May 2018

Monthly Investment Overview

Jerome O'Regan

Chief Investment Officer

Bernard Drotschie

Deputy Chief
Investment Officer

Karl Holden

Head - International Fixed
Income and Currency

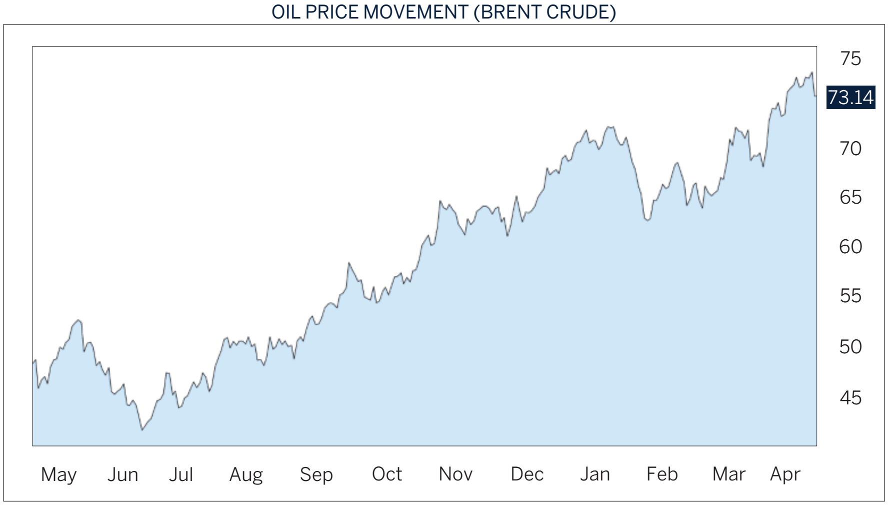
Investment Environment

Equity markets rebounded and outperformed other asset classes in April, as robust corporate earnings overpowered the various geopolitical and trade headlines. Inflation is on the rise and so are bond yields – an important challenge for bond investors and the US fiscus, given the unusual timing of fiscal expansion, via tax reforms, so late in the economic cycle.

After a very uncertain start to the month, **trade war tensions have eased** somewhat with a renegotiated NAFTA looking more likely and China showing some increased flexibility in trade policy and willingness to negotiate. Chinese President Xi reinforced that China will enter a new phase of opening-up the economy to foreign investors with sectors such as financial services and auto-manufacturing looking to benefit. Uncertainty remains, but negotiations are at least a step in the right direction to avoid a full-blown trade war that would cause considerable market disruption.

The **US Q1 earnings season** has been promising thus far, with profits growing almost 25% year-over-year and running well ahead of market expectations and the previous quarter's 15.2%. Top line growth has also been very encouraging, at 10%, as pricing power for companies has improved, enabling them to expand operating profit margins in the face of higher costs associated with strong growth in wages and higher commodity prices. Increased operating costs remain a challenge for companies to contend with and the effects on margins will be closely followed, especially when sales growth starts to stabilise at more normalised levels. Certain manufacturing companies are already pointing to inflated input costs emanating from the tariffs imposed on steel and aluminium imports. However, it is not just higher operating costs that will weigh on future profitability. The inflationary effects of a tightening labour market and the recent spike in commodity prices, with specific reference to the oil price, looks set to drive interest rates upwards as the year progresses. Companies will suffer from the resulting increase in their cost of capital in time as the median US company has doubled its net debt, relative to operating profits, since the financial crisis, when low interest rates enticed management teams to refinance at lower rates.

