June 2018

Monthly Investment Overview

MelvilleDouglas
A Member of Standard Bank Group

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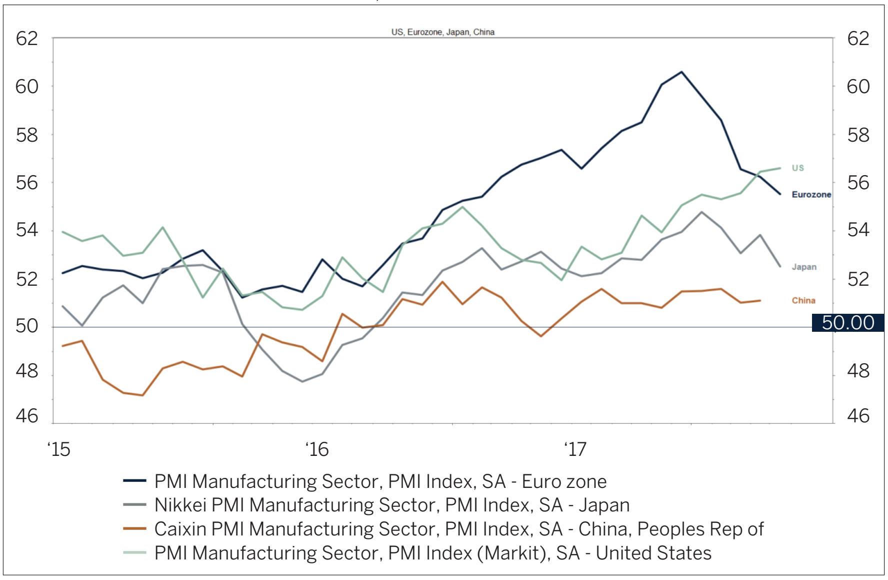
Investment Environment

Several factors have recently created headwinds for markets: US dollar strength, rising interest rates and lower growth outside the US among them. Emerging markets have felt the brunt as vulnerabilities facing countries such as Turkey and Argentina were exposed, given their overreliance on dollar-denominated debt. Political developments in Italy have renewed concerns about poor regional growth and the sustainability of the European Union in its current form.

The powerful engine that was the synchronised global growth of 2017 is now facing the steeper gradient of less favorable central bank accommodation and a stronger US dollar. The US economy is holding up, but manufacturing data and retail sales highlight the divergence between the US and other developed markets. Some leading economic indicators have softened such as manufacturing data outside the US. Europe should rebound from a disappointing first quarter which was partly explained by poor weather and the timing of Easter. However, the political situation in Italy could hamper any pick-up as any contagion would have implications for the European Central Bank and other major Eurozone countries.

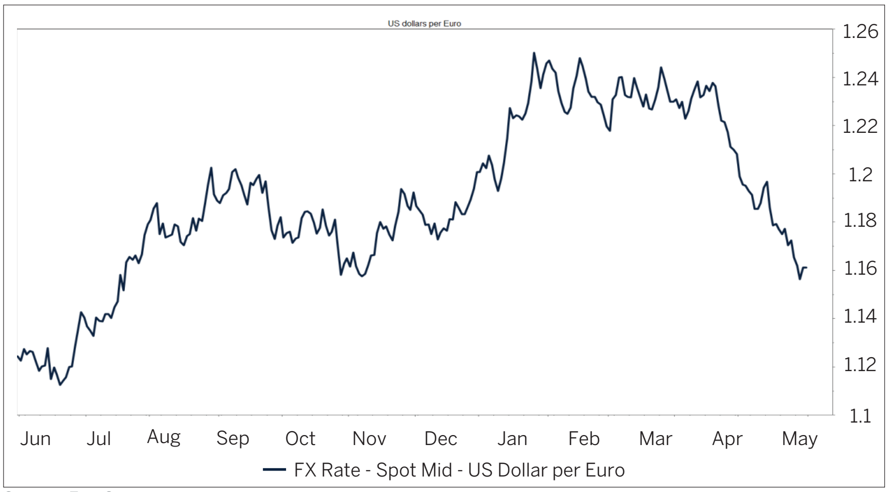
PMI INDICES, MANUFACTURING SECTOR



Source: FactSet

The US dollar has been the primary beneficiary from recent developments. Strong relative growth, supported by tax cuts and infrastructure spend, and the widening of interest rate differentials versus other developed markets have been important contributors to the strength in the currency. The political turmoil in Italy could very well provide additional support for the worlds reserve currency as investors assess the potential spillover effects to the rest of Europe and the global economy in general.

