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Quarterly Commentary

MelvilleDouglas
A Member of Standard Bank Group

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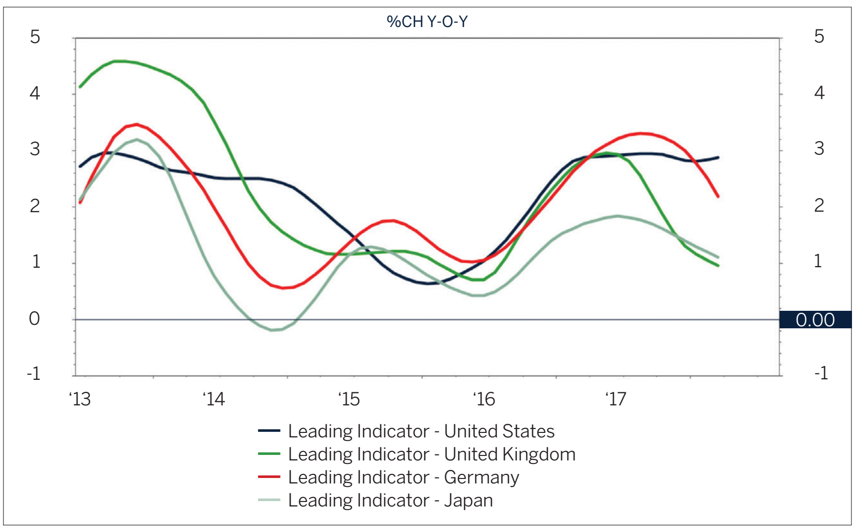
Investment Environment

Volatility in global markets continued in the second quarter and is expected to remain a feature of 2018 as US monetary policy normalisation gathers momentum, leading economic indicators slow and President Trump's belligerent trade policies threaten to disrupt global trade. Emerging markets have been most exposed whilst the US dollar has benefited from the risk-off trade. Is the extended multi-year equity bull market rapidly coming to a conclusion?

After initially starting the year with strong gains, equity market returns have fizzled out. The prospect of another year of synchronised global growth appeared promising, but much of the good news was already reflected in asset valuations after a prolonged 'risk-on' period. Volatility, as expected, has picked up and looks set to continue as the year progresses.

Markets are now starting to discount both the fact that higher wage growth in the US poses a threat to inflation and stricter monetary policy – a real concern for the valuations of risk assets that have benefited from an extended period of abnormally low interest rates. Furthermore, cyclical divergence between the US economy - fueled by tax cuts and investment spending - and most other countries has challenged the expectation that global growth will remain synchronised. These concerns are supported by a number of leading economic indicators, which are pointing to a possible loss in momentum outside of the US, as shown below:

LEADING INDICATORS US, UK, GERMANY, JAPAN



Source: FactSet

However, the slowdown in momentum is generally perceived to be temporary. Europe's economy, which is very reliant on exports and global trade, is currently adjusting to the impacts of a sharp appreciation in its currency and an overhang in inventory which resulted from the strong growth experienced towards the latter part of last year. Notwithstanding an increase in political risk and uncertainties related to the impact of Brexit and Italy, economic fundamentals remain positive. Consumer spending supported by employment and income growth, remains robust, consumer sentiment and business confidence are at historic highs, and high levels of capacity utilisation bodes well for investment spending. Expectations are that growth should rebound during the second half of the year.

Trade Wars

We have previously written about the risks associated with an escalation in protectionist measures which are seen to threaten the open multilateral trading system that has served the global economy so well. Increased competition globally has resulted in more choice for consumers at lower prices and improved quality. The opposite can be expected from increased protectionism. Although the protected domestic industries would initially benefit from this development, the rest of the supply chain will not as they become less competitive globally, which will ultimately result in large layoffs, reduced incomes and a contraction in economic activity. Furthermore, history suggests we should expect reduced productivity and higher inflation from the protected domestic industries as they become less incentivised to invest in new technologies and innovation due to lowered levels of competition.

The recent escalation in protectionist rhetoric and actions does not bode well and is already showing signs of inhibiting investment spending. The Trump administration is in the process of implementing a 25% tariff on $50bn of Chinese imports from 6 July. President Trump has indicated that the US will implement further tariffs should the Chinese retaliate. He has proposed an additional 10% import tariff on a further $400bn of imports from China. Effectively, this works out to be an effective 12% rate on $450bn of imports. He also indicated that his administration is considering implementing 25% tariffs on all imported vehicles and vehicle parts - worth an estimated $340bn - and further announced plans to introduce restrictions of Chinese foreign investment on "strategic" sectors in the US. These proposed tariffs are in addition to the tariffs already implemented on steel and aluminum imports from Europe, Canada, Mexico. These three trading partners vowed to impose 'dollar-for-dollar' retaliatory tariffs on the U.S.

