BENTLEY REID

INVESTMENT VIEWS

FEBRUARY 2019

www.BentleyReid.com

Kung Hei Fat Choi to all our Readers

EQUITIES	:	Markets rebound strongly as the US Federal Reserve turns dovish
BONDS	:	Lower quality credit outperforms as risk appetite recovers
CURRENCIES	:	Emerging market currencies benefit from a softer US dollar
COMMODITIES	:	Tragedy drives iron ore higher as bullion continues to shine

What spooked the US Federal Reserve? In December, they cited solid domestic growth as a justification for the steady withdrawal of QE support. With global growth already on the wane, this panicked equity markets. The S&P500 lost 9%, its worst December since the great depression. Seemingly influenced by this market riot, the Fed executed a precipitous 'volte face', issuing more dovish guidance in late January. The equity market duly rebounded 8%.

Despite this change to their verbal guidance, the Fed continues to reduce its balance sheet by $50bn per month and its 'dot plot' model predicts two more rate rises this year. However, in acknowledging risks to American growth, borne of a slower global expansion and the rumbling trade war, we share the Fed's view that their estimate is vulnerable to the downside.

The indebted world economy is simply unable to sustain rising momentum and target inflation in the face of modestly higher rates and a limited unwind of QE. Indeed, as talk of an end to the global tightening cycle surfaces, it is extraordinary to consider that the G4 nations (US, UK, Japan and the EU) have only managed to lift average base rates to 0.8% pa from their post-crisis lows; if you exclude the US, the rate falls to 0.2%. Furthermore, despite the Fed's $500bn balance sheet reduction, G4 Central Banks still own government debt equivalent to 37% of their combined GDP; up from 10% before the financial crisis. These bonds, purchased under QE to boost liquidity and cap rates, look set to remain stranded in Central Bank coffers.

After an anaemic ten-year recovery, evidence of a global slowdown abounds. Forward looking manufacturing activity indices are weak everywhere; Japanese, Korean and Taiwanese exports are tumbling; shipping rates (the Baltic Exchange dry bulk index) have sunk 64% from their August peak. Some of this is due to the uncertainty of the Sino/US trade war and the Brexit chaos. Whilst investment markets could well cheer an orderly resolution to either of these threats, this could prove a temporary fillip. An economic renaissance seems unlikely even if Trump and Xi make peace and the Brexit impasse clears.

Why? With monetary policy changes typically taking 6-12 months to impact activity, the world faces the delayed impact of last year's US and Chinese tightening. Indeed, as China struggles to pare back domestic debts, they are showing a far higher tolerance for slower domestic growth than many expected. After the scatter-gun support of 2007/8 and 2015/16 left a sizeable hangover of unsustainable loans, the authorities are now taking a far more disciplined, rifle shot approach to support. This is unsurprising when you consider the sheer scale of the problem; China's epic credit fuelled boom has doubled total debt from approx. 150% of GDP to 300% in the 9 years to 2017 (source: DT). For the time being, China will be a less powerful driver of marginal global demand.

Closer to home, the cyclical slowdown in the EU looks set to metastasise. The region only managed GDP growth of 0.2% in the fourth quarter and momentum is waning; the German government slashed its 2019 domestic GDP growth forecast to 1% from 1.8% at the end of the month (source: Reuters).

Of more note, Italy entered recession during the second half of 2018, with government debt touching €2.3 trillion, equivalent to 132% of local GDP. To set this in context, Greek debt-to-GDP was 127% when it triggered the last EU debt crisis (source: Trading Economics).

The increasingly fragile 5-Star/League coalition has only just agreed a 2% budget deficit cap with the EU, based upon 1% Italian growth this year; both figures seem optimistic. As the populist government triggers counter-cyclical spending to offset the recession, the deficit is set to balloon posing a direct challenge to the EU fiscal rules. Furthermore, as debt metrics deteriorate, concerns will resurface about the creditworthiness of Italian government bonds (BTPs). Although local banks own the majority of BTPs, major EU institutions are also heavily exposed; BNP and Credit Agricole own €240bn of Italian debt between them (source: Bloomberg). Any sell-off will undermine their core capital, threaten their solvency and choke off lending. Whether this morphs into a full-blown credit-crisis will have much to do with the ECB's reaction, although their policy locker seems a tad bear given current 0% base rates. Finally, the outcome of the EU elections in May will also be important. Success for populist parties will question the Brussels EU orthodoxy just as these challenges mature.

Turning to the US, there is little argument that the economy is slowing. Whether we get a soft landing or a recession during 2019 is open to debate; Trump's personal travails and the soon-to-be published Mueller report will not help. Regardless, first quarter earnings estimates have collapsed over the last four months from nearly 7% growth to a 1% contraction. Rising real wages; the dwindling impact of 2017 tax cuts; tighter monetary policy and a stronger dollar are all undermining lofty market valuations.