OIL PRICE MOVEMENT (BRENT CRUDE)



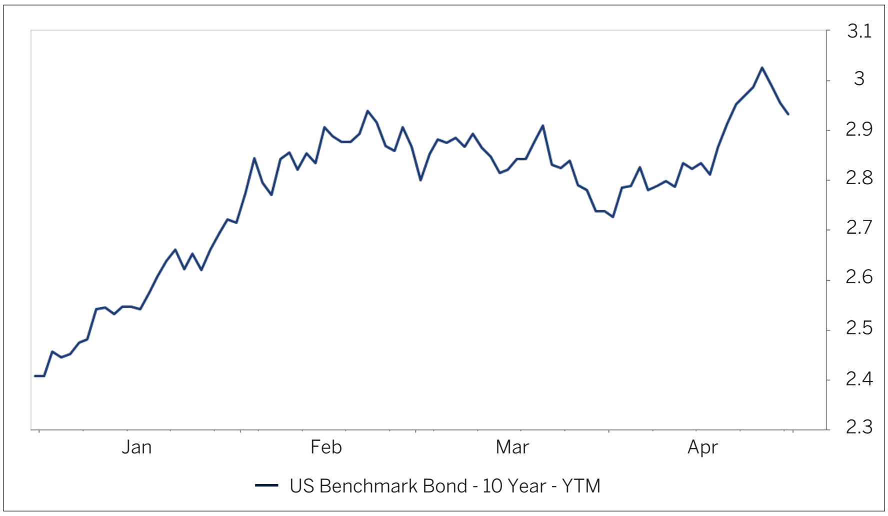
Source: Bloomberg

> "The question of how US authorities intend to provide the necessary stimulus during the next economic downturn or financial shock, given the deteriorating fiscal position, remains to be answered."

The Congressional Budget Office (CBO) recently released its latest projection for the US budget deficit, their first estimate since the tax cuts were approved and signed into law by President Trump. The budget deficit is expected to exceed $1trn by 2020, two years earlier than previously expected. Nearer term, the deficit is expected to be $804bn in fiscal 2018 (vs. $563bn previous) and $981bn in fiscal 2019 (vs. $689bn previous). The CBO expects that the Federal debt held by the public will rise to 96% of GDP by 2028 from 76% of GDP last year, which would be a **record level of indebtedness for the US government** since 1946 and more than twice the average level recorded over the last 50 years. In effect, their estimates indicate that the annual fiscal deficit will increase to approximately 5% of GDP by 2022, vs. 3.5% at the end of 2017.

Indeed, the **timing and magnitude of the US fiscal expansion are very unusual** given the trends of fiscal consolidation expected from the G20 economies over the same period and during an environment of strong economic momentum and rising inflation in the US. Fiscal accommodation of this magnitude is usually deployed to combat periods of serious recession, such as the Global Financial Crisis of 2008 - 2009. The question of how US authorities intend to provide the necessary stimulus during the next economic downturn or financial shock, given the deteriorating fiscal position, remains to be answered. When the US previously deployed a similar pro-cyclical fiscal policy in the 1960s inflation edged higher, a key risk that will be closely monitored by the Federal Reserve, especially given that Core CPI is already above the Fed's target rate of 2% and is expected to be higher in the coming months. Rising inflationary pressure will lend further support to the view expressed by a growing number of FOMC participants, that the appropriate path for the Federal Fund rate over the next few years would likely be steeper than what they had previously expected.

US BENCHMARK BOND - 10 YEAR - YTM



Source: Factset Research System

It is not only the risk of inflation emanating from tax cuts at this point of the business cycle that could push interest rates upwards. The CBO report also highlighted that it is **reasonable to expect an increase of fiscal crises in the US given growing levels of government debt**, which ultimately should result in investors demanding enhanced (interest) rates of return to finance the government's increasing borrowing requirements; an impediment to future government spending and economic growth in general. Additionally, the challenges and risks associated with the funding of an ever-increasing debt burden at a time when the Fed is shrinking its balance sheet and foreign purchases of US government bonds will fall as quantitative easing comes to an end in Europe, look set to become more apparent. It is difficult to envisage that this will be achieved smoothly and without increased volatility in most asset classes around the world.

"A period of abnormally low interest rates is coming to an end and investment markets have started to adjust for this reality."