EURO: EXCHANGE RATE VS. US DOLLAR



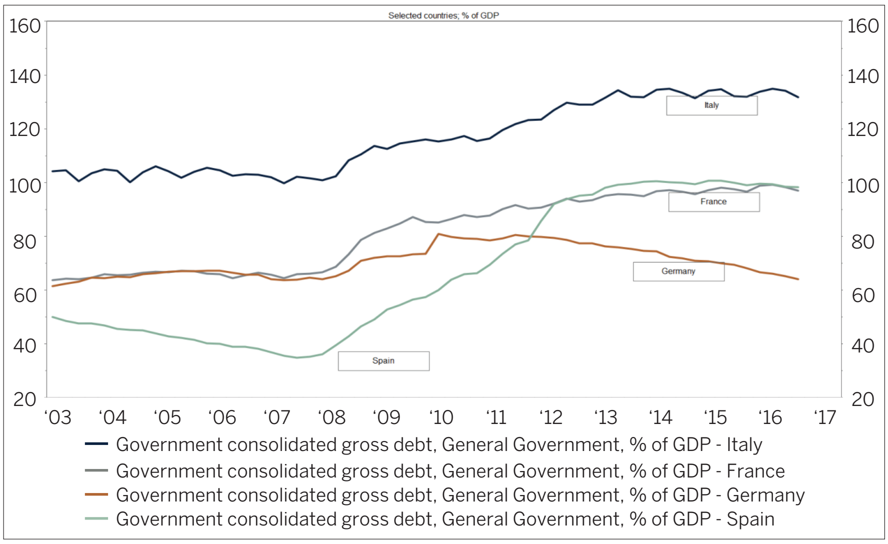
Source: FactSet

Italy's problems pose a significant risk. The backdrop to the political situation is that the country has not been able to recover economically along with the rest of the Eurozone since the financial crisis. In terms of GDP per head, it remains well below where it was in 2007, the peak of the previous upcycle. Yet other major European economies (including Spain) are larger than where they were then. The result is a dissatisfied electorate, seeking reforms. The economic problem is manifold, but for a start there is too much government debt (over 130% of GDP – see chart below). This imposes a significant limitation on what the government can achieve by fiscal means – it has little flexibility to lower taxes to stimulate growth. The new coalition has a loud Eurosceptic component, and its attempt to appoint a longstanding Eurosceptic academic to the post of finance minister exacerbated the political uncertainty: the Italian president rejected the appointment and asked a new prime minister to appoint a cabinet, which the coalition resisted.

"The backdrop to the political situation is that the country has not been able to recover economically along with the rest of the Eurozone since the financial crisis."

In addition, the coalition of the far-right League and the "anti-establishment" Five-Star Movement has promised that it will demand that the European Central Bank renegotiates debt terms in an attempt to reduce the countries debt burden. This spooked global markets as it raises the spectre of some kind of default, as it did with Greece. The problem is that Italy is much larger than Greece, and the systemic impact if markets start to close to the Italian government could be severe.