Taken together what does all this mean? To us, growth is slowing and will continue to do so. This will question the optimism baked into risk asset valuations; over-valuation has not been washed out by December's wobble. Markets will remain volatile with risks heavily skewed to the downside.

The main test for this narrative is if the authorities embark on meaningful stimulus, fiscal or monetary. On the latter, although we seem to be near the end of this truncated tightening cycle, we see a high barrier to another round of aggressive quantitative easing. Central Banks have been unable to unwind a decade of QE and reload their policy armoury.

As for governments, populist anger will continue to grow as growth slows; the growing cohort of economically disenfranchised will be disproportionately impacted. Protests, both orderly (at the ballot box) and disorderly (riots), will increase. This is not a particularly encouraging backdrop for asset prices in the near term but could be the trigger for the final reflationary push, as authorities double down in their efforts to inflate away the world's debts. As such, whilst near term caution remains warranted, we continue to use bouts of market turmoil to add to exposures that we feel will outperform as and when this comes to pass.

IN OTHER NEWS…

Throughout the year, a friend harvests sayings that resonate and jokes that amuse; he sends a summary round each Christmas. A selection of these are shared below.

- You know you're getting older when your back starts going out more than you do (*Phyllis Diller)*
- I have learned from my mistakes and I am sure I can repeat them exactly (*Peter Cook)*
- Diplomacy is the art of telling people to go to hell in such a way that they ask for directions (*~~Boris Johnson~~ Winston Churchill)*
- A mind is like a parachute. It doesn't work if it isn't open (*Frank Zappa)*
- Davos is where billionaires tell millionaires what the middle class feels (*Jamie Dimon)*
- All men are cremated equal (*Spike Milligan)*

EQUITIES

The S&P 500's 8% monthly gain was its best January since 1987. Such pronounced relief rallies are not uncommon during bear markets and, after a 20% peak-to-trough fall in the fourth quarter, a meaningful bounce was always possible. Pockets of weak economic data and a sharp decline in earnings forecasts suggest the downtrend could resume; the Citigroup earnings revision index has plunged at the fastest pace in a decade with just 6% profits growth now anticipated this year after a 20% expansion in 2018 (source: Factset).

Energy stocks led the way, boosted by a near 20% spike in the oil price. However, most sectors posted high single-digit gains; even the defensive laggards, such as consumer staples and healthcare, made solid progress. The latter was boosted by M&A activity with Bristol-Myers paying US$74bn for Celgene, an oncology focused group. There was also notable corporate activity in the gold mining space, with Newmont's US$10bn takeover of Goldcorp. The growing number of deals adds weight to our belief that this unloved sector is primed for a sustained upswing. Already a position in growth mandates, we are looking to add this more broadly.

The Fed's January announcement that further rate hikes are not pre-ordained also boosted sentiment. That said, even if December's rate rise is the last in this tightening cycle, the Fed is persevering with quantitative tightening, or QT, reducing its QE bond holdings by US$50bn per month. This ongoing adjustment reduces liquidity, a key prop to prior market gains.

In the UK, the Parliamentary omni-shambles grinds on. Prime Minister May's (delayed) attempt to secure MPs' backing for her Brexit plan failed by a record margin; a 230 majority voted against her proposal. Jeremy Corbyn immediately tabled a vote of no confidence in the Tory government (which he lost) before the House of Commons endorsed the "Brady amendment". This forces the PM to return to Brussels to re-negotiate the Irish "backstop" element of her Brexit plan. Whether the EU will listen remains to be seen.

UK assets proved resilient despite the Westminster woes. The FTSE 100 gained 4% and sterling moved 3% higher. Markets are probably correct in assuming that some sort of compromise deal or Article 50 delay will occur before the end of March; a majority of MPs are pro-remain and want to avoid a hard Brexit. Absent a no deal scenario, UK stocks are increasingly interesting, especially small and mid-cap companies where certain sectors have been priced for a collapse in domestic activity.

Elsewhere most regions struggled to keep pace with the US. European indices posted 5-6% gains despite looming recession. The Italian economy is already in one, but Germany and France are struggling too. Last month's rumours that debt-ridden Deutsche Bank could be forced to merge with fellow-struggler Commerzbank seemed to encapsulate the wider Eurozone condition. Despite emergency ECB policy support, management missteps and an unwillingness to face-up to prior errors (poor lending in the case of the banks) is being brutally exposed by slower growth.