Conclusion

The outlook for the global economy remains positive for the remainder of this year, even though the first quarter showed some signs of a slowdown compared to the very strong growth trajectory experienced towards the end of last year. Geopolitical risks and trade tensions appear to have eased for now as the dialogue between the various economic powerhouses has become more conciliatory. This will however remain a risk for policy makers to contend with.

A period of abnormally low interest rates is coming to an end and investment markets have started to adjust for this reality. Although the lower taxes in the US will provide some underpin for near term growth, **the longer-term outlook for growth, inflation and returns is less certain.**

Market Performance %

Equities	APR	YTD	12M
Global			
FTSE All World TR Net (Sterling)	2,83%	-1,83%	7,21%
FTSE All World TR Net (US dollar)	0,96%	-0,04%	14,14%
UK			
FTSE All-Share TR	6,43%	-0,89%	8,16%
US			
S&P 500 TR	0,38%	-0,38%	13,27%
Europe			
Dow Jones Euro STOXX TR	4,95%	2,06%	4,84%
Fixed Income			
Bloomberg Barclays Series -E UK Govt 1-10 Yr Bond Index	0,00%	-0,84%	-1,37%
Bloomberg Barclays Series -E US Govt 1-10 Yr Bond Index	-0,58%	-1,32%	-1,29%
JP Morgan Global Government Bond (Sterling)	-0,01%	-1,48%	-2,03%
JP Morgan Global Government Bond (US dollar)	-1,82%	0,31%	4,30%
Iboxx Sterling Corporates Total Return Index	0,07%	-1,41%	0,94%
Iboxx US Dollar Corporates Total Return Index	-0,86%	-3,06%	0,62%
Currency vs. Sterling			
US Dollar	1,84%	-1,85%	-5,92%
Euro	-0,18%	-1,19%	4,30%
Yen	-1,04%	1,14%	-4,06%
Currency vs. US dollar			
Euro	-2,00%	0,61%	10,86%
Yen	-2,80%	3,07%	2,01%

May 2018

Monthly Investment Overview

MelvilleDouglas
A Member of Standard Bank Group

Asset Classes

Equities	Neutral
Fixed Income	Underweight
Cash Plus	Overweight

- With leading global economic data pointing towards continued growth, but at a more modest pace, and inflationary and trade war fears abating, we continue to suggest that **stock prices** will, subject to increased volatility, edge higher as the year progresses.

- Despite **equities** on a relative basis offering ongoing value, valuations compared to their long-term averages remain elevated and both the bull market and economic expansion are long in the tooth. This together with the headwinds of rising bond yields suggests a less favourable risk reward ratio. As such our equity weight is set to neutral.

- 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 capital loss as interest rates gradually rise.

Equities

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

- A little over a half of the S&P 500 index constituents have now reported their first quarter results. So far, the overall increase in earnings is 24.6%, with **financials** and our favoured **technology** sector showing stunning growth of 27% and 33.5% respectively. Encouragingly, top-line sales growth is also in excess of expectations at 9.7% suggesting the market can withstand concerns over rising bond and interest rates.

- Given the success of our **Shopify** positions and the nervousness of markets in highly rated stocks, we have decided to take excellent profits and sell our positions. Whilst we are comfortable about the long-term prospects and the business model, the valuation makes us nervous and for that reason we feel it is prudent to crystallise gains at the current time.

- With the proceeds we have introduced a new position, **Snap-on,** which provides exposure to a high quality industrial stock at a decent valuation. The prospects for the group are encouraging in the long run and recent negative investor sentiment to the sector allows us to access the stock on a forward price earnings ratio of less than thirteen times, well below the sector and the rest of the market.

May 2018

Monthly Investment Overview

MelvilleDouglas
A Member of Standard Bank Group

Fixed Income

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

- After dipping in March, **US government bond yields** resumed their upward trajectory in April, with the ten-year benchmark yield rising some 21 basis points and briefly breaching the key technical level of 3%. Given our ongoing defensive strategy, we expect fixed income portfolios to have meaningfully outperformed their benchmarks in the month.