> "Increased competition globally has resulted in more choice for consumers at lower prices and improved quality. The opposite can be expected from increased protectionism."

We cannot be certain that any of the new proposed tariffs will be approved by the administration in Washington, and even so, will take significant time before they are implemented. However, the risk for investment markets is that trade relations are harmed to such an extent that large-scale economic damage is done, even though economists estimate that the direct cost to the global economy will be less than 0.5% should all the proposed tariffs come to fruition. The indirect impact will be less measurable, but tariffs impose a cost of doing business that will raise required rates of return and thus undoubtedly will affect businesses' profitability and willingness to invest.

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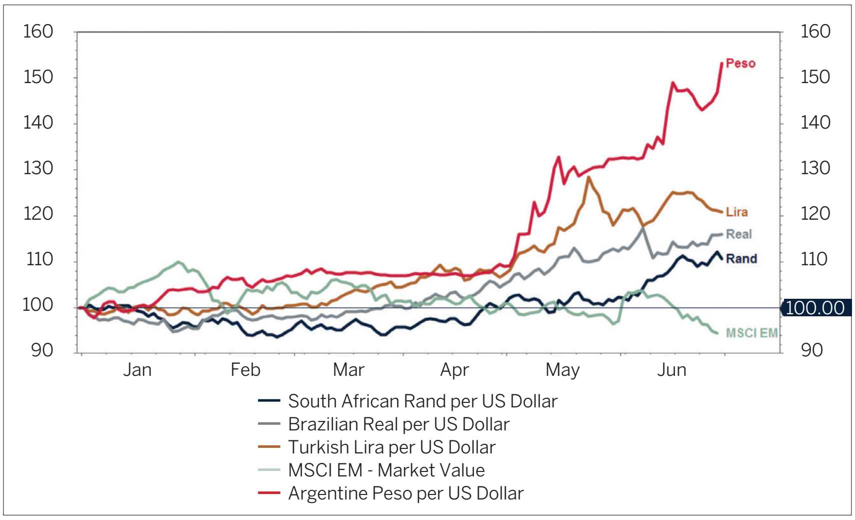
Emerging Markets

The US dollar has changed course this year as growth and interest rate differentials widened between the US and the rest of the developed economies. The stronger dollar will be beneficial for export orientated economies such as Europe, but has, in conjunction with higher long-term interest rates, resulted in an abrupt tightening of financial conditions in emerging economies. Economies with weak current account and/or fiscal positions experienced large capital outflows. Signs of stress first emerged in countries such as Turkey and Argentina. Both are reliant on large scale US dollar funding and are particularly vulnerable to dollar appreciation. This phenomenon later spread to other emerging markets as foreign investors became increasingly concerned about the impact on growth from higher policy rates as central banks tried to defend their currencies and, in some cases, safeguard financial stability. Certain central banks had to abandon planned rate cuts given the change in sentiment towards emerging markets. Further dollar appreciation combined with the renewed risk of a slowdown in global trade could materially affect the growth outlook for these regions in the near term. However, many of these concerns are already reflected in valuations. Some improvement in growth momentum and/or risk appetite will surely attract foreign investors again, barring an outright trade war.

EMERGING MARKET CURRENCIES VS USD AND MSCI EMERGING MARKET EQUITY INDEX



Source: FactSet

“The stronger dollar will be beneficial for export orientated economies such as Europe, but has, in conjunction with higher long-term interest rates, resulted in an abrupt tightening of financial conditions in emerging economies.”

Conclusion

Both the prolonged economic and stock market cycles would appear to be entering their final chapters and therefore investors should tread more carefully and expect future returns to be lower and more volatile than what they have been accustomed to over the past few years. However, despite a softer economic backdrop during the first half of this year, apprehension in emerging markets and trade fears, the medium-term outlook for global economic growth remains favourable and is still expected to exceed long run potential output, whilst inflation looks to pick up only moderately. Our work shows that rising economic uncertainty and the trade spat have reduced the price investors must pay for some quality businesses and as such, some attractive long-term opportunities are arising. In addition, there are plenty of companies that will be completely unaffected by trade issues, direct or indirect. We therefore remain with neutral weighting to Equities and expect them to still deliver superior returns relative to other asset classes.

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Investment Performance

Despite various negative geopolitical and trade skirmish headlines, the stand out feature with regards to portfolio performance was the 4%+ rally in the US dollar during the period. Global GBP multi-asset portfolios benefitted and performed strongly as a result, reversing first quarter declines. Our ongoing strategy of supporting global businesses with substantial overseas earnings together with our overweight positioning to the technology sector continues to drive favourable absolute and relative returns. In contrast, US dollar mandates, in-line with their benchmarks, struggled to make headway both on the quarter and year-to-date. Lower risk and fixed income portfolio strategies also delivered lack lustre returns as the gradual normalisation of interest rates leaves us prudently defensively positioned. Pleasingly, longer term all of our portfolio risk weighted strategies continue to deliver favourable absolute and relative returns and are constantly monitored and adjusted to meet clients' goals.