Asian stocks trended higher with Japan's Topix gaining 5%. Recent news flow suggests the Japanese economy is being dragged into the region's slowdown. Exports fell by 4% y/y in December, with shipments to the Middle Kingdom tumbling by 7% y/y. On various reliable valuation metrics, Japanese equities are very cheap; hence we own modest exposure across mandates. However, we remain mindful that Japanese fortunes are closely linked to the health of both global and Chinese trade. We thus await signs of renewed reflation before adding to existing positions.

Despite a 2% y/y contraction in Chinese industrial profits during December, the stock market rallied; the Shanghai Composite gained almost 4%. Buoyed by several announcements of targeted policy support, its near-term fate will also be heavily influenced by the outcome of US/China trade talks. Some form of deal, that reduces external pressure on the Chinese economy and enables Trump to sell a "win" at home, seems likely before the March 1st deadline. However, relations between the two superpowers will remain fraught as the focus of the power struggle shifts to tech supremacy. A case in point will be the formal proceedings, launched by the US Attorney General, against Huawei (the Chinese telecoms giant) and its CFO; he alleges intellectual property theft and the violation of US trade sanctions against Iran. The matter is set to rumble on.

The Hang Seng will be influenced by these Trump/Xi cross-currents too. However, in January, the market chose to focus on talk of a more dovish dollar rate policy, adding 8% from its depressed 2018 close.

Latin American stocks were the standout performers in January with Brazil's Bovespa hitting a string of record highs during its 11% advance. The new President, Jair Bolsonaro, has only been in power for a month but has appointed a market-friendly Minister of Finance as one of his first acts. As the Congress reconvenes this month, the man who has been nicknamed "the Tropical Trump" must now deliver. Our Latin American funds have benefited but a pause seems overdue, particularly if crucial pension reforms become mired in fractious multi-party politics.

BONDS

The 10-year US Treasury firmed in response to the Fed's dovish policy flip; its price ticked higher as the yield fell from 2.7% to 2.6%. Becalmed US inflation of 1.9% pa clearly influenced policymakers as did the December downturn in various activity indicators, including consumer confidence and manufacturing surveys; the monthly ISM fell from 59.3 to 54.1 with weak order books suggesting worse is to come.

It was, therefore, a surprise to see the measure rebound in January, albeit modestly. Strong jobs data reinforced the rosier picture, suggesting the Fed may have acted prematurely; non-farm payrolls increased by 304,000 in January and have averaged 241,000 per month over the past quarter. For now, the US outlook remains uncertain.

In Europe, the ECB did not add to its QE bond holdings in January for the first time in four years. As noted above, Italy is a growing concern but Germany, typically Europe's growth engine, is also a focus. German output shrank by 0.2% in the third quarter with trade and manufacturing activity the main drags. Fourth quarter data is yet to be released, but the economy remains weak enough for senior German ministers, including Angela Merkel, to call for tax cuts and infrastructure spending. The fiscally-austere Finance Ministry was quick to quash any stimulus debate and Bunds rallied; the 10-year yield fell to 0.15% p.a.

UK gilts also attracted buyers. UK CPI has drifted back to +2.1% y/y and struggling retailers reflect a much broader malaise. KPMG/BRC data suggest Christmas consumer spending growth was the worst since 2008. The 10-year gilt yield finished the month 0.1% lower at 1.2%. As for base rates, there is scant reason for the Bank of England to raise from the current 0.75% level. However, a soft or no Brexit outcome could see yields rise as the threat of economic dislocation lifts.

UK index-linked gilts sold off mid-month as a House of Lords Economic Affairs Committee recommended the retail price index (RPI) measure of inflation should be replaced with/evolved towards the CPI version. The former is used to calculate the payments from index-linked bonds and, over the long-term, has been around 0.8% p.a. higher than the CPI gauge. Whilst future issues may well be linked to the CPI, the government would struggle to alter the methodology used for existing ones as it could be deemed a default. If that proves correct, the existing RPI-linked bonds that we own could attract a scarcity premium.

The Fed's U-turn and the resulting US dollar pullback meant it was a good month for emerging market bonds; they enjoyed their best returns since 2016. We topped up our exposure towards the end of 2018. Credit markets also recovered although spreads remain higher than before the fourth quarter sell-off. The improved sentiment also saw US junk bond issuance return last month; the market had gone a record 41-days without any new issues.

CURRENCIES

The 35-day US government shutdown, which President Trump paused until mid-February, makes it difficult to judge the true state of the US economy; a lot of government data has been delayed. The market thus took its lead from the dovish Fed, with the trade-weighted dollar falling 0.6% last month. In a recent Bloomberg survey of economists, 90% of respondents anticipate a weaker dollar in 2019. Whilst we broadly agree, the weight of the consensus tempers our conviction.