- Some G7 growth indicators dropped a gear in the first quarter, particularly in the Eurozone, but we don't see this as the start of an ongoing deceleration in global growth conditions. Higher energy prices (oil) and the uncertainty over possible trade wars will have had a dampening effect on sentiment (and therefore growth) but we see neither as likely to derail **global GDP** this year which the IMF expect to be around 3.9%. The foot may have eased off the pedal, but the synchronised growth story remains intact for now.

- Our overweight allocation to the inflation-linked market in US dollar strategies remains in-situ. Both headline and core **US inflation** have edged higher and we see more upside in the coming months as both sides of the 'cost push/demand pull' equation remain intact. Stronger commodity prices continue to feed into higher manufacturing input prices and we continue to see the potential for a tighter employment market, which should enable wages to increase from current levels.

Currencies / Interest Rates

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

- The **US dollar** has broken out of its lull, rising some 1.6% on a trade-weighted basis in April. We have long held the view that the currency would experience a retracement given the sheer weight of its positive interest rate and yield differentials against peers. This has been amplified in the month by a scaling back of monetary policy expectations in both the UK and Eurozone.

- Expectations for a UK interest rate hike in May have fallen back sharply and taken **Sterling** with them. Bad weather undoubtedly played a part in the recent weak first quarter GDP data (+0.1% quarter on quarter versus +0.3% forecast) but nevertheless, UK economic growth remains markedly behind its peers and the market odds of a May hike have swiftly fallen to approximately 20%.

- The **Eurozone** has hit something of a soft patch in economic data recently, but we don't view this as indicative of a sustained slowdown – in fact, the deceleration is entirely normal given the robust pace of recent quarters. As the ECB's tightening expectations have been scaled back, the Euro has lost ground against the US dollar, which sits well with our current strategy.

May 2018

Monthly Investment Overview

MelvilleDouglas
A Member of Standard Bank Group

Melville Douglas

Melville Douglas is a subsidiary of Standard Bank Group Limited. Melville Douglas Investment Management (Pty) Ltd. (Reg. No. 1962/000738/06) is an authorised Financial Services Provider. (FSP number 595)

Disclaimer

This document has been issued by Standard Bank International Investments Limited, Standard Bank House, PO Box 583, 47-49 La Motte Street, St Helier, Jersey, JE4 8XR. Tel +44 1534 881188, Fax +44 1534 881399, e-mail: sbsam@standardbank.com. For information on any of our services including terms and conditions please visit our website, www.standardbank.com/wealthandinvestment

Melville Douglas is a registered business name of Standard Bank International Investments Limited which is regulated by the Jersey Financial Services Commission. Standard Bank International Investments Limited is a wholly owned subsidiary of Standard Bank Offshore Group Limited, a company incorporated in Jersey. Standard Bank Offshore Group Limited is a wholly owned subsidiary of Standard Bank Group Limited which has its registered office at 9th Floor, Standard Bank Centre, 5 Simmonds Street, Johannesburg 2001, Republic of South Africa.

Prospective clients residing in the UK should be aware that the protections provided to clients by the UK regulatory system established under Financial Services and Markets Act 2000 ("FSMA") do not apply to any services or products provided by any entity within the Standard Bank Offshore Group. In particular, clients will not be entitled to compensation from the Financial Services Compensation Scheme, nor will they be entitled to the benefits provided by the Financial Ombudsman Service or other protections to clients under FSMA.

This document does not constitute an invitation or inducement to engage in investment activity and is presented for information purposes only. Investment in the portfolio should only be undertaken following the receipt of advice from an appropriately qualified investment professional.

The value of investments may fall as well as rise and investors may get back less cash than originally invested. Prices, values or income may fall against the investors' interests and the performance figures quoted refer to the past, and past performance is not a reliable indicator of future results.

2018-130