1.5% as the 10-year government bond yield drifted up to 2.7% (+0.2%).

As we have long contended, the reduction in global liquidity is now exposing the over-indebted; with the QT narrative set to build into Christmas, further stress seems inevitable.

CURRENCIES

Currency markets were relatively calm this month compared to recent volatility; the trade weighted dollar finished unchanged. US GDP increased at an annual rate of 4.2% in the second quarter, according to the final estimate from the Bureau of Economic Analysis. Despite some softer forward looking indicators, with consumer spending rising 3.8% in Q2 and business investment 4.5% higher (both annualised), the US dollar looks well bid in the near-term.

Both the Canadian dollar and Mexican peso gained on the news of the new trilateral USMCA trade deal. The CAD gained 1% whilst the MXN gained 2% versus the greenback this month. The exact details of the trade deal are unclear, but it will likely address rules of origin (how much of a product is manufactured in the domestic market), minimum wages, access to markets and a sunset clause which specifies an end date for the deal. Trump was keen to stress it represented a win for US auto makers and farmers.

The euro was flat against the dollar this month at $1.16. Unemployment in the euro area dropped to 8.1% in August, from 8.2% in July. This is the lowest level since November 2008. Levels of unemployment vary significantly by country, with just 3.4% in Germany compared to over 19% in Greece. A one-size-fits-all monetary policy suits neither extreme.

Sterling traded marginally higher this month, up 0.5% to $1.30 against the dollar. In the short term, the direction of sterling will depend on the state of Brexit negotiations. Any whiff of a hard Brexit and the currency falls, whilst signs of a soft Brexit will see the currency rally. To illustrate the point Theresa May's post Salzburg address, threatening a hard Brexit, pushed the pound 2% lower on the day. In early October, cable has once again traded below $1.30. For all the noise, at least some of the Brexit uncertainty is priced in; bets on a softer pound are approaching a ten-year high. We see value emerging in UK assets and are revisiting both active and passive opportunities.

As covered in the Equities section above, sentiment towards emerging markets started to turn this month. The balance of payments crisis in Turkey has been contained for now given the emergency rate hike of 6.25% to 24%. The Turkish lira bounced 7% this month. The Russian rouble was helped by rising oil prices and a policy rate rise of 0.25% to 7.5%. After the sharp sell-off in both EM currencies and local debt, we remain positive on the prospects for emerging market debt given the high real rates available in several markets.

GOLD/COMMODITIES

Oil remains one of the strongest commodity markets this year. The price of US WTI rose $4 to $72, whilst European Brent prices rose $5 to $83. Global supply and demand are in reasonable balance. However, forthcoming US sanctions on Iran and lower inventories are pushing prices higher. Iran exported 1.7m bpd in September, down from a peak of 3.1m bpd in April this year. Sanctions will be imposed on 5th November, demanding that importers cut purchases to zero. Iran sends oil mainly to Asian markets. India (Iran's second biggest market) has pledged to cease imports by November and South Korea has followed suit. China is Iran's largest customer and has so far ignored US demands.

September saw gold fall back 0.8% to end at $1,992/oz. Gold is down 8% this year as quantitative tightening raises short term real dollar rates. Retail investors continue to sell; holdings of gold ETFs fell by 0.45m/oz to 67.5m. Gold remains a vital source of portfolio diversification, with unloved gold equities looking increasingly attractive. The bottom of an industry cycle is often marked by industry consolidation, as incumbents recognise value in their peers. This month Canadian firm Barrick Gold bid $6bn for Randgold. The all equity deal will create the world's biggest gold miner with a market cap of $18bn and annual production of 6.5m ounces. Before the deal was announced, both stocks had more than halved from their peaks.

Cocoa was the worst performing agricultural commodity this month. Prices fell by 11% as the risk of El Nino weather conditions fade for two of the major producers; Ghana and the Ivory Coast. After bumper crops and falling prices in 2016 and 2017, prices rebounded in early 2018 as heavy rainfall and floods threatened crops; this risk has faded of late.

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, 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-SEP-18	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.3031	+0.5%	-1.3%	-2.7%
CHF	1.0186	-1.3%	+0.9%	-1.4%
AUD	0.7224	+0.5%	-2.4%	-7.8%
JPY	113.70	-2.3%	-2.6%	-1.0%
EUR	1.1604	+0.0%	-0.7%	-1.8%
BOND YIELDS (10 yr)				
UK	1.57	+0.15	+0.30	+0.21
US	3.06	+0.20	+0.20	+0.73
Germany	0.47	+0.14	+0.17	+0.01
Australia	2.67	+0.15	+0.04	-0.17
Japan	0.12	+0.02	+0.10	+0.06
EQUITIES				
US. S&P 500 (USD)	2,913.98	+0.4%	+7.2%	+15.7%
UK. FTSE 100 (GBP)	7,510.20	+1.0%	-1.7%	+1.9%
MSCI Europe ex UK (EUR)	1,324.48	-0.1%	+1.7%	-1.8%
Japan. Topix (JPY)	1,817.25	+4.7%	+5.0%	+8.5%
China. Shanghai Comp (RMB)	2,821.35	+3.5%	-0.9%	-15.8%
HK. Hang Seng (HKD)	27,788.52	-0.4%	-4.0%	+0.9%
Australia. All Ords (AUD)	6,325.51	-1.6%	+0.6%	+10.1%
MSCI Pacific ex Japan (USD)	1,340.31	-1.1%	-1.8%	+0.3%
MSCI World (USD)	2,184.01	+0.4%	+4.5%	+9.2%
MSCI World (GBP)	1,674.60	-0.2%	+5.8%	+12.1%
COMMODITIES				
Oil (WTI)	73.25	+5.6%	+4.4%	+42.0%
Gold	1,192.50	-0.7%	-4.8%	-6.8%

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