Indeed, it is hard to build a compelling argument in favour of the other major currencies. The euro flat lined last month as President Draghi announced that “risks surrounding the euro area growth outlook have moved to the downside”. In the UK, sterling rallied by 3% (to US$1.31) as investors started to price in a soft Brexit or a 2^{nd} referendum. Further signs that a no deal is being ruled out could easily drive the pound up towards the $1.40s. Of course, the converse is true if March 29^{th} heralds a Brexit on WTO terms. For all the obvious uncertainty, we still like sterling below $1.30 on a long term view.

The Japanese yen firmed by almost 1% last month and, on January 2rd, experienced a “flash crash”. It surged over 3% against the US dollar and by almost 8% against the Aussie dollar in just 7 minutes. The trigger seemed to be the downgrade of Apple, with some geared investors hedging their Apple stock via long yen positions. Prices quickly reverted to normal once European markets opened.

Emerging market currencies are set to benefit most if forecasts for a softer dollar do transpire. The positive mood surrounding Latin America was evident as the Brazilian real and the Mexican peso added 7% and 3% respectively. Asian currencies also fared well. The renminbi added 3%, a timely advance as a firmer RMB undermines US accusations that China is supressing its currency to make its exports more competitive.

GOLD/COMMODITIES

The gold price benefited from Central Bank talk of fresh reflationary stimulus, potentially lowering real interest rates. Bullion rallied another 3% last month to U$1,321/oz, taking its 3 month return to 9% in dollar terms. It is noteworthy that the authorities are adding to their gold reserves at a pace not seen since President Nixon took the US off the gold standard in 1971. China and Russia are leading the way with the latter buying 274 tonnes last year, funding the purchases from sales of their US treasuries (source: World Gold Council).

January also saw the iron ore price surge by 12% in response to the devastating Brazilian mine collapse that killed over 100 people (with several hundred still missing). Vale, the mine’s owner, controls about a quarter of the global iron ore market. It has been forced to halt 40mn tonnes of production, sparking concerns over tight supplies. Elsewhere, other industrial metals remain depressed by China’s ongoing slowdown; official fourth quarter GDP came in at +6.4 y/y, matching the early 2009 modern day low. Numerous (more-impartial) indicators suggest a much weaker pace of growth.

Oil’s roller-coaster ride continued last month with WTI crude rebounding 18% to U$54/barrel. News of OPEC production cuts offset the continued ramp up of US shale output. Despite the surge, the oil price is still down 18% over the past three months. Recent events in Venezuela could have long-term implications for the oil market as the country sits on the world’s largest proven reserves. If Juan Guaido, backed by the international community, unseats the incumbent President, Nicolas Maduro, Venezuela could become an increasingly important producer. During the communist era daily oil production has fallen from 3 million barrels in the early 2000’s to just 1 million barrels today. However, despite widely accepted signs that Maduro rigged the elections to hold on to power, he shows no signs of going quietly.

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
○		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-JAN-19	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.3109	+2.8%	+2.7%	-7.6%
CHF	1.0057	-1.3%	+1.4%	-6.3%
AUD	0.7273	+3.2%	+2.8%	-9.7%
JPY	108.89	+0.7%	+3.8%	+0.3%
EUR	1.1448	-0.2%	+1.2%	-7.8%
BOND YIELDS (10 yr)				
UK	1.22	-0.06	-0.22	-0.29
US	2.63	-0.06	-0.51	-0.08
Germany	0.15	-0.09	-0.24	-0.55
Australia	2.24	-0.08	-0.38	-0.57
Japan	0.00	+0.00	-0.12	-0.08
EQUITIES				
US. S&P 500 (USD)	2,704.10	+7.9%	-0.3%	-4.2%
UK. FTSE 100 (GBP)	6,968.85	+3.6%	-2.2%	-7.5%
MSCI Europe ex UK (EUR)	1,238.25	+6.2%	-1.0%	-10.0%
Japan. Topix (JPY)	1,567.49	+4.9%	-4.8%	-14.7%
China. Shanghai Comp (RMB)	2,584.57	+3.6%	-0.7%	-25.7%
HK. Hang Seng (HKD)	27,942.47	+8.1%	+11.9%	-15.0%
Australia. All Ords (AUD)	5,937.29	+4.0%	+0.4%	-3.4%
MSCI Pacific ex Japan (USD)	1,310.63	+7.0%	+7.2%	-11.2%
MSCI World (USD)	2,028.49	+7.7%	+0.3%	-8.3%
MSCI World (GBP)	1,545.87	+4.6%	-2.5%	-0.9%
COMMODITIES				
Oil (WTI)	53.79	+17.7%	-18.2%	-9.8%
Gold	1,321.20	+3.0%	+8.8%	-1.8%

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