EUROPE: GOVERNMENT DEBT RATIOS



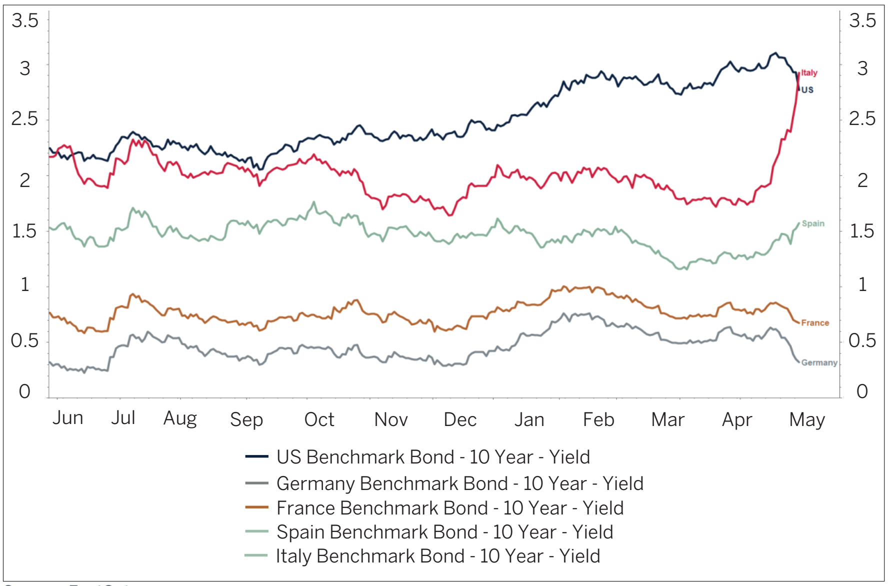
Source: FactSet

> "the ECB for now continues to behave as if nothing has changed, thus raising the risk of a clumsy outcome."

Effectively, Italy's new government is attempting to switch a slow internal deleveraging to a swift external one – i.e. shifting the cost to the ECB (essentially asking Germany and France to take the pain). Markets, predictably, think this is politically unacceptable to the other members of the Eurozone, so the risk of a sudden disruption is higher. Even if it is workable, the basic impulse would be disinflationary at best in the short run. Without significant liquidity support from the central bank, asset prices would find it hard to hold current levels. That is exactly what has already happened to Italian government debt prices: bond yields have jumped sharply.

As the chart below shows, the fallout into other bond yields has been limited, more of a safe-haven retreat – but still implying a higher risk of disinflation. Continuing comments from the ECB that they will stick to the current monetary path (probably announcing the end of quantitative easing measure before the end of the year) are, therefore, not helpful – the ECB for now continues to behave as if nothing has changed, thus raising the risk of a clumsy outcome.

EUROZONE: 10 YEAR BOND YIELDS VS US



Source: FactSet

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Summary

The near-term outlook for global growth remains good, but political developments in Italy have the potential to slow if not completely derail the expected growth path. The Federal Reserve will continue to normalise rates given the strong US economic backdrop and higher inflation, but other central banks such as the European Central Bank and the Bank of Japan need be in no rush to follow, though the risk of a policy error has risen. For now, we do not so much change our outlook as recognise that there are additional hurdles that will probably defer a return to full strength in Europe.

Other risks have not gone away: US-China trade negotiations have started; the US exit from the Iran nuclear deal and renewed sanctions have already raised tensions; North Korea's on-again off-again denuclearisation runs on; and risks to the long-term survival of the Euro have re-emerged.

Investors should not place extreme bets on the outcome of uncertain political events. Fundamentals matter most in the long run and the best route is to ensure that portfolios are aligned with long-term investment objectives, while at the same time making sure that they are adequately diversified to cater for these unexpected events.

"we do not so much change our outlook as recognise that there are additional hurdles that will probably defer a return to full strength in Europe."

Market Performance %

Equities	MAY	YTD	12M
Global			
FTSE All World TR Net (Sterling)	3.54%	1.65%	8.41%
FTSE All World TR Net (US dollar)	0.03%	-0.01%	11.74%
UK			
FTSE All-Share TR	2.79%	1.88%	6.53%
US			
S&P 500 TR	2.41%	2.02%	14.38%
Europe			
Dow Jones Euro STOXX TR	-1.50%	0.53%	1.64%
Fixed Income			
Bloomberg Barclays Series -E **UK Govt 1-10 Yr Bond Index**	0.85%	0.01%	-0.63%
Bloomberg Barclays Series -E **US Govt 1-10 Yr Bond Index**	0.65%	-0.68%	-1.02%
JP Morgan **Global Government Bond (Sterling)**	2.53%	1.01%	-1.27%
JP Morgan **Global Government Bond (US dollar)**	-0.95%	-0.64%	1.77%
Iboxx **Sterling Corporates** Total Return Index	0.09%	-1.33%	-0.32%
Iboxx **US Dollar Corporates** Total Return Index	0.46%	-2.62%	-0.06%
Currency vs. Sterling			
US Dollar	3.52%	1.61%	-3.05%
Euro	0.21%	-0.98%	0.81%
Yen	4.03%	5.22%	-1.30%
Currency vs. US dollar			
Euro	-3.19%	-2.60%	3.99%
Yen	0.48%	3.56%	1.79%