Market Performance %

Equities	Q2 2018	YTD	12M
Global			
FTSE All World TR Net (Sterling)	6.66%	1.83%	8.83%
FTSE All World TR Net (US dollar)	0.38%	-0.61%	10.61%
UK			
FTSE All-Share TR	9.20%	1.69%	9.02%
US			
S&P 500 TR	3.43%	2.65%	14.37%
Europe			
Dow Jones Euro STOXX TR	2.53%	-0.30%	3.50%
Fixed Income			
Bloomberg Barclays Series -E **UK Govt 1-10 Yr Bond Index**	0.57%	-0.28%	0.01%
Bloomberg Barclays Series -E **US Govt 1-10 Yr Bond Index**	0.06%	-0.69%	-0.76%
JP Morgan **Global Government Bond (Sterling)**	3.02%	1.51%	0.06%
JP Morgan **Global Government Bond (US dollar)**	-3.04%	-0.93%	1.70%
Iboxx **Sterling Corporates** Total Return Index	-0.35%	-1.83%	0.37%
Iboxx **US Dollar Corporates** Total Return Index	-0.92%	-3.12%	-0.88%
Currency vs. Sterling			
US Dollar	6.14%	2.30%	-1.37%
Euro	0.64%	-0.38%	0.87%
Yen	1.85%	4.09%	0.09%
Currency vs. US dollar			
Euro	-5.19%	-2.67%	2.26%
Yen	-3.99%	1.80%	1.49%

"Our ongoing strategy of supporting global businesses with substantial overseas earnings together with our overweight positioning to the technology sector continues to drive favourable absolute and relative returns."

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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

- The **US bank sector** has had a disappointing quarter, underperforming the main index by 3.6%, mainly due to the influence of a flattening yield curve. However, following the Federal Reserve releasing the Comprehensive Capital Analysis Review the sector is now able to make significant share buy backs and cash dividend increases. In particular, **Wells Fargo** surprised on the upside with their scope to return shareholder capita via dividends and buy backs whilst the overall picture for the sector as a whole was just about in line with expectations.

- It is understandable that investor confidence should be shaken a little with concerns over how close President Trump pushes his trading partners towards trade wars. However, it is encouraging to note that **first quarter profits** in the US were up more than 23% on a sales increase of 8%, with similar 20% plus figures expected in the second and third quarters of this year. Importantly, this brings valuation levels sharply downwards although around 7-8% of these increases are the result of the ‘one off’ nature of the Trump tax cuts.

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Fixed Income

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

- Growth in the **US** remains firm and inflation is all but at the Federal Reserve's (Fed) target level. As such, interest rates were raised for the seventh time in the current tightening cycle to 2% in June and we expect additional hikes every quarter through to at least the end of 2019. Tax cuts and infrastructure spending plans will be detrimental to the US's already high debt pile and deficits in the years ahead, and importantly this comes at a time when the Fed's balance sheet reduction process is in full flow. Yields at the longer-end of the curve have done little in the quarter as safe haven assets have been boosted by trade tensions, but we believe this will represent little more than a pause in the ongoing normalisation process and remain defensively positioned.

- Economic conditions in the **UK** are now firmly below trend and point to a very subdued interest rate normalisation process. Despite our sanguine outlook for the UK, we are mindful of the strong correlation between developed government bond markets and our ongoing expectations for higher yields in both the US and Eurozone are sufficient for us to err on the side of caution and maintain our defensive duration strategy.

- The **Eurozone** is experiencing a slowdown of growth which has not gone unnoticed by the markets – the Euro has weakened, and German government bond yields have fallen. Eurozone growth north of 2% (arguably above trend) does not sit well with a German ten-year yield of approximately 0.32%. Something has to, and will, give but thanks to the ECB's recent forward guidance on monetary policy and ongoing Italian political uncertainty, it may now take a little longer.

Currencies / Interest Rates

RECOMMENDATION - INTEREST RATES			
		CURRENT	DIRECTION
US Dollar	Overweight	2.00%	↑
Sterling	Neutral	0.50%	→ ↑
Euro	Underweight	0.00%	→

- We stuck to our positive convictions on the **US dollar** and this has paid off with an approximate 4.2% trade-weighted rally in the quarter. The longevity of the current rally is much harder to call and will almost entirely be decided by the size of the gap between higher yielding US government bonds and their respective counterparts, and on that front, we expect a bit more strength in the quarter ahead.

- For **Sterling** International mandates, we still consider it prudent to maintain a moderate level of foreign currency exposure. For much of the quarter, a blend of weaker than expected domestic economic data and a broad-based rally in the US dollar have combined to weigh on the currency. Looking ahead, BREXIT remains a very real potential source of two-way volatility and we maintain the view that the UK does not have the upper hand.

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Melville Douglas

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