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Asset Classes

Equities	Neutral
Fixed Income	Underweight
Cash Plus	Overweight

- With an ongoing global economic expansion leading to **strong corporate revenue and earnings growth** we believe that there will be further upside in equities, subject to increased volatility, as the year progresses.
- Despite attractive fundamentals our **equity allocation remains set at neutral** in recognition that valuations remain elevated relative to long term norms, whilst both the bull market and economic expansion are long in the tooth. This, together with the growing headwinds of interest rate normalisation and geopolitical tensions, suggest a less favourable risk versus reward outlook, thereby moderating our enthusiasm.
- We **remain underweight fixed income** as an asset class in all our multi-asset strategies and defensively positioned via shorter-dated issues in order to protect against the prospect of capital loss as a result of gradual interest rate normalisation.

Equities

Consumer Staples	Neutral
Consumer Discretionary	Overweight
Energy	Underweight
Financials	Neutral
Technology	Overweight
Healthcare	Underweight
Industrials	Overweight

- With bond yields across the world falling in the wake of a 'risk off' investor mood, the **financial sector,** and particularly bank shares, have proved weak. The potential for slower interest rate rises and a flattening yield curve are primarily the reason why valuations have come under some modest pressure. However, we see this as more of an opportunity rather than anything more sinister.
- Our overweight stance in the **technology sector** has again proved valuable given the resilience of the sector at a time of escalating volatility and thus will continue to be a 'bedrock' of our portfolios.

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Fixed Income

G7 Government	Underweight
Index-Linked (US Government)	Overweight
Investment Grade – Supranational	Overweight
Investment Grade – Corporate	Overweight

- The ongoing rise, or normalisation, in **US bond yields** hit a roadblock in May, as global events took centre stage and sparked a bout of risk aversion, leading to an over 30 basis point peak to trough plunge in the ten-year benchmark yield. An uncertain political outlook in Italy (amplified by the country's huge debt burden) and the ongoing cat and mouse game between President Trump and North Korea proved sufficient enough to prompt a risk-off rally in global government bonds (with the exception of Italy's).

- Despite the intra-month volatility in major global government bond markets, the benchmark ten-year US Treasury yield ended May only nine basis points lower. We remain **defensively underweight duration** throughout all strategies on the belief that yields remain too low based on both fundamental and technical factors. In particular, we expect the yield, or term, premium on longer dated US government bonds to rise from current negative levels as investors demand more return for the embedded duration risk.

Currencies / Interest Rates

RECOMMENDATION - INTEREST RATES			
		CURRENT	DIRECTION
US Dollar	Overweight	1.75%	↑
Sterling	Neutral	0.50%	→ ↑
Euro	Underweight	0.00%	→

- 2018's **'weak US dollar'** consensus opinion continues to be challenged, with a further 1.5% trade-weighted gain in May. For some time we have held the view that the sheer weight of positive, and rising, interest rate and yield differentials in the US would help the currency retrace some of last year's slump. Whilst this outlook has proved to be correct, it has been helped by recent volatility, and a scaling back in monetary tightening expectations, in both the UK and Eurozone.

- We do not view the current soft patch in **Eurozone** economic data as signalling the beginning of a sustained slowdown in activity. However, it does reduce the urgency for the ECB to ease off the stimulus pedal. With the US Federal Reserve still firmly in tightening mode, the subsequent reaction has been a sharp fall in the Euro which is now down 2.6% against the US dollar year-to-date.

- **Sterling** is currently suffering a similar fate, losing some 3.4% against the US dollar in May. Growth conditions in the UK have deteriorated, inflation continues to moderate and a once heavily discounted interest rate hike in May never materialised. BREXIT has quietly stepped away from front page news but will remain an ongoing source of two-way volatility in the coming quarters.

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Melville Douglas

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